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RESEARCH NOTE

Doing whatever it takes with someone else's money

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Bryce Wilkinson

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I predict an unprecedented crisis that will lead to the biggest wipeout of wealth in history. And most investors are completely unaware of the pressure building right now.
John Mauldin[1]

Overview

Australia and New Zealand got through the 2008 Global Financial Crisis (GFC) and its aftermath without increasing public debt to imprudent levels while holding their central banks' policy interest rates at or above 2.5%.

This was not the case in the US, UK, and Europe. By 2012 their central banks' policy interest rates ranged between 0.05% and 0.75% and their general government net financial liabilities ranged upwards from 64% of GDP, compared with 7% for New Zealand and -9% for Australia.

Heavily indebted governments have certain incentives. With the fattest cheque books in the world, they can keep interest rates low and share market prices high for as long as their public debt ratios credibly promise essentially unlimited support for investors.

In response to Covid-19, those four major northern hemisphere central banks and their governments doubled down. By April, their four central banks had lowered their policy rates to between 0.125% and -0.1% while injecting a lot more cash into their banking systems with additional measures. Their respective governments are pumping up their already high public debt ratios. But just as before, there seems to be no realistic plan for reducing those public debt ratios and winding back their liquidity injections before the next crisis hits.

This paper traces the myopic policy decisions which led to the US, UK and Europe ratcheting up their public debt and central bank balance sheets and had the effect of turning thrift and sensible investment into a mug's game. It warns New Zealand not to go the same way without a credible plan for getting off that path.

The central concern in this research note is that this northern hemisphere impulse to keep interest rates artificially low while pumping up the public debt beyond prudent levels is a major threat to global financial stability. It is keeping the prices of financial assets – bonds and shares – artificially high.

Specifically, fears of recession in the US in March saw major share market prices fall and yields on global government bonds rise as investors fled from risk in a 'dash for cash.' Liquidity in some

[1] John Mauldin," The 'Whatever It Takes' Decade", Forbes, 1 April 2020. https://www.forbes.com/sites/johnmauldin/2020/04/01/the-whatever-it-takes-decade/#2f7445e7393e

markets started to dry up as anxious sellers couldn't find buyers and the major central banks rushed to inject money to calm financial markets. Yet, serenity may not be what is needed right now.

To date, central banks claim they have successfully pushed share market prices back up (bond prices are even higher than before the crisis because yields are lower). But this 'success' only reflects assets prices valued on the expectation of escalating monetary and fiscal support. This is penalising thrift and prudence and rewarding those who borrow to invest in risky assets. The unsustainability of this dynamic is behind the analyst's fear quoted at the top of this paper.

The more conventional risk is that central banks may not be able to turn off the money tap in time to prevent a recurrence of costly wage and retail price inflation.

New Zealand and Australia are in no position to prevent a global asset price crash. But they can hope to avoid the syndrome of pumping up public debt and banking system liquidity by creating a credible plan for unwinding those situations before the next crisis hits.[2]

A first step is to limit government spending increases and central banking liquidity injections to those that can be properly justified. The superficial justification for the increasing government operational spending and central bank purchases of government bonds by tens of billions of dollars is that unprecedented times justify unprecedented measures.[3] Actually, the only proper justification for any policy – unprecedented or normal – is that the benefits to the public outweigh the costs.

The value of the amount of money spent in New Zealand to date can be debated, but that is water under the bridge. The first issue is the quality of the public interest case for future government spending. Precisely what is the cost-benefit justification for spending billions of dollars to buy more government bonds? The answer is unclear. Such an action stops investors from pricing assets at what they are really worth and taxes prudence and thrift for the benefit of borrowers and risk takers. Does general stimulus impede the needed process of shifting resources from unprofitable areas – such as international tourism – to more profitable areas?

Another concern is the public airing of seductive arguments about cheap central bank credit which could threaten New Zealand's fiscal and monetary constitution (prudent debt target requirements and central bank independence to achieve monetary policy targets). Both aspects of this constitution make it harder for any sitting Government to fiddle with interest rates or boost spending to help win a myopic partisan agenda.

Regrettably, Reserve Bank Governor Adrian Orr has publicly said he is open to directly filling the Government spending gap by printing new money if the Government legally asked him to do so. To be fair he was not recommending this and pointed out that if the RBNZ was obliged to do so it would

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[2] The Government's Budget Policy Statement 2020 defined prudent debt levels of net core Crown debt as being "within a range of 15-25% of GDP (subject to any significant shocks to the economy") (page 31). Treasury's BEFU 2020 fiscal forecasts to 2034 do not envisage it falling below 40% of GDP. New Zealand will experience negative economic shocks well before 2034. On these projections it might be above 40% of GDP for a generation.

[3] The Budget Speech 2020 defends much increased public debt ratios for New Zealand on the basis that many other OECD countries have higher debt ratios. If that is good, why do other OECD countries have lower ratios than New Zealand?

likely undermine the its independence.[4] In contrast, the Governor of the Reserve Bank of Australia has been much more dismissive of this seductive proposition.

This research note suggests the Government's objectives for monetary policy be revisited. Little or no consideration has been given to the possibility that the benefits from allowing consumer price inflation to languish at the bottom end of the 1-3% range, or lower, might exceed the costs. (At inception the range was 0-2%.)

Secondly, the existing objectives are being interpreted too myopically. They are biased towards fixing any incipient economic downturn with little weight on the longer-term risks to financial stability by penalising thrift and prudence and rewarding those who borrow to buy assets at artificially inflated prices.

A stricter focus on medium term price stability with a much lower bottom range limit would allow central banks to 'look through' incipient recessions, while still allowing short term monetary policy easing should that be consistent with stabilising prices.

The dire fiscal situation internationally

The world has been living through bizarre, dangerous and unprecedented financial times since at least the 2008-2012 Global Financial Crisis (GFC). The word "unprecedented" is now reappearing more often in descriptions about policy responses to the Covid-19 pandemic.

To fix the fiscal issues of the GFC, the US and Europe bailed out their failed banks at the expense of the public debt and taxpayers. By 2012, general government net financial liabilities for Japan, the UK, the US and Eurozone countries ranged from 64% to 123% of GDP, compared with 7% for New Zealand and -9% for Australia. The UK, the US and Europe (except Germany) maintained those expanded debt ratios all the way up to the Covid-19 crisis (Figure 1).

As the Reserve Bank of New Zealand (RBNZ) observed in its May 2020Financial Stability Report:

> On the fiscal front, government debt ratios coming into this [COVID-19] crisis were well above pre-GFC levels. For advanced economies, average net debt ratios reached 77% of total output in 2019, an almost two-thirds increase since 2007. The scale of current fiscal support, combined with ongoing national output losses, may mean that some countries face unsustainable public debt paths in coming years, which could slow the recovery in global demand.[5]

In contrast to its northern hemisphere peers, Australia and New Zealand banks did not suffer significant losses during the GFC, which is why Figure 1 shows general government net financial liabilities did not rise materially.

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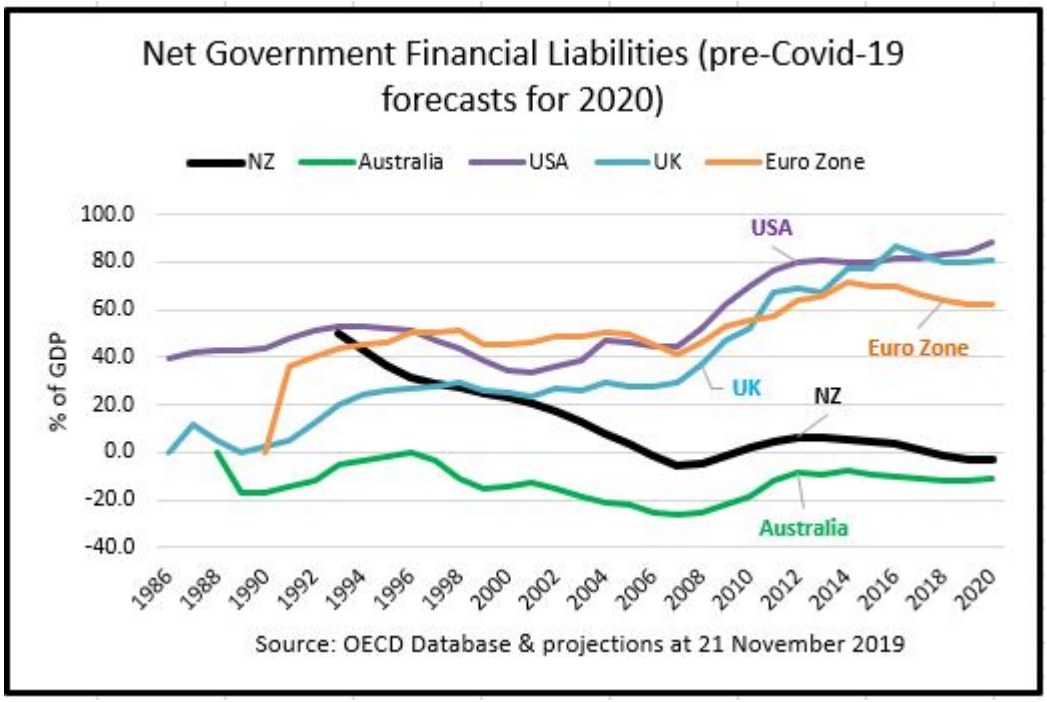
[4] See for example, https://www.stuff.co.nz/national/300022305/adrian-orr-open-to-creating-even-more-money-but-wont-move-on-bank-capital-changes and https://www.interest.co.nz/bonds/105145/adrian-orr-more-qe-would-be-simple-way-reserve-bank-boost-economy-going-further-and

[5] Reserve Bank of New Zealand, Financial Stability Report, May 2020, 18.

Figure 1: OECD Net Government Financial Liabilities 1987-2020



Today, Covid-19 is compelling many countries to further increase government spending. For instance, Bloomberg columnists Timothy O'Brien and Nir Kairssar describe the US response to the crisis as, "the most massive economic bailout in US history" … "with at least $US5.6 trillion in public funds and guarantees."[6]

All the public debt ratios in Figure 1 are expected to rise dramatically as Governments hand out money to people clamouring for compensation for income lost during the Covid crisis and lockdown.

These fiscal injections are necessary and desirable so long as their benefits exceed their costs. They can help alleviate household financial need, but they primarily shift financial pain around rather than fix it. Money is purchasing power, not income, and government money is not a free lunch. It comes at a cost to others in the community. (The total cost exceeds the amount transferred by the administrative costs and those of the public's behavioural responses to avoid the tax burden and make oneself eligible for the government money.)

Essentially, the only way to recover lost national income is for the country to generate more national income. Everything else is a transfer of wealth (Appendix 1 explains the difference between money and income in greater detail).

It is a real concern that the UK, the US, the Eurozone and Japan – amongst others – failed to restore their public debt ratios to prudent pre-GFC levels before Covid-19 hit. Worse, they seem to have no credible plan for doing so after Covid-19 and before the next crisis. Yet ratcheting up ratios every time a crisis arrives, largely irreversibly, is clearly unsustainable and potentially disastrous.

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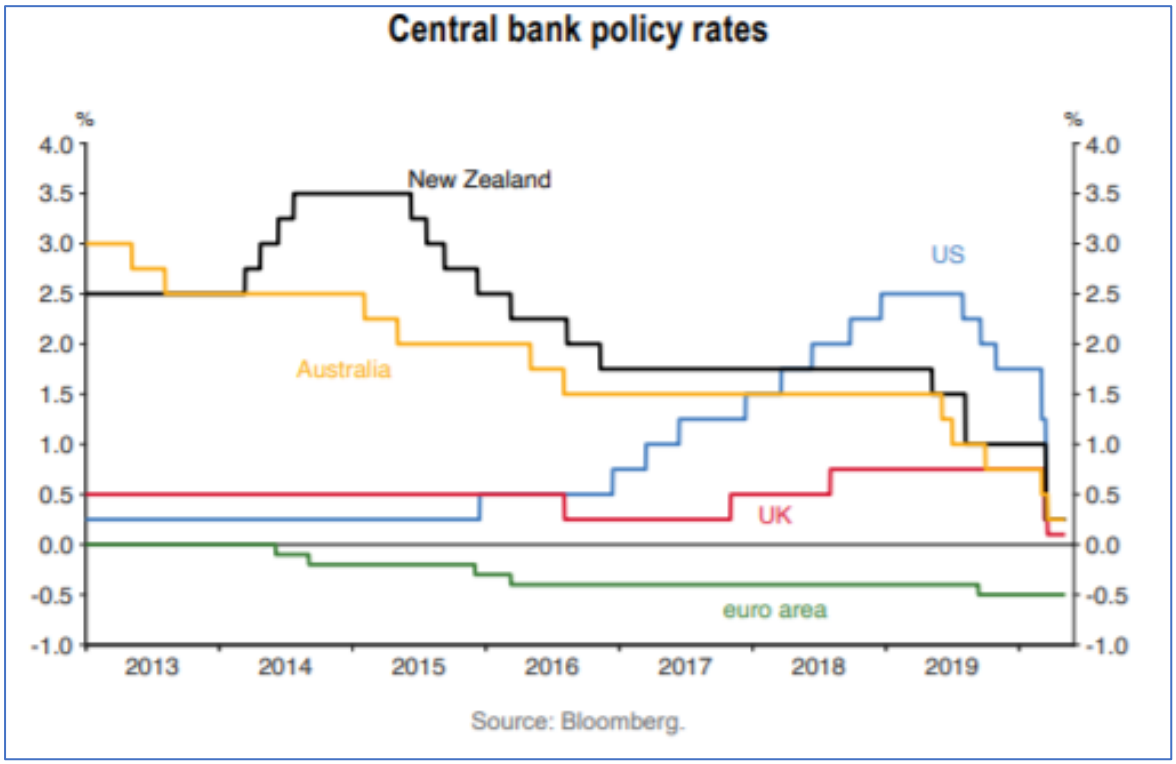
[6] Timothy O'Brien and Nir Kairssar, "Are the Coronavirus Bailouts Working? What we know so far," Bloomberg 27 May, 2020, https://nz.news.yahoo.com/coronavirus-bailouts-working-know-far-100003006.html

The dire monetary policy situation internationally

High public debt ratios to income incentivise governments to keep interest rates and debt servicing costs low. This has the potentially destabilising consequence of penalising savers and encouraging private borrowing to invest in risky assets.

The US, UK and European central banks also responded to the GFC and its aftermath by reducing their key discount rates as much as they dared using 'unorthodox' ways to increase banking system liquidity by printing money. The major central banks responded to Covid-19 again by cutting their policy interest rates as much as they dared (Figure 2). The US, UK and European central banks have now lowered their policy rates to between 0.125% and -0.1% and injected a lot more cash into their banking systems with additional measures.[7]

Figure 2: Central bank policy rates 2013-2020



Source: Reserve Bank of New Zealand, "Monetary Policy Statement, May 2020," Figure 4.6, page 27

The previously mentioned May 2020 RBNZ report sums up the international central bank scene:

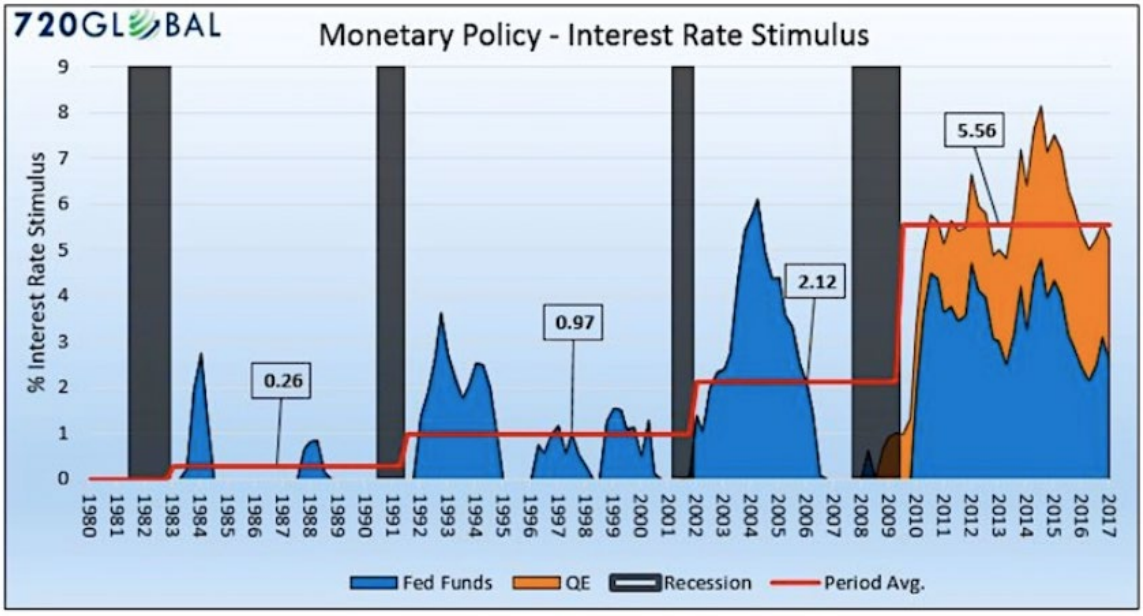
> Many central banks now have policy rates at historical lows, leaving little room to cut further, with some already in negative rate territory. As the conventional monetary policy tools approached their lower bound, monetary authorities restarted or expanded previous crisis measures to ease conditions. These include purchasing a wider range of

[7] The Bank of International Settlements database shows that in April 2020 the policy rates of 29 of 38 central banks around the world were higher than for these four central banks. Israel, with a policy rate of 0.1%, was the only non-European central bank to be below New Zealand and Australia's 0.25%. Almost one third of the central banks had policy rates of 2.5% or higher in April.

government and corporate bonds, ensuring debt servicing costs remain low for a wider range of borrowers.

US-based investment analyst Michael Lebowitz showed the combined effect of US Federal Reserve interest rate reductions and new money injections between 1980-2017 (i.e. pre-Covid-19) is ratcheting up (Figure 3).

Figure 3: US Federal Reserve monetary stimuli since 1980

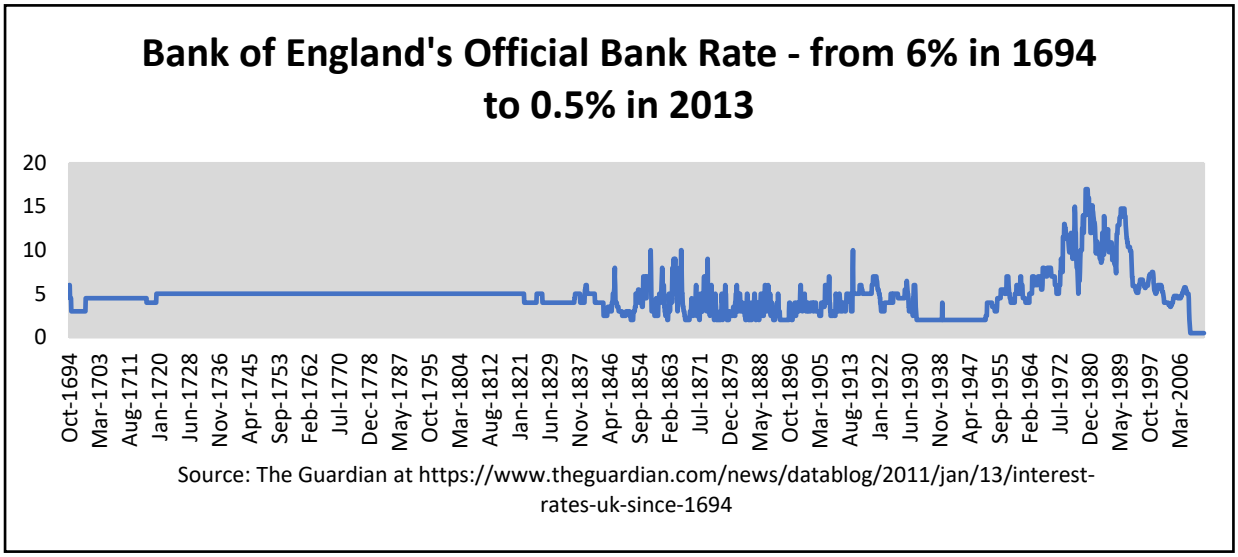


Source: Michael Leibowitz, "Monetary Stimulus: How Much is too much", 30 August 2017, https://www.seeitmarket.com/monetary-stimulus-how-much-is-too-much-federal-reserve-17236/

The extreme nature of the current situation can be illustrated by reviewing over 300 years of the Bank of England's policy discount rate (Figure 4). Its records go back to 1694 when its bank rate was 6%[8] (its median official bank rate since 1694 has been 5%). It had never fallen below 2% before January 2009 when it hit 1.5%. Two months later it had slipped to 0.5%. On 11 March, when Covid-19 arrived, the Bank of England's policy rate was reduced from 0.75% to 0.25% and then to an all-time low of 0.1% on 19 March. Such low rates are pathological.

[8] The term "Official Bank Rate" was introduced in 2006. See https://en.wikipedia.org/wiki/Official_bank_rate

Figure 4: Bank of England official discount rate 1694-2013



Source: The Guardian at https://www.theguardian.com/news/datablog/2011/jan/13/interest-rates-uk-since-1694

The abnormally high discount rates for the early 1980s occurred because of disinflationary policies. Other countries, including the US and New Zealand, experienced similar pain. The widespread focus on price stability since then reflects a resolve by governments to forever avoid that pain of bringing down entrenched inflation expectations. Yet, instability threatens nonetheless.

Why must the UK's official bank interest rate be at its lowest in over 300 years while other central bank rates are also at or near historic lows?[9] And it is not just low policy interest rates. Central banks have been deploying a range of additional measures to increase banking system liquidity and reduce interest rates more generally. As Table 1 shows, the European Central Bank and the Bank of Japan are both in the dire situation of having negative policy interest rates. The remainder have rates so low as to be on the verge of negative rates – including New Zealand and Australia (0.25%).

A great deal of economic research has been devoted to analysing the wisdom of abnormally low interest rates (and inflation) in recent times. A global savings glut is one hypothesis, while secular stagnation with depressed capital formation is another. The literature is too vast to review in this paper, but the following partial observations might be helpful.

First, the sharp reductions in policy discount rates are an active response to hurtful economic shocks rather than a passive response to secular trends. Think of it as a response to signs of financial market stress – falling share prices, rising bond yields, a 'dash for cash' and market turnover drying up – causing step reductions in policy discount rates, with limited reversals for fear of triggering renewed signs of stress.

Second, policy discount rates still differ considerably around the world. They are the lowest by far amongst European and Scandinavian countries, Japan, the UK and the US. Outside that group, the Bank of International Settlements shows only Israel has a policy interest rate lower than

[9] The Federal Reserve Bank of St Louis' April 2020 value of 0.5% for the effective federal funds rate is the lowest recorded in monthly data going back to 1955. See https://fred.stlouisfed.org/series/FEDFUNDS?utm_source=series_page&utm_medium=related_content&utm_term=related_resources&utm_campaign=categories

New Zealand and Australia's 0.25%. Of the 38 central banks in its dataset, half had policy discount rates in April of 1% or more.

Third, a savings glut should create low real interest rates, but not necessarily low nominal interest rates. These pose difficulties for central banks wishing to ease monetary policy and are caused by low wage and consumer price inflation (along with low real rates). Low inflation is another much-discussed issue, but central bank targeting of inflation, globalisation of supply chains and technological change are all key factors.

Table 1: Policy responses by central banks in advanced economies to Covid-19[10]

Central bank	Policy rate	Sovereign debt purchases[(b)]	State and local gov debt purchases	Private sector asset purchases	Expanded liquidity operations[(c)]	Expanded lending facilities[(d)]	FX swap line
Fed	1.625% → 0.125%	As required (currently $8bn/day)	✓	✓	✓	✓	✓
ECB	–0.5%	€870bn	✓	✓	✓	✓	✓
BoJ	–0.1%	Upper limit removed	✗	✓	✓	✓	✓
BoE	0.75% → 0.10%	£200bn	✗	✓	✓	✓	✓
BoC	1.75% → 0.25%	As required (min. CAD$5bn/ week)	✓	✓	✓	✓	✓
RBNZ	1.00% → 0.25%	NZD$30bn	✓	✗	✓	✓	✓
Riksbank	0%	SEK300bn	✓	✓	✓	✓	✓
Norges Bank	1.50% → 0.25%	✗	✗	✗	✓	✗	✓
RBA	0.75% → 0.25%	As required (yield curve target)	✓	✗	✓	✓	✓

(a) Includes policies implemented or modified since 3 March.

(b) Some figures include private sector asset purchases; purchases by the Fed, BoJ, BoC and RBA are open-ended; figures on a per annum basis unless otherwise indicated.

(c) Includes decreases in cost and/or increases in availability of short-term liquidity through changes to the size, terms and price of open market operations and standing facilities.

(d) Includes new or expanded term funding schemes and purchases of bank loans to certain corporations; also includes facilities that provide loans secured by corporate bonds.

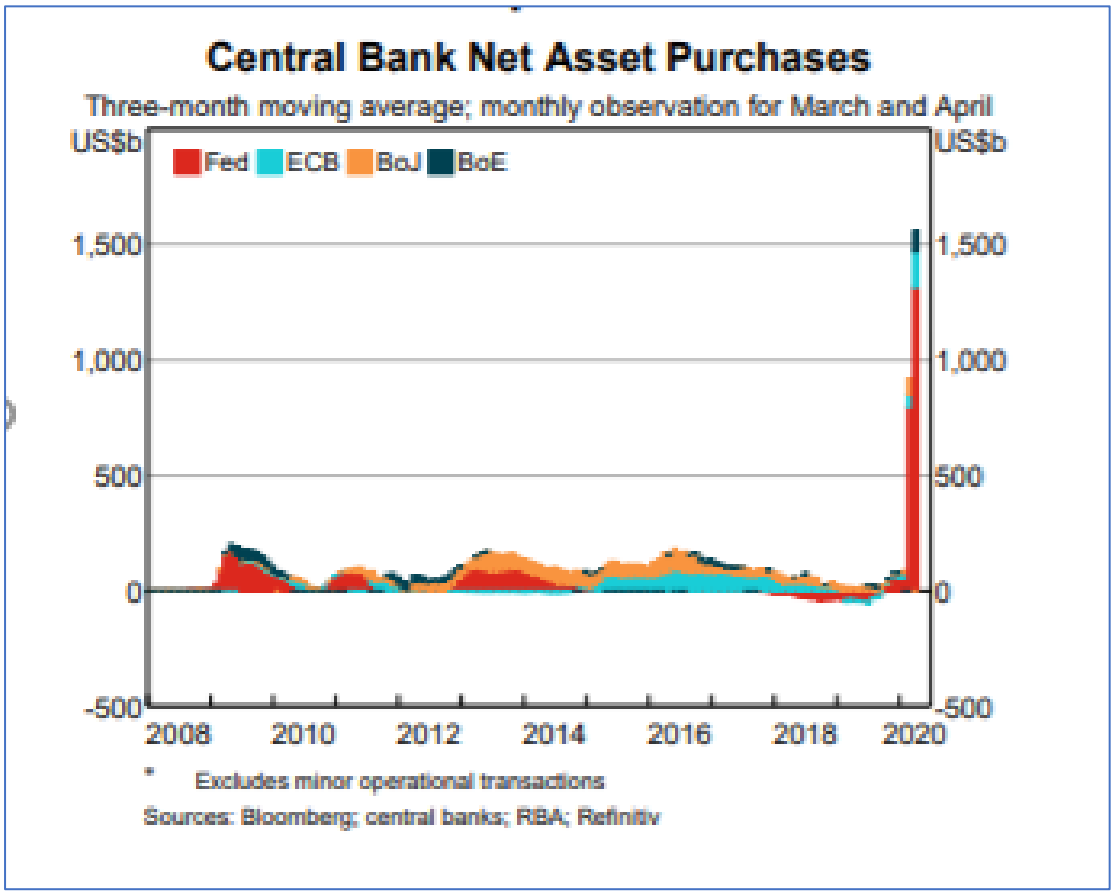
Source: RBA Statement on Monetary Policy May 2020, page 19. https://www.rba.gov.au/publications/smp/2020/may/pdf/statement-on-monetary-policy-2020-05.pdf, page 19

Smaller countries with open capital markets have no choice but to adjust to the world's interest rates. If the New Zealand Government tried to hold onto higher interest rates (risk and tax adjusted), investment would flood into the country until the Kiwi dollar had appreciated so much that investors reckoned the costs of depreciation outweighed the interest rate benefits. That would be hard on New Zealand's export and import-competing industries.

[10] This was Table 2.1 in the RBA's statement.

No matter how low interest rates go, asset prices will always fall when investors think they have become over-priced. Since policy interest rates are unable to be lowered much further, central banks have collectively pumped trillions of dollars of new money into their respective economies. The pace of this action has far exceeded that of the GFC and European sovereign debt crises. In some cases, these purchase programmes were expanded to include securities issued by state and local governments as well.[11] (Figure 5.)

Figure 5: Major central bank asset purchases 2008-2020

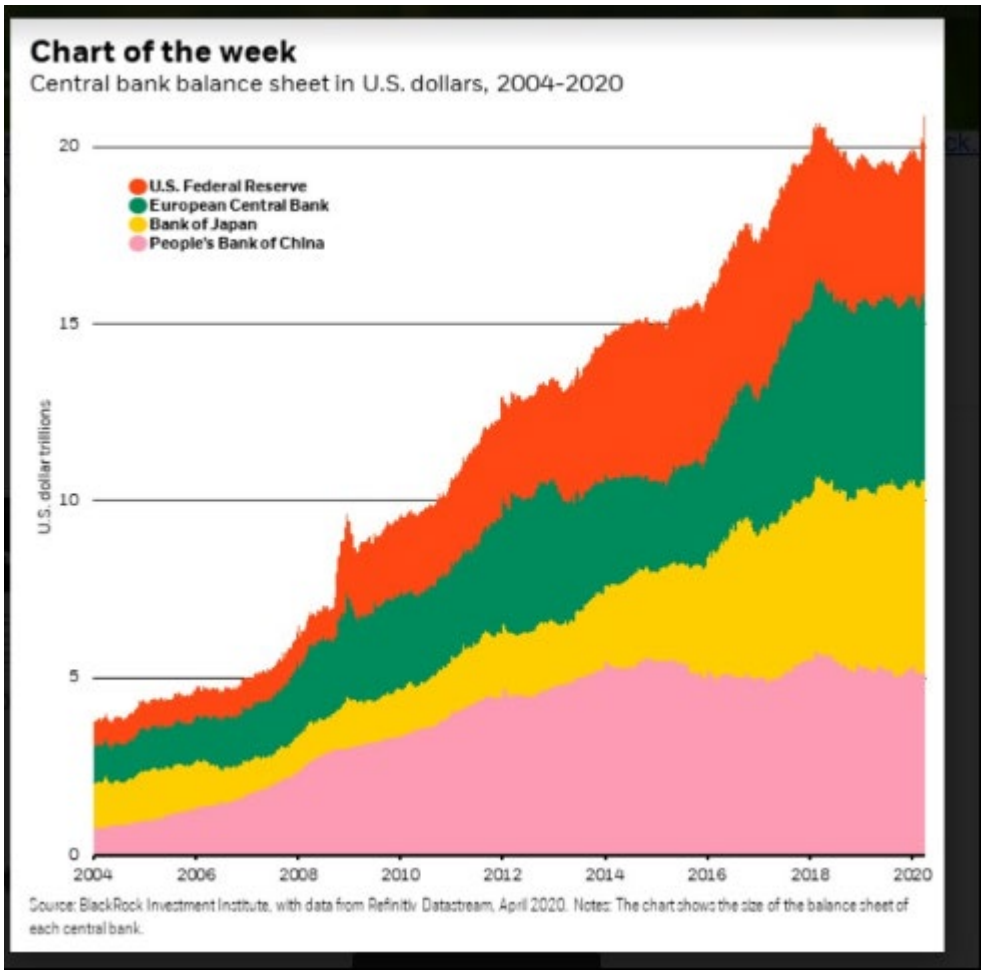


Source: Reserve Bank of Australia, Monetary Policy Statement, May 2020, Graph 2.2, page 21

In a new and disturbing development, the Bank of Japan and the US Federal Reserve have both began buying corporate debt along with government debt. Since this favours some private issuers over others, the reasons for those choices are difficult to justify. Injecting billions or trillions of local currency into a banking system increases the component of the money supply called M1 (see Appendix 2) and also greatly expands their balance sheets (Figure 6).

[11] The Reserve Bank of Australia's May 2020 Monetary Policy Statement May 2020, page 21.

Figure 6: Expansion of central bank balance sheets 2004-2020



Source: BlackRock Investment Institute with data from Refinitive Datastream, April 2020. The chart shows the size of balance sheet of each central bank.[12]

Why worry about enormous and irreversible expansions in central bank balance sheets? An analogy might help. A household which borrows to invest in risky assets is dangerous, since if asset prices fall unexpectedly bankruptcy can be a real possibility. Similarly, central banks know that borrowing short to invest long is risky because if interest rates sharply rise, a bank can become insolvent. Central banks enthusiastically support requirements for private banks to hold enough cash on hand to survive a shock, but not for themselves. When central banks print money to buy risky assets, the cash they inject into the banking system is at-call borrowed money.[13]

Compared to households, central banks can be dangerously relaxed about their ballooning balance sheet risks because they are backed by governments.[14] Despite how this is packaged to the public, it

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[12] https://www.marketwatch.com/story/this-chart-shows-why-blackrock-is-upbeat-on-us-credit-despite-the-pandemic-2020-04-06

[13] Banking system settlement balances at a central bank are ready cash for any one bank, but not for the banking system. Central banks are not in any danger of aggregate withdrawals. Instead, under a floating exchange rate, reduced confidence in the future value of these balances would see the New Zealand dollar sink in world markets.

[14] The New Zealand Government has explicitly indemnified the RBNZ against losses. See https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Monetary%20policy/ump/Letter-of-indemnity-

is not a social benefit. It merely shifts the risk of financial pain to the community through the government's balance sheet.

Large-scale central bank credit creation is a threat to financial instability and, like a narcotic, the immediate gratification is always coupled with a serious potential for pain later on.[15] Proponents of stimulus might say a little money printing is fine and the addiction is avoidable. Perhaps so, but it is not their decision. How would they stop politicians from declaring that, yet another round of money printing is safe? When will the straw break the camel's back?

The core concern is the ratcheting up of the central bank balance sheets in countries with the greatest capacity to influence global government bond yields and thereby world interest rates. most of them seem to lack any will to shrink their balance sheets before the next crisis arrives.

New Zealand's monetary response to Covid-19

The RBNZ's official cash rate (OCR) of 0.25% is by far the lowest it has been since its inception. As indicated in Table 1 it has supplemented the drop with a range of additional support measures.[16]

One of those measures is the intention to buy unprecedented amounts of central and local government bonds, up to $60 billion as of May. To put that in perspective, the total market value of nominal central government bonds on issue was $79 billion on 30 April. To date, the RBNZ has bought those bonds faster than the government can issue them to fund its enormous fiscal deficit.[17] And on four occasions so far, the RBNZ has purchased bonds at a negative yield for taxpayers.[18] This absurd and, until now, unremarked event is highly unusual in New Zealand's monetary policy history.

This aggressive bidding up of government bond prices by the RBNZ has given bond holders paper gains and bond dealers the prospect of buying new issue governments bonds one day and selling them or similar bonds to the RBNZ at a higher price later. To see the incentive here, the profit on $60 billion worth of bond transactions could be about $120 million.[19] The RBNZ does not yet appear to have formally justified to Kiwis the net benefits of shouldering the costs of its purchase programme.

An intended effect of the bond purchases is to pump liquidity into the banking system.[20] Settlement balances of deposit-taking institutions at the Reserve Bank averaged $29.0 billion in May – 3.7 times higher than the average of $7.8 billion in February (Figure 7).

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from%20MOF-RBNZ-for-purchase-of-NZ-domestic-governement-bonds.pdf?revision=95317a96-fc4e-4fa1-9d65-5269ff8f797a&la=en

[15] See, Jamie Cariana, "Why Central Bank Balance Sheets Matter, BIS Papers no 56, 2012, and note Figure 2, page 5. https://www.bis.org/publ/bppdf/bispap66b.pdf and George Selgin, "The menace of fiscal QE" {Quantitative Easing, injecting cash rather than lowering interest rates), February 2020, Cato Institute.

[16] See https://www.rbnz.govt.nz/covid-19

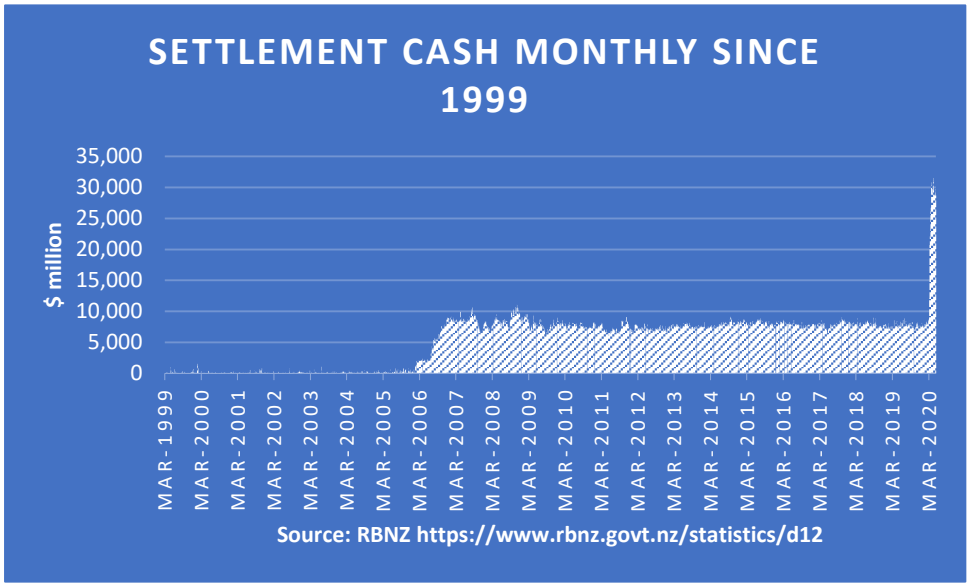
[17] Between 25 March and 31 May 2020, the Treasury issued $7.7 billion of nominal and indexed government bonds and the Reserve Bank purchased $13.8 billion.

[18] On 18 May and 25 May, it purchased the September 2030 bond at a weighted average yield of -.052% and -.007 % respectively. On 20 May it purchased the September 2035 bond at a weighted average yield of -.045% and on 22 May it purchased the September 2025 bond at a weighted average yield of -.26%. The total amount spent was just $145 million, but the precedent has been set.

[19] Maria Slade, "COVID-19 pay dirt for banks, National Business Review, 8 June 2020.

[20] This is not the only source of the increase in banking system settlement cash at the RBNZ. Foreign exchange swaps with banks to allow for access to US Federal Reserve System support has also been an important factor.

Figure 7: Banking system settlement balances at the RBNZ from 1999



When a central bank issues IOUs to buy assets, it increases its total assets and liabilities equally. It is no surprise then that the RBNZ's total assets jumped by $15.2 billion (49%) between February-April.

The Reserve Bank of Australia's (RBA) response to Covid-19

The RBA's Covid-19 response package aims to "keep funding costs low across the economy and ensure credit is available to businesses and households" by:

i. "a reduction in the cash rate to 25 basis points with forward guidance that the cash rate will not be increased until we are making sustainable progress towards our goals for full employment and inflation;

ii. "the introduction of a target for the yield on 3-year Australian government bonds of 25 basis points, and a preparedness to buy government bonds in whatever quantities are needed to achieve that target;

iii. "the introduction of a Term Funding Facility, under which authorised deposit-taking institutions (ADIs) have access to funding from the Reserve Bank for three years at 25 basis points, with additional funding available if ADIs increase lending to business, especially small and medium-sized businesses;

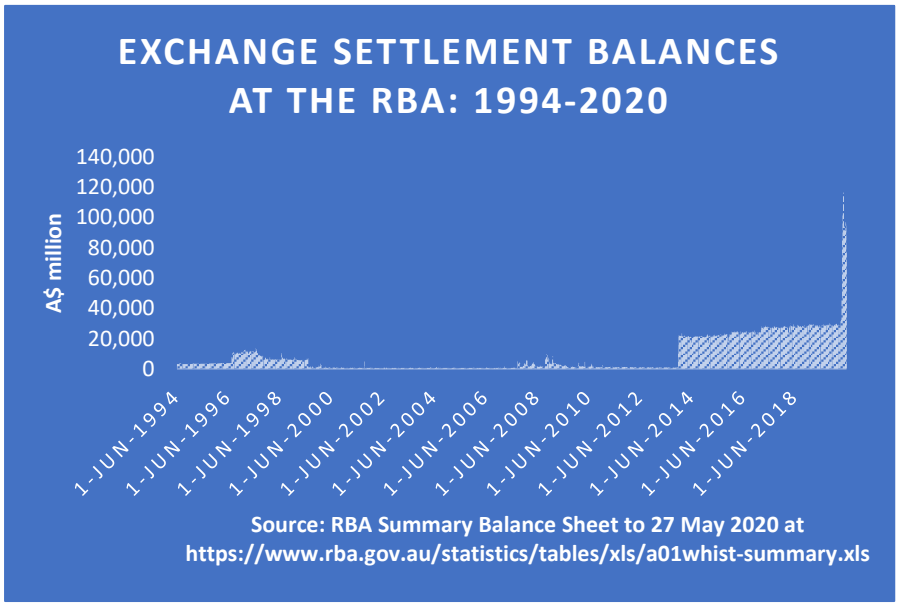
iv. "using our daily open market operations to make sure that there is plenty of liquidity in the financial system and using our bond purchases to promote the smooth functioning of the market for government securities;

v. "modifying the interest rate corridor system so that balances held in Exchange Settlement Accounts at the Reserve Bank earn 10 basis points, rather than zero."[21]

[21] Philip Lowe, "An Economic and Financial Update, Reserve Bank of Australia, 21 April 2020. https://www.rba.gov.au/speeches/2020/pdf/sp-gov-2020-04-21.pdf

In pursuing these policies, the RBA has also engineered a major expansion in banking system settlement balances and thereby its balance sheet. This year, settlement balances have increased from an average of $A29 billion in February to $90 billion in May – a 3.1-fold increase (Figure 8).

Figure 8: Banking system settlement balances at the RBA from 1994



Comparing the RBNZ to RBA on funding fiscal deficits

The most immediate difference between the RBNZ and RBA's policy response to Covid-19 is that the RBA set a 0.25% interest rate target for a three-year government bond while the RBNZ set a $60 billion cap for bond purchases.

The RBA's much less aggressive bond purchasing programme means its lowest purchase yield (highest price paid) for a 2026 federal government bond was only 0.221% on 3 April. It has not held a tender under its long-dated open market operations facility since 6 May, so presumably it feels it has met its price objective.

The two banks also appear to differ fundamentally on philosophy. RBNZ Governor Adrian Orr is widely seen to have effectively publicly invited the elected Government to legislate to enable or instruct him to directly fund its fiscal deficit. He was quoted saying "[t]here's no right or wrong" about directing monetary policy at funding fiscal deficits rather than at meeting an inflation target. He even expressed the RBNZ's capacity to do so in cavalier terms, "I've got the ATM." In the same interview he was explicit about his willingness to implement such a policy. To be fair, Orr was not recommending this and pointed out that the Bank could not yet do this legally and to be obliged to do so would likely undermine the central bank's independence.[22]

[22] See for example, Jenée Tibshraeny, "Adrian Orr: More QE would be the 'simple' way for the Reserve Bank to boost the economy: Going further and getting the Bank to directly finance government initiatives would be 'achievable'", *interest.co.nz*, 22 May 2020 at https://www.stuff.co.nz/national/300022305/adrian-orr-open-to-creating-even-more-money-but-wont-move-on-bank-capital-changes and https://www.interest.co.nz/bonds/105145/adrian-orr-more-qe-would-be-simple-way-reserve-bank-boost-economy-going-further-and

Technically, the Governor is correct. It makes little overall difference whether the RBNZ buys $100 million of government stock in the primary market or one day later in the secondary market. The issue is clarity of purpose for doing so, which is a question of governance. But to say there is no right or wrong is to throw out institutional constraints and say that incentives do not matter. Fortunately, the Minister of Finance Grant Robertson has distanced himself from the suggestion that the RBNZ create money to fund specific government policies.[23] The RBNZ should be more explicit about the shape of the government bond yields and the level it requires to fulfil its mandate.

In contrast, the RBA Governor has clearly outlined his principle:

> "I would like to restate that we are buying bonds in the secondary market and we are not buying bonds directly from the government. One of the underlying principles of Australia's institutional arrangements is the separation of monetary and fiscal policy – that is, the central bank does not finance the government, instead the government finances itself in the market. This principle has served the country well and I am confident that the Australian federal, state and territory governments will continue to be able to finance themselves in the market, as they should."[24]

The issue at stake is the objective for monetary policy measures and how it is best pursued. Fiscal policy is political, so are the objectives for monetary policy. On the other hand, the implementation of monetary policy is technical. If an elected Government instructs a central bank to fund its fiscal deficits, then monetary policy decisions are framed by that purpose and would put the future inflation rate at risk. Politicising the implementation of monetary policy can reduce predictability and enhance risk premiums in market prices. Kiwis could pay a high price for that if it leads to exchange rate and asset price instability and impacts the cost of capital and business investment.

The politics of funding fiscal deficits by printing money is not to be taken lightly because elected Governments have a strong incentive to defer financial pain until after a general election.

Making thrift and prudent investing a mug's game

Central bank cash injections may seem successful if signs of financial stress are eased and asset valuations restored, or at least further falls averted. Yet when investors expect these interventions, the effect only disrupts and distorts asset repricing mechanisms. The prices are distorted because investors must consider how much money authorities might throw into the banking system during the next downturn. The dangerous result is that asset prices will end up reflecting not what investors think an asset is worth, but what the government is prepared to spend to stop them from falling.

Compounding this price distortion is today's historically low policy interest rates. The overall effect is to encourage borrowing rather than thrift and discourage prudent investing.[25] Governments once preached the virtue of private savings, yet their signals are ambiguous at best.

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[23] Jenée Tibshraeny, "Finance Minister Grant Robertson has no intention of getting the RBNZ to print money to pay for specific government policies, despite RBNZ Governor Adrian Orr saying this would be 'achievable'", *interest.co.nz*, 29 May 2020. https://www.interest.co.nz/bonds/105275/robertson-has-no-intention-getting-rbnz-print-money-pay-specific-government-policies

[24] Speech by the Governor of the Reserve Bank of Australia Philip Lowe, "An Economic and Financial Update, Reserve Bank of Australia, 21 April 2020

[25] Low nominal interest rates are not the only factor affecting asset prices. Taxes, expected inflation rates, policy uncertainties, regulatory barriers and other restrictions on property rights also matter, and can be changing through time.

When I was a young lad, the default option at primary school was to sign up for a Post Office savings account and attempt to make regular contributions. At the time, the standard interest rate was 3% per annum. Much later, when acting as a young Treasury Officer in the mid-1970s, the redoubtable then-Secretary to the Treasury Henry Lang asked me to draft a newspaper article explaining the importance of thrift and saving. The major daily newspapers ran an annual Savings Week feature which led off with articles about the importance of thrift from the Treasury, Reserve Bank, Savings Bank representatives and other institutional worthies.

I cannot remember in any detail what I wrote now, but it was surely how thrift helped to provide for contingencies, future asset purchases and retirement. At an economy-wide level, the message would have been about the importance of a supply of funds for capital formation and the need to contain deficits in the overall balance of payments.

I remember Lang holding my draft and telling me in sorrow that he could not put his name to it. "Why not?" I asked. My draft article was surely banal, but I was confident it was a mainstream opinion. "Because it would be dishonest," he replied, and explained that he could not and would not preach the virtue of saving when the high inflation of the 1970s made the 3% return on savings seriously negative in real terms. I could not help him with that problem. Treasury did not contribute an article that year, or, to the best of my knowledge, ever again.

During the 2000s, successive New Zealand Governments increased Crown net worth by over-taxing Kiwis at the expense of private savings. Official estimates of aggregate household saving rates dipped seriously negative for a period but were unreliable. Rather than lay the blame on the high taxes, the tendency in Wellington was to scapegoat Kiwis' "exuberant spending" for the diminished savings. NZ First led a national referendum initiative for compulsory savings but it was roundly defeated. Eventually, KiwiSaver was introduced to fix the problem, but it had to include large tax incentives to avoid a politically embarrassing low uptake of the scheme. Subsidies aside, it would be more rational for households to reduce their mortgages.

By the end of the 2000s it became clear that the big spender was the Government, not the average Kiwi.[26] It had over-estimated the growth in tax revenue and was in such heavy fiscal deficit when the GFC hit that it took the next National-led government the best part of a decade to eliminate it.

That wheel has now turned on advocating thrift. Today Wellington wants Kiwis to spend their way out of the Covid-19 lockdown crisis as if their personal circumstances were irrelevant. People fearing redundancy with little in their savings accounts would be better advised to resist calls to jump on a plane and holiday in Queenstown. The Government is practising what it preaches by spending money, but those funds are other people's money and the next general election is but several months away. Households necessarily have longer time horizons than that.

The age-old orthodox view is that the prudent action for mortgage-free households saving for retirement is to build an investment portfolio of about 50% risky share market investments and 50% relatively safe interest-earning investments. Today, government and central bank policies are making the latter part of that structure look like a mug's game.

Currently, people accrue savings from their after-tax income. They pay more taxes along the way on interest and dividend income, even if the real return is negative. When they reach retirement, they pay GST on all purchases of goods or services. As if that is not enough, Governments are being

[26] Core Crown operating spending excluding losses and finance costs per capita rose by 31.2% in real terms (CPI) between the years ended June 2001 and 2009.

pressured to add some form of wealth or capital gains tax as well. If Government fiscal deficits continue to grow, this will intensify the pressure to add more taxes.

New Zealand and Australian Governments cannot do anything about low global interest rates. But if they want to encourage thrift and prudence among their citizens, they can and should seek to avoid socialising losses from aggressive borrowing and risky investing. When a shock causes asset prices to tumble, many risk-takers chasing high returns will be hit with heavy losses. Governments can only bail them out by taking money from those who still have net wealth, which unfairly includes everyone whose prudence stopped them from borrowing too heavily in the first place. Of course, the welfare system support households in dire financial need regardless.

The pathology behind today's public debt and interest rate attitude

International investors are getting the message that borrowing to invest in risky assets (e.g. property and share markets) is good while prudently investing in interest-earning assets is a mug's game.

In the largest economies, officials have essentially told risk-loving investors that the government and central banks will underwrite their losses – with taxpayers' money.[27] Rather than being extraordinary, investors now expect this safety net for a few crucial reasons:

- The "too big to fail" doctrine used to justify taxpayer bailouts for banks after the bailout of Continental Illinois in 1984 – one of the 10 largest US banks at the time;[28]
- The "Greenspan put" which refers to an expectation firmly embedded in asset pricing in the form of higher valuations, narrower credit spreads and excess risk-taking that the US Federal Reserve would inject new money as required to help sustain asset prices;
- A "we will do whatever it takes" mantra after the president of the European Central Bank in July 2012 pledged to put an unlimited amount of other people's money at risk to "save" the euro. *The Economist* shows central bankers and politicians are using this justification more often;[29]
- The development of "Modern Monetary Theory" which advocates continuous central bank money printing to achieve full employment and discounts concerns about budget deficits, public debt spirals or entrenched wage and price inflation.[30]

It has become orthodox to describe a financial market as dysfunctional when: asset prices fall; credit spreads widen as folk take risks more seriously; the demand for cash and liquidity rises; and willingness to lend diminishes. In the past, each of these would have been seen as expected consequences of dashed bullish expectations, and thereby a normal cyclical event. Now central

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[27] The world's most famous investor, Warren Buffet, is very clear in his latest annual report on Berkshire Hathaway that US share prices are where they are today because of the Federal Reserve's determination to pump liquidity into the financial system should prices falter.(see 1:32-1:39 hours into the transcript at https://www.rev.com/blog/transcripts/warren-buffett-berkshire-hathaway-annual-meeting-transcript-2020)

[28] Following that bailout, the US Comptroller of Currency applied the term the term "too big to fail" to the 11 largest banks in the US. See the speech by Jon Cunliffe, "Ending too-big-to fail: How best to deal with failed large banks", European Economy on-line journal, 5 December 2016, page 4.

[29] *The Economist*, "Policymakers promise "whatever it takes" to save the global economy", 30 March 2020, https://www.economist.com/graphic-detail/2020/03/30/policymakers-promise-whatever-it-takes-to-save-the-global-economy. See also the RBA's use of the term dysfunction cited above.

[30] How this can be reconciled with the stagflation of the 1970s is unclear. Nor does there seem to be a concern that destabilising asset price or wage inflation may get entrenched before there is political will to act. https://en.wikipedia.org/wiki/Modern_Monetary_Theory

banks may consider such normal signs of disruption enough justification for large scale intervention, even if the banking system is not under stress.[31]

But those destabilising doctrines did not emerge in a vacuum. Apart from historically low central bank discount rates, they were responding to four genuine problems:

- an unstable EU currency bloc;
- the advent of complex, large and globally diversified financial firms;
- chronic weaknesses in US financial and banking regulation; and
- the drive to lift inflation rates to a target inflation band.

The euro was adopted as a currency by 11 European member states on 1 January, 1999 and – with the addition of Greece – banknotes and coins arrived on 1 January, 2001. The currency has since been an ongoing source of instability because it does not allow member countries with uncompetitive economies to devalue. They are instead stuck with debilitating youth unemployment and chronic deficits in their balance of payments. The "do whatever it takes" doctrine and heavy borrowing only kicks the underlying problem down the road – which risks causing a constitutional crisis in the European Union.

Across the Atlantic, the US has long been a major source of banking instability since its bank failures led the Great Depression of the 1930s. Encouraging US banks prior to 2008 to lend to people with no job, no income and no assets while major state agencies underwrote half of all mortgage lending was irresponsible almost beyond comprehension, and instigated the GFC. The contrast with the stability of Canada's banking system is stark.

The advent of large global banks subject to complex national regulatory regimes posed the question of whom should pay for any losses. As the Bank of England deputy governor observed in 2016 the conclusion was that losses in a national region should be paid by local taxpayers. There is wide agreement that this creates perverse incentives, but while much work has been done to address this problem, it is far too soon to call a victory.[32]

Another unexamined presumption is that the absence of inflation is just as bad as high rates of inflation.[33] This is a little debated consequence of the process of wringing high inflation out of people's expectations by requiring central banks to get inflation down into a target band. What was not foreseen at the time was the degree to which globalisation (low cost supply chains and digital

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[31] The Reserve Bank of Australia's May 2020 Statement of Monetary Policy describes the selloff of government bonds in Australia in March as contributing to 'severe dysfunction" in that market and describes the similar 'dysfunction in the US Treasury market as "especially consequential" (see page 2). https://www.rba.gov.au/publications/smp/2020/may/pdf/statement-on-monetary-policy-2020-05.pdf. The Bank of England's Interim Financial Stability Report, May 2020, graphically describes on page 1 a "dash for cash" in the UK in March 2020 to explain why the authorities acted vigorously to alleviate the sudden demand for liquidity. Yet 10 pages later it observes that "the stressed market conditions did not transmit stress in the core UK banking system".

[32] Jon Cunliffe, "Ending too-big-to-fail: How best to deal with failed large banks", speech based on an article on bank resolution for the European on-line journal, 5 December 2016. https://www.bankofengland.co.uk/-/media/boe/files/article/2016/ending-too-big-to-fail-how-best-to-deal-with-failed-large-banks.pdf?

[33] The RBNZ's Monetary Policy Handbook, 1 April 2019, page 63, states explicitly that it has treated deviations of inflation from the target range symmetrically, undershooting being as bad as over-shooting.

change) largely eliminated inflation in traded goods. Central banks came under attack because inflation was below the middle of a target range created for a different purpose.

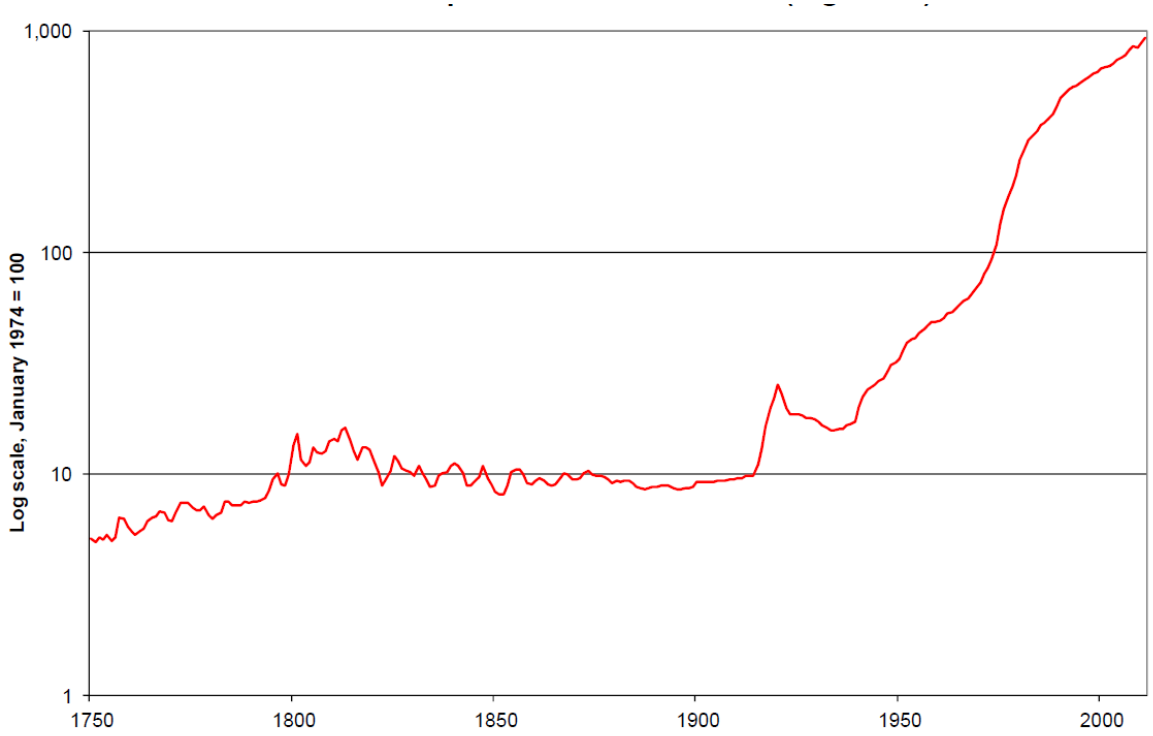
Central banks, and their critics, should ask themselves why lower prices from welfare-enhancing developments like this should require a response from monetary policy. What is the social cost of low inflation from this source? The current approach of injecting new money to increase consumer prices encourages borrowing to excess, artificially inflating asset prices.[34]

Should central banks try to generate commodity price inflation?

It is easy enough to explain why central banks should stop high inflation from becoming entrenched. Inflation is a hidden and insidious tax which destroys historical senses of value and undermines money as a store of value. Inflation is caused by printing too much money and high asset price inflation encourages risky borrowing and speculation. When 'doing whatever it takes' turns out to be not enough, asset prices will keep falling. That will also result in bankruptcies, unemployment and wealth destruction from excessive borrowing.

In contrast, what is the social cost of prolonged low consumer price inflation? Disinflation is often assumed to be bad because it is associated with the 1930s Great Depression. But that confuses correlation with causation. The UK had low inflation through its period of industrialisation during the 19th century and Figure 9 shows what happened to retail prices after it went off the gold standard for World War I.

Figure 9: UK Retail Price index 1750-2011 (log scale)



[34] Lost output from the Covid-19 lockdown results from supply constraints, not demand constraints. Switching of public demand from tourism and communal service industry activities to other activities (home delivery, ZOOM conferencing, etc) is a resource reallocation issue rather than a demand deficiency problem.

Source: House of Commons Library, "Inflation: The value of the pound 1750-2011," Research Paper 12/3, 29 May 2013, chart 2, page 4.

A related fear is that nominal wages cannot adjust downwards to help restore international competitiveness. This may be a problem for public sector wage rates and in the private sector where wage rates are rigidly regulated. But the problem is less clear in practice when employers and employees are free to renegotiate contracts as situations change. The above chart suggests fears that wages are inflexible and can't sustain stable prices may be overstated.

Perhaps no economist has made a stronger case for allowing commodity prices to fall with productivity growth than US economist George Selgin.[35] Real wages can increase through falling prices rather than by increasing nominal wage rates. His position is not theoretical. Incomes rose in the UK while prices fell between 1873-1896 (Figure 9). By UK economist Angus Maddison's estimates, real GDP per capita in the UK rose 26% during this period.

Central banks that focus on lifting consumer price into a target range set for a different purpose risk exacerbating excessive gearing and artificially inflated asset prices. The original Reserve Bank Act 1989 was clear that monetary policy was about achieving and sustaining stability in "the general level of prices." Ever increasing prices are a different thing from stability in their general level and the Act added that issues of financial market efficiency and soundness must also be considered. Artificially inflated bond and share market prices are neither efficient nor sound.

Astute central bankers globally are concerned that unduly low interest rates, if sustained, will discourage thrift and encourage people to borrow unduly and take on more risk than is prudent.[36] The danger is that political pressure, intervention precedents, and myopic interpretations of their mandates will dominate their decision-making.

The question of how monetary policy should respond to asset price inflation was faced by Japan in the 1990s. Japan experienced major asset price inflation in the 1980s because monetary conditions were stimulatory. At its peak, the inflated real estate value of the Tokyo Imperial Palace was said to be greater than the entire state of California.[37]

The Bank of Japan tightened monetary policy in December 1989, lifting its official discount rate from 2.5% to 4.25% and later to 6%. Its share market (Nikkei 225) also lost 35% of value in 1990 as values starting slumping.[38] From 1993, Japan's government tried unsuccessfully to stimulate household spending and corporate investment by boosting its own spending. Economic growth did not take off, but public debt did. The effect on the real economy was so serious that the 1990s is now referred to

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[35] George Selgin, "Less than Zero: The Case for a Falling Price Level in a Growing Economy," Institute for Economic Affairs, Hobart Paper 193, 1997.
http://www.iea.org.uk/sites/default/files/publications/files/upldbook98pdf.pdf

[36] George Selgin (2002), op. cit. chapter10, Financial Stability subsection, cites then Federal Reserve Governor Powell as expressing concern in October 2012 that "[i]nvestors really do understand now that we will be there to prevent serious losses" ..and "have every incentive to take more risk, and are doing so". His conclusion was that this "should give us [central bankers] pause".

[37] https://en.wikipedia.org/wiki/Japanese_asset_price_bubble#:~:text=The%20Japanese%20asset%20price%20bubble,market%20prices%20were%20greatly%20inflated.&text=Even%20though%20asset%20prices%20had,for%20more%20than%20a%20decade.

[38] The Japan Real Estate Institute's Home Price Indexes show how dramatic the price falls were in Tokyo. They are copyright restricted by can be viewed at
https://www.reinet.or.jp/pdf/fudoukenjutakuhyouka/LatestRelease20200331-E.pdf (see Exhibit 5).

as a "lost decade" of national income growth. Today, Japan's ratio of net government financial liabilities to GDP is second only to that of Greece amongst OECD member countries.

How well can monetary policy fine-tune the real economy?[39]

The efficacy of monetary and fiscal stimulus for fine-tuning real economic activity is more problematic than some Keynesian economists presume.

The stagflation in prosperous countries like New Zealand in the 1970s confounded Keynesian macroeconomic thinking. The dire, but wrong, predictions of 364 UK economists about the contractionary effects of Margaret Thatcher's 1981 Budget was another set-back. Similar predictions by University of Auckland economists about New Zealand's 1991'contractionary' Budget also failed. As mentioned, fiscal expansion in Japan in the 1990s did not have the expected stimulatory effect.

Analysis shows that much of the response to macro-policies depends on the institutional context. For example, George Selgin argues that adding to banking system reserves will not materially affect banks' willingness to lend under the current US Federal Reserve system, which pays banks interest on their reserves. Doing so reduces their incentive to expand private lending.[40] Anything which affects credibility and time consistency also matters,[41] as do expectations, along with the nature of the exchange rate regime and how monetary policy responds to fiscal policy. Fiscal expansion has little effect on real output if the money supply is unchanged and interest rates are set by world markets.[42]

The effect on the S&P 500 of the March decision by the US Federal Reserve to inject trillions of dollars of liquidity essentially proves such actions lift share and bond prices while holding-off bankruptcies and business failures in the short-term. But by the same token an injection like this can prevent necessary resource reallocation, create weak banks and "zombie" companies while raising concerns about future taxes and financial stability when the next downturn occurs.

To claim victory for trillion-dollar monetary bailouts because the S&P 500 reversed a sharp fall is Pyrrhic. The action does nothing to address the underlying causes of the fall. One is reminded of the fellow who dropped from a 20-story building and muttered as he flew past level 12, "well, it's all right so far." Asset prices held artificially high by trillions of injected dollars, backed by expectations of more to come if necessary, is not a good situation.

For a small, open, economies, monetary policy mostly works directly and immediately on the nominal exchange rate. It is no accident that the Monetary Authority of Singapore targets a range for the exchange rate in order to keep domestic inflation low. Similarly, the Hong Kong Monetary Authority is essentially a currency board. Apart from a direct effect on the asset market, a sudden

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[39] For expressions of doubt, see Lawrence Summers and Anna Stansbury, "Whither Central Banking" Project Syndicate, 13 August 2019 and Gauti Eggertson, Lawrence Summers, Ragnar Juelsrud and Ella World, "Negative nominal interest rates and the bank lending channel, December 2018, Working Paper 2019/4, Norges Bank and George Selgin's argument (op. cit., 2020) that the Federal Reserve's current 'floor' system that pays interest on all banking system reserves held at the Fed makes QE ineffective for stimulating bank lending.

[40] George Selgin (2020) op. cit., chapter 7. The alternative to the current 'floor system' is a 'corridor' system that does not reward banks that hold reserves more than required.

[41] New Zealand's monetary and fiscal arrangements from the early 1990s aimed to enhance credibility and time consistency by clarifying accountability and enacting structured changes in policy decisions.

[42] In those circumstances, fiscal policy largely affects the current account balance in the balance of payments in a Keynesian model.

expansionary monetary policy should depreciate the exchange rate, lifting the domestic price level for tradable goods and increasing international competitiveness in the short term.

New Zealand is too small to affect the real global cost of capital for business. As a capital importing country, Kiwis must pay the world post-tax price. Nominal New Zealand government bonds are priced against overseas government bonds with similar credit ratings (most notably Australia) – that is, when the RBNZ is not outbidding everyone using its "ATM."

In the long run, most monetary economists assume monetary policy determines the inflation rate, not real output and income. In the short run (perhaps over some years), material changes in the supply of money and credit, relative to demand, are surely important for lubricating the wheels of commerce. But the efficacy of monetary policy for fine-tuning real economic activity in a predictable way cannot be assumed.

Concluding comments

The expectation that governments and central banks will bailout risk-takers poses a serious threat to global financial stability. Mantras such as 'too big to fail,' 'do whatever it takes' and the 'Greenspan put' have contributed to a headlong plunge towards negative interest rates, purchases of corporate bonds and the unhealthy ratcheting of public debt ratios above prudent levels.

Any for-profit system is incompatible with a system that shifts the burden of losses onto taxpayers. Unless something changes with the major central banks, bond and share market prices will crash when the declaration to 'do whatever it takes' is no longer credible. The fallout would be severe. The GFC gave us a taste of what could happen. The response merely scotched the snake.

No one can be sure when this moment will occur, but It will probably result from an unforeseen mix of circumstances. As the Swiss historian and diplomat Carl Jacob Burckhardt once said:

> "It is one of the most difficult things that can be imposed on a thinking person, knowing that he has to witness the course of a historical process among the ignorant, the inevitable outcome of which he has long known with clarity. The time of others' mistakes, of false hopes, of mistakes made blindly becomes very long."[43]

It is dangerous for decision-makers to think financial markets are becoming dysfunctional when they see credit spreads widening, a 'dash for cash' or liquidity disappearing as sellers race to unload their positions and buyers hold back. An increase in the demand for credit and liquidity does not necessarily need to be met by an increase in supply when the banking system is not at risk. To inject liquidity too readily encourages excessive borrowing and risk taking.

Market prices for government bonds and global shares have come to incorporate expectations that governments will inject many trillions of dollars to keep prices high should they falter. Such prices overstate what investors think those assets are really worth to the community.

Such distorted prices and incentives are a threat to the stability of the world's financial system, not just Australia and New Zealand. The best they can do is build economic strength and resilience to cope with future crises. Australia and New Zealand have largely resisted these 'one-way' pressures

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[43] See also Carmen Reinhart and Kenneth Rogoff, "This Time is Different", for an overview to eight centuries of financial folly, and why warning signs are discounted.
https://press.princeton.edu/books/paperback/9780691152646/this-time-is-different

to drive up bank liquidity and public debt, but New Zealand's response to Covid-19 is taking it down the same dangerous path.

Loose talk from the RBNZ about funding government spending by printing money risks ending the monetary and fiscal constitution that has served the country well from the early 1990s. The RBNZ needs to be much clearer about what it is saying about its future independence and the separation of responsibilities for monetary policy, funding the fiscal deficit and managing the Crown's balance sheet. The optimal term structure for public debt is fundamentally a Crown balance sheet issue.

The RBNZ also needs to be much clearer about why it believes the benefits to the public from purchasing up to $60 billion of government bonds to reduce interest rates and smooth the yield curve.

This research note further suggests that the government's objectives for monetary policy be reviewed. Little or no consideration seems to be have given to the possibility that the benefits from allowing consumer price inflation to languish at the bottom end of the 1-3% range, or lower might exceed the costs. (At inception the range was 0-2%.)

The RBNZ's current remit is to:

- keep future annual inflation between 1-3% over the medium term, with a focus on keeping future inflation near the 2% midpoint; and
- support maximum sustainable employment, considering a broad range of labour market indicators considering that maximum sustainable employment is largely determined by non-monetary factors.[44]

The concern is the absence of a clear case that there is a social cost to inflation below the 2% pa target that warrants action to increase it. Under its baseline scenario, the RBNZ in May expected the annual increase in the Consumers Price Index to be below 2% from the year ended June 2020 to at least June 2023.[45] The RBNZ should not be required to aim to lift inflation to around 2% pa without a clear cost-benefit justification.

This report recommends a review of the RBNZ's monetary policy remit to ensure it can look past periods of low inflation which do not arise from insufficient demand and put proper weight on the importance of incentives to save, borrow and invest prudently.

A final suggestion is that the existing objectives may be being interpreted too myopically. The current interpretation appears to be biased towards leaning against any incipient economic downturn putting too little weight on the longer-term risks to financial stability from penalising thrift and prudence and rewarding those who borrow to buy assets at artificially inflated prices. A stricter focus on medium term price stability with a much lower bottom range limit would allow central banks to 'look through' incipient recessions more, while still allowing short term monetary policy easing should that be consistent with the price stability or employment objective.

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[44] RBNZ, Monetary Policy Statement, May 2020, ii. https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Monetary%20policy%20statements/2020/mpsmay20.pdf?revision=8507e6ed-000b-4ddf-be17-0e7791b40e69

[45] https://www.rbnz.govt.nz/monetary-policy/monetary-policy-statement/mps-may-2020

Appendix 1: Don't confuse government handouts of money with income

The recently retired Secretary to the Treasury recycled a statement attributed to Robert Kennedy that GDP measures nothing useful. Since national income is the biggest component of GDP, surely no one believes that?

However, Green party politicians urge less of a focus on GDP and the wider Coalition Government is dishing out billions of dollars of money, all on taxpayer credit. In recent months, every conceivable community group is clamouring for more money from the government. Amazingly, the bill for the Pike River non-recovery has hit $50 million.[46] That represents a cost of about 10 statistical lives in forgone road safety spending.

What these groups really need is more income, but all a government can provide is purchasing power over Crown net worth. This is only positive income to the recipient because it represents negative income to everyone else – the total national income is unchanged. Those who miss out are could have otherwise benefited from that resource.

In other words, money is not income. To confuse the two is to risk financial ruin. An ATM machine spews out money not income. Money is a means of payment while income is earned by putting labour and capital to productive use. Production precedes sales revenue and income. To be short of money is a symptom of insufficient income and the only way to fix this is to boost income relative to spending. Higher income requires greater saleable output which required in turn productivity, capital, skill, experience, work effort and know-how.

Money for living costs can be borrowed when necessary and managed with some luck. Yet, self-discipline is a rare virtue and misfortune part of the human condition. For many households and nations, borrowing for current needs has been a path to misery and even financial ruin. Charles Dickens charmingly illustrated the pain of insufficient income, and the illusion of borrowing as the remedy, in the novel *David Copperfield*:

> "Mr. Micawber was waiting for me within the gate, and we went up to his room (top story but one), and cried very much. He solemnly conjured me, I remember, to take warning by his fate; and to observe that if a man had twenty pounds a-year for his income, and spent nineteen pounds nineteen shillings and sixpence, he would be happy, but that if he spent twenty pounds one he would be miserable. After which he borrowed a shilling of me for porter, gave me a written order on Mrs. Micawber for the amount, and put away his pocket-handkerchief, and cheered up."

Many central banks, including the Reserve Bank of New Zealand are now 'printing money' on a large scale to fund loans and asset purchases by issuing IOUs to the nation's banks.

The Governor of the Reserve Bank of New Zealand is a major cheerleader for such credit creation, even declaring that "I've got the ATM," as if his ability to spend is unlimited. What does it matter if he spends $30b, $60b or $90b of taxpayers' money to buy government stock and other assets? People might soon wonder why they need an ATM card, or even to earn income.

Former ACT leader Rodney Hide once defied any adult to explain to an infant how they could be short of money after the infant pointed out that all they had to do was put a card into an ATM

[46] https://www.odt.co.nz/star-news/star-national/pike-river-mine-tunnel-re-entry-cost-doubles-over-50m

machine. Talk of ‘helicopter money’ and a universal basic ‘income’ are part of this ‘free lunch’ genre. If it were free, why should anyone ever have to work for an income?

All this is sometimes defended by saying that unprecedented times justify unprecedented measures. Yet borrowing with insufficient regard to the real problem (inadequate income from excessive barriers to employment and productivity) is anything but unprecedented. Successive New Zealand governments pursued ‘spend, borrow and hope’ in the decade to the mid-1980s in the vain hope that this would be successful. New Zealand’s present high net indebtedness to the rest of the world can be traced back to that period. The debt is being coped with, but its cost endures.

What does not seem to be sufficiently understood in government, now and then, is the need for rigorous assessment of the costs and benefits of stimulus policies. Those pressuring governments for new or enlarged handouts cannot be expected to meet this need.

This is not arguing against handouts that pass the cost-benefit test. Kiwis have lost a lot of national income from the Covid-19 lockdown. Help for households in dire financial need is good. Money to help reduce adjustment costs may pass the cost-benefit test. But the social costs of handouts exceed the amount paid because of administrative costs and the cost of behavioural responses to avoid the increased tax burdens and to make oneself eligible for the handout.

The only thing that can lift all boats is greater national income, particularly in conjunction with higher productivity and less involuntary unemployment. If central bank-induced increases in the money supply could lift national income on a sustained basis, central banks would have been doing that forever. Economists know it cannot do this. Sustained increases in national income have other sources.

Appendix 2 Different definitions of money endlessly confuse public discussion.

What is money? Confusion arises because similar but different things can all be called money, or not.

When someone asks “how much money do you carry,” they are likely asking about notes and coins. If they ask: “how much money to you have in the bank,” they are asking a different question, but they are both about money.

If they ask you how much of your credit card limit is left to spend, they likely do not think they are asking you a question about money. Yet likely you can use either notes and coin, your ATM card, or your credit card as ready money at your local store.

When a central bank creates money, it is commonly said to have ‘printed money,’ but not necessarily more notes or coins. Currently, the RBNZ is creating billions of dollars of new money by buying government stock. Sellers get the Reserve Bank’s IOU credited to their bank accounts. Their bank presents the IOUs to the RBNZ. The result is that the Reserve Bank has borrowed from the banking system to buy government stock.

Banks’ accounts at the RBNZ are called settlement balances and are a means of payment. These banks can use them to settle transactions between themselves and with the government (e.g. customers’ tax payments) and the RBNZ.

Economists sometimes refer to this form of money as ‘high-powered’ money since funds at the bankers’ bank are at the apex of the pyramid of the cascading flow for deposits and lending for the entire financial system.

Governments can appear to borrow relatively cheaply because they can raise taxes to service their debts. This is not a social benefit, because taxpayers bear that risk. The fact that the risk is unpriced (nobody explicitly compensates the taxpayers) and thereby unseen does not make it less real. It is wrong to think of government borrowing as cheap because the interest rate is lower than for private borrowing which is not backed by government.

From the 1930s, social creditors have argued that economic development should be funded by ‘cheap’ central bank credit creation. In 2020, the Social Credit Party in New Zealand has placed full page newspaper advertisements asserting that central bank credit creation is costless.

The assertion is false. Banks can demand full value for each dollar lent and the cost of central bank borrowing for one purpose is a lost opportunity to use those same funds for a higher value purpose elsewhere. This confusion about the costs of central bank credit will outlive us all since people will always want to believe there is a painless way to prosperity.

Further confusion is introduced by saying if it is OK for banking system to create money by extending credit, why can’t the central bank do the same? The short answer is that different things are counted as money supply and those differences matter.

Default by a private bank can be addressed by RBNZ as lender of last resort if necessary. Default by the central bank would mean default by government to honour its own debt. Such a default would be as devasting for the financial system as an Exocet missile hitting a launch. Lifetime savings have been wiped out when a currency made worthless by too much credit creation is replaced by new currency. Hence why money is not income.

Setting this aside, the notion that private banks create money in the form of bank deposits by borrowing on deposit and lending is orthodox in economic textbooks. Under a fractional reserve system of banking, borrowing on deposit and then lending a portion of that deposit can be prudent and efficient. If the bank is sound, depositors probably won't want to withdraw all their money at once.

To over-simplify, if a reserve equal to 10% of deposits is adequate to meet expected withdrawals on any day of the year, a bank can hold $10 of reserves at the central bank for every $100 of deposits and lend out the other $90. Economists sometimes refer to reserve claims on the central bank as high-powered money.

If a central bank doubles high-powered money by purchasing government bonds, it might hope to double bank deposits and bank lending under an unchanged reserve to deposit ratio. Whether that happens depends on whether depositors and borrowers want to hold the additional deposits on the one hand or incur the additional debt obligations on the other. If no one wants to borrow the so-called credit multiplier will be zero. In the above example, deposits would be $110 and lending $90, and reserves would be $20 for every $100 of the original level of deposits.

To illustrate the uncertainty about the banking system credit multiplier, consider whether total bank deposits go up or down when a person takes out a mortgage and buys a house. Does the seller who pockets the proceeds wish to hold more or less on deposit than the buyer held before the purchase? That might depend in part on how large the seller's mortgage was. Beyond this, it depends on whether something has happened to raise the public's demand for bank deposits.

The important point is that private sector creation of bank deposit is pyramided on the supply of high-powered money. The policy question is the extent to which high-powered money should be supplied, knowing the implications of the overall system.

The confusion between central bank injections of high-powered money and banking system creation of money in the form of demand deposits arises because they are both components of the money supply. The differences between assets called money are reflected in the short-hand names for different measures of the money supply. In the past, terms like M0, M1, M2 and M3 were in use, where M0 was the narrowest definition of the money supply, being notes and coins on issue from the Reserve Bank and M3 the broadest).[47]

Now the terminology seems to be even more confusing. The RBNZ's summary balance sheets calculate M1 as deposits included in the money base, yet its published money and credit aggregates calculates M1 as a much larger aggregate, being currency held by the public and transaction deposits at the banking system. The larger M1 is called narrow money. Broad money is narrow money plus savings and term deposits.

The difficulty is that technological change is changing the degree to which things that were once not a ready means of payment now are or may be. The public who try to understand what is meant by 'money' can be forgiven for some confusion.

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[47] See https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Bulletins/1999/1999jun62-2collinsthorpwhite.pdf, page 11 and https://www.interest.co.nz/charts/credit/money-supply