Draft of Proposal for Using the Bank of Canada to Finance Vital Municipal Projects

by
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At the beginning of our investigation of any crucial problem we must check the language used to discuss it. Are we preempting our research with an answer locked into an accepted terminology? For example, the very word "inflation"? Does it allow us to sort out the possibly different causes that may contribute to similar symptoms, but designating very different processes headed for very different results? In the case of rising prices, may these at least in part be due not to an excess of demand over available supply – the cause usually diagnosed, but to something vastly different. For example, our society – particularly since World War II – had to catch up with the neglect of routine maintenance of our infrastructures during sixteen years of depression and a world war. Moreover there was a huge backlog of technological revolutions that could not be assimilated first because of the Depression and then because of the war.

Our Municipalities Left Holding the Bag

And then came the baby boom, which provided a disproportionate number of children after the "hollow years" when families were not being formed because of those two great catastrophes. That catch-up required a disproportionate number of schools and hospitals. And a vast immigration had to be housed and otherwise assimilated. And urbanization proceeded at a pace never known in Canada before. A modern metropolis requires many more services, and more costly ones than small towns: subways, universities, all sorts of institutions. In the countryside many of these services are provided by the farmers themselves or not at all. When an orthodox economist moves from a town of 10,000 people to New York City or even Toronto, he does not expect his living costs to stay the same. Why then should he do so when society as a whole makes such a move?

Some of these may, moreover, be providing socially indispensable returns for the higher prices they contribute to, while others may simply reflect the uncontrolled appetites of a particular social group. Should we not try sorting out the very different causes and final effects from similar symptoms thrown up en route?

And thus identify what we spend for our health or educational systems or for environmental conservation, which economists dismiss as externalities? Or to bail out our gambling banks?

This is all very relevant to the finances of our cities. Because for the last thirty years any divergence from a flat price level has been considered an economic disease of an acutely epidemic sort – one that had to be assailed with high interest rates – "high enough to get the job done," as the chorus goes. If it didn't work, then the dosage had to be stepped up, with no room for doubts or questions.

It just happens that Canada has had historically the highest percentage of its tax revenue levied on housing – In 1961-62 it was 15.8 % of the total tax revenue in Canada compared to 12.6 in the US (1962), 1.6% (1962) in Austria, 2.2% in France and Germany, 0.6% in Norway.[1] It also happens that housing is the most expensive capital good that the ordinary citizen acquires or rents, and he has been far more victimized by the burden of high interest rates chosen to "fight inflation" over the past quarter of a century, than more affluent members of our society.

That disproportionate burden born by the city-dweller may in large part be traced to a mistaken view of what inflation might be.

Obviously, there are groups in society that benefit richly from the maldistribution of the financing costs of modern infrastructures – not only the physical ones but the human ones such as schooling, health and social security.

Its minority status has abruptly made our federal government sensitive to the plight of the municipalities victimized by the downloading of social programs without enough funds to take care of them. Now they are suddenly receiving more attention, but it tends to be basically flawed. Thus we read in *The Globe and Mail* (17/05, "Toronto to get $705.3 million over five year from gas tax" by Jennifer Lewington): "In a deal that sees both big cities and small communities get what they want, Prime Minister Paul Martin will announce today how millions of dollars of federal gas tax dollars will flow to Ontario over the next five years."

But that is like rescuing a church so that it might continue its good deeds by giving it a cut of the avails of prostitution. Possibly embroidering the pillows where the commerce thrives with the logo: "Jesus also loves you."

It was not a portion of the gasoline tax that was taken from the municipalities to bail out the banks from their speculative losses. To make our banks whole once more a huge swath of the money-creation of the country was shifted from the government itself via the central bank to the commercial banks. That is what must be restored. That, moreover, was followed by further deregulation of our banks to allow them to appropriate the liquid reserves of the stock market firms, the real estate mortgage companies, and the insurance and re-insurance establishments. This was done to increase the grip of the speculative financial sector over the economy and over the government itself. That is what must be reversed. Bribing the municipalities as though they were another bunch of politicians being bought to cross the floor of Parliament won't do.

Our Municipalities' Revenues Must not be Linked to Increased Oil Consumption

For such grand purposes, two principal measures were brought in under the guidance of The Bank for International Settlements (BIS). It was at BIS that the most extreme version of the dogma of "zero inflation" was formulated, on the scatter-brained argument that if the slightest rise of the price index were tolerated it would inevitably come to match the destruction of the currency as happened in Germany in 1923. It was a fact, however, that the German hyperinflation followed upon Germany's defeat in a world war, its suspension of reparation payments to the Allies who insisted on their being paid in a strong currency that Germany could not earn, the resulting occupation of the industrial German heartland by the French and Belgian armies, and a national strike supported by the Right and the Left to resist it. What the BIS position implied is that had interest rates been raised high enough there would retroactively have been no loss of a world war, no reparations, no occupation of the Ruhr industrial base, no general strike, no virtual civil war.

But there were more than historical grounds to question the wisdom of the federal government assigning part of the proceeds of the gasoline tax to the municipalities. Diversion of oil tax money does nothing to reverse the power position and the return of the proceeds of money creation from the banks to the federal government. It will leave the federal government missing substantially the amount of money that flows according to the contours of power established by the redistribution of the national revenue due to the financing of the federal government on the money market. And it will at the first return of the major old-time parties to majority government guarantee the resumed shift of taxation from the wealthiest layers of the population to the most defenceless. Moreover, it puts the municipalities and those who now depend on them for social services. in the dubious situation of living on the avails of the gasoline industry – one of the greatest polluters in the land. In short it confuses the underprivileged about their real interests.

Besides the draft of what is to be presented to the Duncan Council does not grasp the heart of the system whereby the central bank could create near interest-free credit for the federal government This, however, is still in the *Bank of Canada Act*, and could readily be adapted to deal with the plight of the municipalities, That, indeed, was its original purposes when the BoC (Bank of Canada) was nationalized in 1938. All the key legislation for our purpose is still intact in that Act. However, it is important to note that it is no longer in the *Bank Act* which deals with the obligations of the chartered banks and not those of the central bank. The latter are to be found in the *Bank of Canada Act* which concerns itself with the central bank and only in a secondary way with the chartered banks in their role as clients of the Bank of Canada. Let me describe the crucial sections still there, and how they can be used for near-zero interest financing with the cooperation of the senior levels of government.

The phasing back in of the statutory reserves would be needed. These were phased out over a two-year period terminating the modest portion of the deposits received by the chartered banks from the public that had to be redeposited on a non-interest bearing basis. The purpose was for the central bank to hold a modest measure of security against *not the credit banks could create on the basis of the cash deposited with them by the public, but of the deposit themselves*. In the case of chequing accounts which had to be paid out as soon as a cheque came in claiming a given amount, the statutory reserve was anywhere from 8 to 12%, In the case of time deposits, where notice had to be given for a deposit to be reclaimed the reserve was less – often as low as 4%. But these reserves had yet another important purpose. If the economy was overheated, the central bank could, rather than raise interest rates that hit everybody in the economy whether excessive investments were being made or not, could leave interest rates alone or, in addition to raising interest rates less, the reserve requirement would be increased instead. This would leave the bank with less money base on which to lend out what is called "near money," i.e., money that earns interest by its very creation out of nothing. Real money – whether paper bills or just computer entries are not created by being loaned out. They created and put into circulation by the government when it spends it.

The "gimmick" in the central government being able to borrow from the central bank at almost zero interest is this: In Canada the Bank of Canada was founded as a private bank in 1934, but was nationalized by a minority government under William Lyon Mackenzie King in 1938. When the central government borrows money from the BoC, all the interest it pays on that debt comes back to it as dividends (less the handling costs of the BoC). Note well the same does not hold when a province or a municipality borrows from the central bank. It is only by the cooperation of and an understanding between the borrowing province or municipality and the federal government that arrangements can be negotiated to have the federal government pass on all or some of the advantage that it enjoys as sole shareholder of the BoC. But since the federal government initiated the present round of acute financial problems of the municipalities by slashing its grants to the provinces who are responsible for the municipalities, the exposed minority position of the Federal Government puts the country in an excellent position to persuade it to cooperate with the provinces, the municipalities and the citizens of the land to undo the tremendous damage that the Mulroney and Chrétien governments did to the country by abolishing the statutory reserves and deregulating the chartered banks. It is important that that the activists that go to present the case get their facts absolutely straight. Hence we shall document the main points and just where they are to be found.

The Provisions of the BoC Act that Our Finance Minister Must be Obliged to Read in Parliament

Preamble to *Bank of Canada Act*, Chapter B-2: "An Act respecting the Bank of Canada, page 1
"WHEREAS it is desirable to establish a central bank to regulate credit and currency in the best interest of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of Canada."

I was advised by a member of the Supreme Court of Ontario years ago, that preambles to laws have not the unambiguous force of the text of the law that follows, nevertheless, little was wasted during the Depression on anything including paper and print. We should note then that as a general expression of the intent of the *Bank of Canada Act* the preamble mentions "to mitigate fluctuations in the general level of production, trade, prices and employment." And not "prices" alone.

Under the Progressive Conservative government of Brian Mulroney in the 1980s it came to be argued that the Bank of Canada was independent of the Government of Canada. I quote passages in the *BoC Act* still in force that stand in the way of such an interpretation.

Thus 17(1) reads:

"Capital and Shares

17(1) The capital of the Bank shall be five million dollars but may be increased from time to time pursuant to a resolution passed by the Board of Directors and approved by the Governor in Council and by Parliament.

(2) The capital shall be divided into one hundred thousand shares of the par value of fifty dollars each, which shall be issued to the Minister to be held by the Minister on behalf of Her Majesty in right of Canada."

"Government Directive

14(1) The Minister and the Governor shall consult regularly on monetary policy and on its relation to general economic policy.

(2) If, notwithstanding the consultations provided for in subsection (1), there should emerge a difference of opinion between the Minister and the Bank concerning the monetary policy to be followed, the Minister may, after consultation with the Governor and with the approval of the Governor in Council, give to the Governor a written directive concerning monetary policy, in specific terms and applicable for a specific period, and the Bank shall comply with that directive."

The above-quoted subsections establish: (1) The ownership of the bank; (2) The Minister of Finance in the event of a difference of opinion concerning the monetary policy to be followed having the power to instruct the Governor of the Bank on the course to follow and he shall comply.

How in the face of such provisions the banks and the Progressive Conservative government of the day could have argued on behalf of the independence of the BoC remains one of the many buried scandals of Canada's economic history. The fact that the above-cited subsections were allowed to remain in the act is also part of our suppressed history. Under the Mulroney regime there was an attempt on the part of the government to put both the independence of the BoC from the Government and "zero inflation" into the *BoC Act*, but it was turned down by all three caucuses of the Finance and Banking Committee. After that, that Government and its Liberal successor decided to let sleeping dogs lie. To reestablish a more seriously democratic regime, it is essential to bring back our economic and monetary policy control from Basel, Switzerland, where the Bank for International Settlements does its plotting, to Canada's Parliament.

Business and Powers of the Bank

18. The Bank may…. (c) buy and sell securities issued or guaranteed by Canada or any province."

"Buy and sell" implies "hold." This would refer to funded debt formally structured for repayment at a given rate or time….

"(j) Make loans to the Government of Canada or the government of any province, but such loans outstanding at any one time shall nor, in the case of the Government of Canada, exceed one third of the estimated revenue of the Government of Canada for its fiscal year, and shall not, in the case of a provincial government, exceed one-fourth of that government's estimated revenue for its fiscal year, and such loans shall be repaid before the end of the first quarter after the end of the fiscal year of the government that has contracted the loan." This subsection refers to what may be called unfunded debt, which is clearly subject to renewal ("shall not exceed") and roll-over. It is akin to a line of credit in a commercial bank.

We Start with What Worked in the Past

For tactical reasons it is important to emphasize that the first step would be to transfer no larger a proportion of the federal debt from the banks and other private investors to the BoC that was actually attained around 1975 – about 22% compared with the present figure of around 5%. At the same time the statutory reserves would be phased in again – say over a three-year period to give the banks a period to adjust. At the same time and over the same period the banks would be obliged to sell their non-banking financial services – insurance, credit cards, and mortgages, etc., etc. It is highly likely that by then that the present credit boom will be on still shakier legs, and this – rather than another government bailout of the banks will be very timely to put them on a sounder footing. We are convinced that this is an essential part of the picture, but that the municipalities should concentrate on their own needs, and use this as the need arises, to fill in the background picture. Otherwise, without changing the overwhelming power attained by the banks after their 1991 bailout, there is no likelihood that the municipalities will get a proper hearing. You must show a concern for the banks in insisting that they stick to banking, and leave the BoC to look after the public concerns for which it was founded.

COMER is available to answer any questions you may have, and to take part if you wish us to in an advisory in the actual negotiations with the municipal organizations, the BoC and the government. Good luck.

1. These figures are taken from the appendix to *Babel's Tower: The Dynamics of Economic Breakdown* by William Krehm, Toronto, 1977: "Vanishing Shelter" by the late Prof. Samuel Madras, Liberal Science Program, Faculty of Science, York University.

Source: *The Journal of the Committee on Monetary and Economic Reform*, (July 2005), 13, 14, 15, 16.