(*f*) Review of Considerations Involved

(Submitted by Mr. Towers in reply to Mr. Cleaver)

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Many times during the past two months the belief has been expressed or implied that somehow or other there did exist a "costless" method of government financing, and although I have dealt with this question from many different angles it is so fundamental that I am glad to have an opportunity of going over that ground once more.

Government expenditure necessarily involves a transfer of goods and services from one section of the community to another. Where the expenditure is financed by taxation, or by borrowing savings, the incidence of the sacrifice is plain enough, and in this case the money equivalent of the sacrifices passes formally through the government coffers. The reason for calling the financing of expenditure by issuance of new money "costless" is, apparently, that under that procedure the government has no direct dealings with those who forego goods and services in the course of the transfer which government expenditure entails. But the sacrifices still exist in spite of the fact that their money value does not pass through the government's books in the process of being made, and I should now like to indicate how they do arise. I shall do this in connection with Mr. Cleaver's request to trace the effects which might be expected to follow a decision on the part of the government to finance its expenditure, to the extent of $250 millions in a year, by issues of new money, presumably in the form of non-interest-bearing loans from the Bank of Canada.

As the government spends the $250 millions of new money most of it is normally deposited with the chartered banks and if so increases their cash reserves and deposits accordingly. As I have pointed out in the memorandum which has just been placed on the record, this reduces the banks' earnings by the amount of interest paid on the new deposits and by the increased operating costs incidental to servicing them. The banks have both the necessity for and the means of acquiring additional earning assets by way of making loans or buying securities; and in doing so they would of course add to their deposits and thus to the volume of money in the hands of the public.

I. It might be that the banks would not take advantage of the opportunity to expand their assets and thus restore their earnings. They could certainly be prevented from doing so by government action of one type or another which would have the effect of sterilizing the money which it had spent. This would amount to the government forcing the banks to make it a non-interest-bearing loan. The cost to the banks would necessarily be passed on to the shareholders, the staff, or, through a decreased rate of interest on deposits or increased service charges, to the banks' customers.

If we assume that the money requirements of the country, i.e., its medium of exchange needs, are already being adequately supplied, and if we also assume that the addition of $250 millions to the volume of money in the hands of the public remains idle, then average cash balances of individuals and businesses throughout the country will be larger than necessary. As I mentioned in the previous memorandum those who can will attempt to exchange their deposits for some asset which is slightly less liquid but which gives a somewhat higher return, e.g. a government bond. This competition for high-grade liquid assets will drive down the return obtainable from them and the quest for a little higher earnings at the expense of a little less liquidity will continue. How far down the scale of liquidity the pressure of easy money will be substantially felt depends on the circumstances, but the policy we are discussing does always entail some lowering of interest rates and thus a sacrifice on the part of the investor class as a whole.