RESEARCH NOTE

# Deficit spending in a crisis: why there is no such thing as a free lunch

THE NEW ZEALAND INITIATIVE

**Dr Bryce Wilkinson**

**22 April 2020**

## Overview

The New Zealand Initiative supports government deficit spending during the Covid-19 crisis on the basis that it is funded by conventional borrowing. This report explains why funding deficits by central bank credit creation with no credible timetable for reversing the situation is a route to financial disaster.

The cost of the Covid-19 Alert Level 4 lockdown in lost jobs and national income is horrendous, and the government spending response is unprecedented in living memory. To date, over $20 billion of new spending has been committed, with parliament approving up to $50 billion.

That spending must be funded from borrowing, but how? Funding by printing money debases the currency and the golden rule is to fund deficits by conventional borrowing.

At first blush, the funding options are determined by the Minister of Finance on the advice of the Treasury, with the Treasury's Debt Management Office implementing the decisions. The maturity structure of the public debt is a Treasury balance sheet management issue. Conventional funding certainly seems to be the intention, for now. Treasury has announced it will issue an additional $29 billion of additional bonds and bills by June 30, 2020.

Not so fast. Enter the Reserve Bank of New Zealand.

The 'RBNZ's job is to tighten or ease monetary conditions in accordance with agreed inflation targets and keeping output growth and unemployment in mind. It does this by changing the overnight cash interest rate (OCR) or by open market operations that change the term structure of the government debt in the 'public's hands, along with banking system cash.

The RBNZ has a lot of operational freedom. If it wanted, it could monetise the public debt and undo Treasury's balance sheet debt management. Indeed, on March 23, the RBNZ announced it would purchase $30 billion of government bonds some time over the next 12 months.

Central bank purchases of government bonds from the private sector inject cash into the banking system, dollar for dollar.[1] This creates a substantial easing of monetary policy. It raises bond prices and reduces yields and the cost of government borrowing. The aim is to reduce deflationary pressures and output and employment losses during a recession.

[1] If some of the sellers are overseas persons, this may not be the case.

Dr Bryce Wilkinson is a Research Fellow with The New Zealand Initiative.

This is an orthodox open-market operation referred to by some writers as quantitative easing (QE). In the New Zealand context, it is a substantial move towards financing the fiscal deficit by central bank credit, depending on timing. Normally, this should not be a major worry.

What the Reserve Bank is proposing with these bond purchases appears fully justifiable considering its statutory objectives. The difficulty is in the dynamics. In the fullness of time, the same statutory objectives should see the central bank selling government bonds back to the private sector to reduce inflationary pressures and an over-heated economy. There need be no permanent lift in Reserve Bank credit or change in the Treasury's preferred mix for the composition of the public debt.

At least, that's what it says in the textbook. But it is not what has happened in the US, Europe, Japan or the UK. Central banking credit creation has become a one-way upwards ratchet since the 2008 Global Financial Crisis. It has helped fund ongoing fiscal deficits, which creates crippling public debt and troubling asset price inflation as people take advantage of low-interest rates to borrow heavily to buy risky assets. The risk is that New Zealand will go the same way.

The onset of Covid-19 brings this to a head. Heavily indebted governments must spend more but cannot see a way of raising taxes, cutting other spending, selling assets or adding to their public debt. They want a soft option. Over 80 countries have already applied to the IMF for financial support during this crisis.[2]

Those demanding a soft option will find a supplier. Some reputable economists are now arguing that giving away money or central bank credit is that answer.

These economists seem to have a willing audience. Some central bankers are telling markets they will do "all it takes" to hold off financial disaster as if they have their hands in every taxpayers' pocket. A columnist in the influential UK Guardian newspaper even asserted central banks have an "unlimited budget" to determine who sinks and who swims.

Viewing the public purse as bottomless and that central bank funding can backstop any problems is a recipe for financial disaster. Yet those calls are being made and heard in New Zealand.

Up to now, the central banks in Australia and New Zealand have largely stood aside from the potentially disastrous development of escalating central bank credit and public debt ratios. All that relative solidity now seems to be at risk.

This research note explains why the temptation for central bank credit creation in a crisis should be restrained and reversible. Once on this seductive path, the political economy of getting off this debt escalator is extremely difficult and undermining financial stability. This political economy problem is a fatal weakness in these proposals.

To support financial stability, Budget 2020 must provide a credible plan for returning public debt to prudent levels after the Covid-19 crisis and ensuring that the Reserve Bank's balance sheet is contained.

[2] https://www.theguardian.com/world/2020/mar/27/dozens-poorer-nations-seek-imf-help-coronavirus-crisis

# Introduction

Parliament has voted to allow the government to borrow up to $52 billion to deal with Covid-19.[3] To put that in a short-term perspective, in December 2019, Treasury was forecasting that core Crown net public debt in June 2020 would be $63 billion (19.6% of GDP). By comparison, core Crown net debt in June 2008 was 5.4% of 2007/08 GDP.

Minister of Finance Grant Robertson recently told Parliament's Epidemic Response Committee that the government has already committed over $20 billion, with plenty more in the pipeline.[4] This is in addition to the $12 billion of new additional infrastructure spending that the government announced in January.

The government is also signalling that when the time comes, there will be more government spending to "kick start" the economy and yet even more funding beyond that to "reset and rebuild" it.[5]

Where will all this money come from since the additional spending cannot be funded out of normal revenue? Last December, Treasury was forecasting a $900 million operating deficit before gains and losses (OBEGAL) for the year ended June 2020. Tax revenues will be a lot lower now due to the crisis and it will take years for tourism to recover.

Deficit spending is perfectly reasonable in a crisis if it is responsible, restrained and prudently financed through any combination of asset sales and conventional borrowing. Future offsetting fiscal surpluses should be planned to return the public debt to prudent levels.

To its credit, conventional borrowing appears to be the government's plan for this fiscal year. The Treasury's debt management office announced on April 1 that $25 billion of government bonds would be issued in the year ended June 2020, $15 billion more than planned last December. An additional $4 billion is to be raised from selling Treasury Bills.

The dangerous and potentially disastrous alternative is to fund deficits from what is variously called: printing money, quantitative easing, helicopter money, or Reserve Bank credit. All these are variations on the theme of flooding the banking system with some form of cash in one form or another.[6]

This option has obvious last resort appeal for heavily indebted countries in Europe and elsewhere. The hope is that thisapparently free money will allow governments to sustain deficit spending without increasing the public debt and defer the day when fiscal deficits must be replaced by surpluses.

Perhaps in response to political need, the case for funding fiscal deficits by central bank credit is being advocated by some economists internationally.[7] It is also being advocated

---

[3] https://www.interest.co.nz/bonds/104351/finance-minister-and-rbnz-unwilling-stage-link-directly-fund-fallout-covid-19

[4] See for example, https://www.newsroom.co.nz/2020/04/14/1127609/should-we-spend-an-extra-20b-or-40b

[5] 15 April 2020, Minister of Finance speech to Business New Zealand, https://www.beehive.govt.nz/speech/finance-minister-speech-business-new-zealand

[6] These terms are explained in Dowd, op cit.

[7] See, for example Buagi Bissone Tomas Faze, and Richard Wood, "Helicopter Money: The best policy to address high public debt and deflation", 1 October 2014 and other linked articles at the following website https://voxeu.org/article/helicopter-money-today-s-best-policy-option. For a contrary view and a more academic listing of those making this case see Kevin Dowd, "Against helicopter money,' Cato Journal, Winter 2018, page 1. https://www.cato.org/cato-journal/winter-2018/against-helicopter-money

domestically, including by local economists, perhaps most notably by Victoria University of Wellington's Dr Geoff Bertram, under the auspices of BERL.[8] He is not alone. This week the chief economist at government-owned KiwiBank, a government-owned bank, publicly advocated giving away $1,600 to New Zealanders. Treasury had endorsed such possible action back in January 2019.[9]

Propositions that cash could be given away as if dropped from a helicopter are no longer 'off-the-planet.'. In the US, a $2 trillion 'stimulus bill' that became law in late March 2020 included a one-time direct payment of up to US$US1,200 for individuals and US$US2,400 for married couples, plus US$US500 for each child.[10]

A March 23 Reserve Bank of New Zealand announcement[11] that it will purchase $30 billion of New Zealand government bonds during the next 12 months makes the issue of funding fiscal deficits by central bank credit a live issue for New Zealand. At one level this proposal is an orthodox form of quantitative easing. Investors holding those bonds sell them to the Reserve Bank for cash, which is deposited into their bank accounts. Their personal bank owes them the amount deposited and in return, now owns a claim on the Reserve Bank for the same amount. Against that liability, the Reserve Bank holds the asset of the purchased government bonds. As a result, the private sector and the banking system have more cash and fewer government bonds than before, while the Reserve Bank has more government bonds and greater liabilities in the form of the banking system's claims on it.

But the context of this purchase in conjunction with large issuance to fund a fiscal deficit raises a deeper question. Why would the government issue $25 billion of government bonds through one agency (the Treasury) just buy the equivalent (and more) back through another government agency (the Reserve Bank)? Why not just cut to the chase and have the Reserve Bank lend the government $25 billion directly? Indeed, this week the RBNZ Bank's governor Adrian Orr recently stated he was "open minded" on exactly that proposition.[12]

But across the Tasman, the Reserve Bank of Australia just rejected that option, because:

> 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.[13]

This danger is that funding fiscal deficits by central bank credit creation can look like a free lunch. This research note explains why it is not a free lunch. Government spending funded by central bank credit is, as George Washington might have said, a seductive servant and

---

[8] https://www.berl.co.nz/economic-insights/employment-and-skills-gdp-and-inflation-global-issues-government-and-fiscal

[9] https://www.stuff.co.nz/national/politics/114413517/give-kiwis-helicopter-money-cash-payouts-if-economy-crashes--treasury?rm=a

[10] For some details and caveats see here: https://www.cnbc.com/2020/03/27/the-stimulus-payment-calculator-tells-you-how-much-money-you-could-get.html

[11] https://www.rbnz.govt.nz/news/2020/03/rbnz-to-implement-30bn-large-scale-asset-purchase-programme-of-nz-govt-bonds. It has since added another $3 billion, to purchase local government bonds.

[12] https://www.bloombergquint.com/onweb/debt-monetization-is-creeping-closer-by-the-day-in-new-zealand The reason why he was is unclear. It is not as if there will be no government stock outstanding if the RBNZ purchases $30 billion. Over $78 billion was held in 'the market' at 31 March 2020 and the Treasury is issuing at least another $25 billion in short order.

[13] 21 April 2020, https://www.rba.gov.au/speeches/2020/sp-gov-2020-04-21.html

fearful master.

## Why funding from central bank credit is so seductive, a bit of history

Funding current government spending by credit creation is taxation by stealth. It shifts purchasing power around the community in ways that are very visible to beneficiaries but nearly invisible to everyone else who still has the same bank deposits, net worth and net incomes as before.

Neither tax rates nor national income have changed, and no one seems to have lost. Who could be against that? The government can even proclaim its 'generosity.' That is why printing money and other associated rorts have a long history.

Before the advent of central banks, rulers commonly deficit-financed their debt in times of fiscal need by reducing the gold and silver content in what purported to be gold and silver coins, often to fund wars. They intended to fool into thinking that their existing gold and silver coins were as valuable as ever but eventually, the public found that they could not buy as much as before. That is taxation by stealth. The supply of goods and services for non-war time consumption had fallen, but the number of notes and coins available to buy them had gone up. To stop prices from rising, which the rulers would attribute to 'war-time profiteering' rather than a result of their own deceit, they would introduce war-time rationing. In extreme cases, this caused hyper-inflation and much misery. Hyperinflation is a form of government default on its debt.[14] Current inflation targeting arrangements in New Zealand would have to be abandoned by the government before this could happen here.

The introduction of central banks, particularly the establishment of the Federal Reserve Bank in the US in 1913, has made funding deficits by stealth even easier. New Zealand's Reserve Bank started business in 1934 and members of the first Labour government elected in 1935 strongly campaigned for the creation of Reserve Bank credit at an interest rate of 1% per annum to fund economic development.  Many decades later, taxpayers had to write off hundreds of millions of dollars in such loans to primary sector producer board co-operatives. This illustrates how difficult it is politically to remove access to 'cheap' central bank credit, once the privilege has been conferred.[15]

More significantly, the formation of New Zealand's central bank was followed by a massive debasement of the value of money before the passing of the Reserve Bank Act 1991. On the Reserve Bank's calculator, ten shillings in 1935 (one dollar) would have bought 35 times what a dollar could buy in 1991.[16]

To further emphasise the seductive nature of this debasement, it took until the 1980s for its monetary source to be correctly identified. In the 1960s, then-Minister of Finance Robert Muldoon even proclaimed an 'unholy alliance' of trade unions and businesses conspiring to put up both wages and prices. Economists now know the cause of wage and price inflation was the government's monetary policy.

[14] Unanticipated inflation is a tax because it reduces the purchasing power of the amount invested, as does any unexpected tax on that investment.
[15] More encouragingly, it also shows that recourse can be limited if the will to limit it can be sustained.
[16] To be fair, fixing the New Zealand dollar to a pound sterling would ensure that New Zealand had much the same inflation rate as the United Kingdom even if New Zealand had not had a Reserve Bank.

## The most seductive argument of all – income and job growth

If resources are not being used because people do not have enough money to spend, printing money might result in fuller employment and higher national income over the short term. Economists have debated this issue for at least a hundred years, but significant debates remain.

For instance, it is generally agreed that monetary policy does not make a material difference to output and employment in the long run. Output and employment were not higher in 2019 than in 1935 because inflation had increased the consumer price index 35-fold. Monetary policy is best targeted at "achieving and maintaining stability in the general level of prices" as the Reserve Bank Act 1991 directed. Productivity growth and employment growth, not monetary policy, are key to higher income per capita.

Many also agree that changes in monetary policy, particularly unexpected changes, can alter expectations and thereby spending decisions for a time, perhaps even for a few years.[17] While longer-term interest rates for a small, open economy like New Zealand are largely determined in world capital markets, interest rates for close substitutes for cash are heavily determined by the home country's central bank. Lower real interest rates help borrowers at the expense of savers. That could change outcomes until savers wise up.

# Claimed benefits from funding from central bank credit

There is nothing wrong with central banks expanding and contracting their balance sheets in the course of fulfilling their duties. The danger is when the direction is always upwards.

That danger is here now. Across the world, a dangerous idea is emerging that central bank credit is all-powerful and essentially unlimited. There is bravado about 'doing whatever it takes' with someone else's money, mainly without their knowledge or permission, using 'too big to fail' justifications.[18]

Central banks can spend trillions of dollars bolstering asset prices, saving the world for a while from financial collapse. A recent article in the UK Guardian asserted that:

> Because it [a central bank] is the ultimate backer of the currency, its budget is unlimited. That means it can decide who sinks and who swims.[19]

The notion that a central bank has an unlimited budget to borrow short and invest long in risky assets assumes that taxpayers have an unlimited ability to make right on its losses, whether through the inflation tax or any other forms of tax. That is clearly false and makes the notion a dangerous proposition.

Less hyperbolic arguments for greater than conventional recourse to central bank credit have been put forward by economic experts. US economist Kevin Dowd usefully categorised them as follows:

- Negative or near-zero interest rates on government bonds make central bank credit

[17] One argument is that wages might not fall when needed to restore employment. An opposite concern is that if they do fall and the minimum wage does not, those on the lowest wages will not get re-employed.
[18] Country failure takes the form of sovereign debt default, sometimes euphemistically called debt restructuring.
[19] Adam Tooze, "How coronavirus almost brought down the global financial system", The Guardian, 14 April 2020, https://www.theguardian.com/business/2020/apr/14/how-coronavirus-almost-brought-down-the-global-financial-system?CMP=Share_iOSApp_Other

the only weapon left in a bank's arsenal;
- It can hope to lift economic activity when public debt is already so high as to make even greater deficit spending politically unacceptable;
- If the credit so created is targeted at the least well-off, it can usefully reduce economic inequality;
- Increasing banking system cash can ease financial system constraints arising from uncertainties about liquidity;
- Adding to banking system liquidity can reduce the risks of debilitating falling price levels (deflation) and moribund output and employment (secular stagnation);
- Injections of cash might help overcome the impotency of monetary policy that is postulated to arise when lower interest rates do not induce people to reduce their cash balances to increase spending on goods and services.[20]

These categories of claims are not mutually exclusive and Dowd adds that some advocates combine a number of these arguments to make their case.

## The unconvincing case that central bank credit creation can be a free lunch

The economic literature holds a view, apparently shared by Bertram, that some forms of central bank credit creation to fund deficit spending are a 'free lunch' as they create no future claim on either the central bank or the government.

This is not the general case. Governments must provide full value, in cash, for assets it purchases using Reserve Bank credit. There is no free lunch. If the government funds a fiscal deficit by direct borrowing from the central bank, the banking system's claims on the central bank increase dollar-for-dollar as the government spends the money. Banks can use those funds to settle with each other and when they settle transactions with the Reserve Bank in foreign exchange, Reserve Bank Bills and much else. Since the government owns the Reserve Bank, increased claims on the Reserve Bank are increased claims on government.

Double-entry accounting applies. When central banks buy assets from the public crediting the sellers' bank accounts in return, they give the recipient's bank a claim on the central bank. The central bank's assets and liabilities remain balanced.

Government funding from its central bank is a special case of this. If the government draws more from its Westpac bank account during the day than it has funds for, at the end of the day, it draws on the Crown's account with the Reserve Bank to top up the Westpac account. This adds to the banking system's reserves. Claims on the Reserve Bank are unchanged as the fall in the Crown's account balance is offset by the rise in banking system deposits at the Reserve Bank. If the Crown's account at the Reserve Bank is getting low, direct funding occurs when the Reserve Bank makes a paper transaction representing a loan to the government. That loan is a Reserve Bank asset, and the deposit is its offsetting liability. That paper transaction expands the Reserve Bank's balance sheet.

As the government keeps drawing down its Crown account balance to feed its Westpac account, the balance sheets of the banking system expand, but remain in balance. The Reserve Bank then has greater liabilities in bank settlement balances but owes smaller liabilities due to the diminished Crown account balance. Neither the net worth of the

[20] Dowd, op cit, 1. The fear is that people might just park the extra cash under their mattresses because of heightened uncertainty about their future prospects.

banking system nor that of the central bank has changed. At no point was there any free lunch.

Overall, government spending funded by central bank credit creation represents net borrowing from the private sector in the form of increased banking system settlement claims on the consolidated central bank and central government accounts. Despite what some say, government spending by credit creation does mean borrowing from the public.

What if the government tells the Reserve Bank to write off its loan? That merely reduces central bank equity. Since the government owns the Reserve Bank, there is no fiscal gain because the net claims of the private sector on the Reserve Bank and government combined do not change. Again, there is no free lunch.

Former Citibank chief economist Willem Buiter argued that there is a free lunch in a largely hypothetical situation. His model depends on a permanent, one-off injection of irredeemable banknotes. If people can find someone else to accept these as payment if the government will not, total spending on goods and services might rise, reducing unemployment. Yet this hypothetical appears to require that no one can use the banknotes to pay their tax liability or to meet any other government claim on them (otherwise, governments will have to borrow or raise taxes to fund the loss).

The applicability of the situation Buiter modelled to actual institutional arrangements has been questioned by economists from the Bank of International Settlements.[21] They also argue that there is no free lunch and explain that with reference to both Australia and New Zealand.

Dowd makes a related counter-argument to the free lunch proposition. Giving away banknotes (or writing off an asset that would otherwise be a claim on the private sector) means raising revenue or forgoing government spending in the fullness of time to make good the lost purchasing power. Fiscal transfers always benefit the recipient at the expense of someone else.

If there were a free lunch, the issue then arises of which projects it should be used to fund. Should the government fund every project with a net benefit at zero cost? It could mow everyone's lawn were this so. Indeed, were it free on an unlimited basis, there would be no role for private production. No private firm could compete with a government supplier with a zero cost of funds. But if the 'free' funding were limited, the government would need to allocate it to projects with the greatest benefit. The opportunity cost of the last adopted project would need to be greater than the next best project.

This argument also has a fatal political economy flaw. If a government today sees a benefit in declaring a permanent, one-off injection of cash, what will stop a future government from doing the same? A basic constitutional principle is that a current government cannot stop a future government from making its own policy decisions. Promising an action is 'one-off' has no credibility and only creates a precedent for justifying repeat doses.

Ultimately, when resources are scarce, there is no escape from the benefit lost by not funding the best projects.

## A New Zealand version of the economic inequality argument?

[21] Claudio Borio , Piti DIsyatat, anna Zabai, "Helicopter money: The illusion of a free lunch", 24 May 2016. https://voxeu.org/article/helicopter-money-illusion-free-lunch

Bertram argues that issuing government bonds imposes "a large, unnecessary and unfair wealth transfer from future taxpayers to today's older, wealthier buyers of bonds (including overseas investors)."

This is extraordinary. First, there is no wealth transfer to bond holders. They must present cash of equivalent worth to buy the bonds. Their wealth is unchanged. How can a zero-wealth transfer be unfair?

Second, bond holders are not all aged wealthy fat cats. Holders include a cross-section of retirees, government agencies such as the New Zealand Fund, ACC, Public Trust, pension funds for employees and household KiwiSaver funds.

Third, the issue is current spending, which is not financed by current revenue, not the way it is financed, that creates a current benefit at the expense of a future cost.

## The orthodox case for quantitative easing

Recourse to central bank cash can be orthodox even if it is not a free lunch. An orthodox monetary policy case can be made for using cash to buy government bonds (quantitative easing).

In the 1970s, Nobel laureate James Tobin explained why doing so twists the yield curve that traces how yields change with the time to maturity of government bonds. When central banks buy long-duration bonds in volume they raise their price.[22] This is the same thing as lowering their yield. The cash injected into the banking system should make holding cash less desirable. (The central bank controls the interest rate it pays on banking system settlement balances at the Reserve Bank.)

The hoped-for effect of quantitative easing is that plentiful cash and enticingly low borrowing costs should induce some people to purchase that weekend holiday home now rather than later.

Again, not so fast. The degree to which it stimulates overall spending in practice depends heavily on context. The higher prices benefit bond sellers at the buyer's expense. Likewise, the lower interest rates, if sustained, represent a transfer from lenders to borrowers of unchanged income within the community. Again, transfers are not a free lunch. There are winners and losers. To what extent that affects spending is uncertain. Savers might have to save more to achieve the deposit target for buying a house or retirement savings.

Effects on inflation expectations are a vital consideration. The policy intention is to lower long-term real interest rates to encourage greater real capital formation and spending on consumer durables. But if people think the central bank is aiming to lift the future rate of inflation, the fall in longer-term interest rates might be short-lived.

Nevertheless, the balance of professional opinion is that open market purchases of government bonds are more likely to be expansionary than contractionary on economic activity, in the short term.

All these arguments work in reverse for an open market purchase by the central bank of longer-term government bonds. A central bank wanting to lean against inflationary

[22] Whether the price level returns to its earlier value once the central bank has stopped buying it, depends on whether market expectations have changed, and the prevalence of domestic and global substitute bonds.

pressures might use this instrument.

Orthodox quantitative easing of the type described would net out in the long run as central bank fears about inflationary pressures are replaced by fears about deflation. No permanent depressing or lifting of government bond prices or yields is implied or contemplated.

This neutral long-run effect is consistent with the consensus that monetary policy actions will not materially influence output or employment in the long-run. What counts for output, incomes and jobs is productivity and employment growth.

## When quantitative easing becomes dangerously destabilising

New Zealand can learn from the experience of other major central banks that expanded their balance sheets by purchasing assets in response to the 2008 global financial crisis (GFC).

Where the case for open-market operations like this becomes dangerous is when it becomes a one-way street of escalating asset purchases to keep asset prices artificially high. The balance sheets of the major central banks have been getting increasingly inflated, banking systems flush with cash and interest rates kept artificially low. Heavily indebted governments naturally want them to be kept low, despite the risk to financial stability. There are few grounds for confidence that these banks and their governments know how to remedy the problem of excessive debt and unstably high asset values.

It should be no surprise that in practice, the major central banks might prove to be much keener to buy interest-earning assets than to sell them. IMF research Peter Stella wrote, "exit from this role [in stemming crises] has rarely been easy and the damage to the balance sheet and/or institutional reputation in some cases has taken decades to fully repair."[23]

Indeed, a neutral long-run effect is not what we are observing. On the contrary, it is proving to be a one-way street. The US Federal Reserve system's initial response to the 2008 global financial crisis saw its consolidated balance sheet increase from $US893 billion to $US2.2 trillion between years-ended 2006 and 2008. There was no reversal. It increased to $US4.5 trillion by 2015 and $US4.2 trillion by 2019.[24] By 30 June this year, it is likely to hit US$US7 trillion, with some on Wall Street thinking it could soon hit $US10 trillion.25

The following table shows a similar story for the Euro, the Bank of England and the Bank of Japan. In each case, asset purchases have increased the size of their balance sheet at least four-fold since 2006, while their respective governments have got deeper into debt. Government net financial liabilities for this group are all in excess of 60% of GDP. By contrast, Australia and New Zealand have come through this period in starkly better shape.

The risk is that by the end of the next decade, New Zealand could be in the same parlous shape. New Zealand's net core Crown public debt could be over 50% of GDP by the end of 2020 and rising. The Reserve Bank Act and the fiscal responsibility provisions in the Public

[23] Peter Stella, "The Federal Reserve System Balance Sheet: What Happened and Why it Matters", IMF Working Paper, WP/09/120, May 2009, 5.

[24] Chart attributed to Reserve Bank of St Louis https://www.pbs.org/newshour/economy/making-sense/how-the-feds-balance-sheet-works-and-why-investors-care

[25] https://www.pbs.org/newshour/economy/making-sense/how-the-feds-balance-sheet-works-and-why-investors-care

Finance Act are designed to protect against both spiralling inflation and public debt. The danger is that when the time comes to remember these mechanisms, the political will to adhere to those safeguards might be too weak. Most people alive today will be unaware of New Zealand's dire financial situation New Zealand which led to those safeguards being put in place.

| Central bank region | 2006 | 2019 | Proportionate Increase | Government net financial liabilities in 2019 as a % of GDP (OECD Statistics) |
|---|---|---|---|---|
| US Federal Reserve (US$ trillion) | 0.893 | 4.174 | 4.67 | 84.5 |
| Euro System (EUR billion) | 1.038 | 4.673 | 4.50 | 62.5 |
| Bank of England (£ billion, 2018 only) | 61.67 | 604.79 | 9.81 | 79.9 |
| Bank of Japan (trillion yen) | 115.5 | 573.1 | 4.96 | 125.2 |
| Reserve Bank of Australia (A$ billion) | 105.45 | 181.81 | 1.72 | -3.0 |
| Reserve Bank of New Zealand ($ billion) | 16.860 | 26.697 | 1.58 | -11.5 |

It is easy to understand the political economy reasons for why it is so hard to avoid a ratcheting up of central bank balance sheets, asset inflation and likely wage and commodity price inflation. Selling the purchased assets in an economic upswing tends to depress asset prices and lift interest rates and create public fallout from leveraged firms and individuals. Politicians and central banks would be accused of 'choking off' economic recovery and central banks would lose revenue from those assets, which may have implications for their cost structures.

The current focus of monetary policy on leaning against current recessions, perhaps at the risk of making the next recession worse, is a consequence of current arrangements. Yet the big risk from the sort of credit creation shown in the above table is to future financial stability from the temptation to excessive gearing and risk-taking based on the confidence that central banks are under-writing risk. The complexities of this issue are beyond the scope of this report.

## The dangerous current swirling in New Zealand

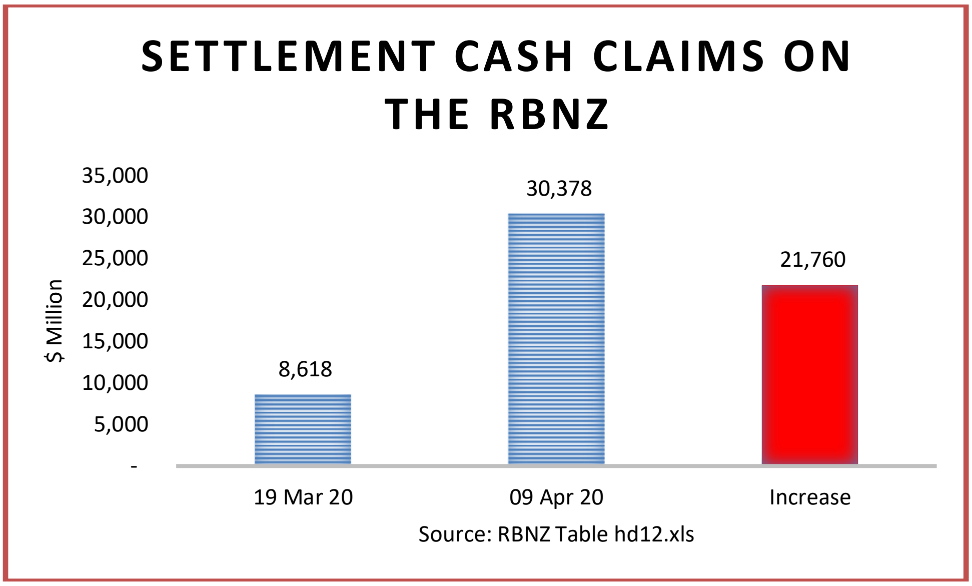
The international situation just described is extraordinarily dangerous for financial stability. Governments and central banks are trapped into creating more credit to sustain an unsustainable debt situation.

As history shows, people and companies respond to this ratcheting liquidity by borrowing as much as possible at inflated values to buy existing assets, such as houses and shares. The widespread leveraging of debt destabilises the financial system. Anything that then causes a major fall in asset prices creates a financial crisis, illiquid markets and potentially a banking crisis.

Central banks have a formal or informal lender of last resort obligation to provide liquidity in a financial crisis which creates a systemic risk to the banking system. During the response to the 2008 Global Financial Crisis, they spent trillions of dollars collectively in loans and other forms of assistance. In Europe and the US, this turned a banking crisis into an unsustainable public debt problem. As a result, these regions were poorly placed to respond to Covid-19.

New Zealand now might to be heading in the same direction. Even when it was clear that economic recovery had been prolonged, we saw the government under pressure to provide yet more fiscal stimulus – to reduce the risk of a recession.[26] Politically, monetary and/or fiscal retrenchment is something of a last resort and something best left for one's political opponents.

According to the Treasury's settlement cash measurement, there has been massive credit creation since March 19. Banking system settlement cash claims on the Reserve Bank more than doubled in about three weeks, a lift of $21.8 billion (see the following chart). Unfortunately, no hard statistical information has emerged about what assets the Reserve Bank has been buying with this money, although it has published foreign exchange swap information which implies the Bank was augmenting it, at least early in those three weeks.




Presumably, the Reserve Bank has allowed banking system cash to expand to lean against deflation and rising unemployment. But does the RBNZ have a timetable for reducing the risks to taxpayers? Again, this is uncertain.

The Reserve Bank of Australia publishes vastly more information, including a weekly summary of its balance sheets. Banking system settlement balances have also risen dramatically in Australia since early March with increased claims on "Australian dollar investments" being the balancing factor on the asset side. The latter includes loans to the government. If New Zealand had the same information available, the potential role played by foreign exchange swaps could be assessed by looking at the change in the RBNZ's holdings of foreign assets.

## Constitutional issues and central bank independence

The more a central bank impinges on fiscal policy matters, the more it risks its operational independence is at risk. [27]Under current arrangements, it has operational independence to implement monetary policy objectives that are specified by the government of the day. Fiscal policy is much more under more direct political control.

Manipulation of interest rate differentials, which are central to monetary policy, are broad

[26] The government's announcement in January 2019 of $12 billion of additional spending on infrastructure followed such pressures.
[27] See above for the Reserve Bank of Australia's opinion on this matter.

brush, largely in discriminatory instruments from a fiscal perspective. They are not like welfare benefits, taxes, subsidies or grants for various groups.

The notion that central banks will decide whom in the community is most deserving of helicopter money (cash deposited in bank accounts) or which companies can access Reserve Bank support through loans or equity offends the doctrine that Parliament determines fiscal policy and does not delegate the power to tax. [28]

Excessive recourse to Reserve Bank credit could be deeply corrupting of institutional integrity. It undermines the separation of executive powers and obfuscates purpose and transparency.

## Concluding comments

Deficit spending is reasonable in a crisis but it should be responsible, restrained and prudently funded. It also needs to be stopped and reversed within a credible time frame.

Deficit spending funded by borrowing from the central bank that is not expected to be reversed is a route to financial instability and in the extreme, government default.

Large scale central bank purchases of government or private assets funded by credit creation are a more general source of potential financial instability. These are dangerous instruments because their costs and risks are hidden.

They also involve the central bank in matters that are essentially fiscal, undermining its legitimacy as a politically impartial monetary policy functionary.

The danger for fiscal policy is that having abandoned the appearance of fiscal discipline, encouraging the feeling that the public purse is bottomless, the government will be unable to run offsetting fiscal surpluses when needed. A related danger is that the Reserve Bank will prove to be no better than other central banks in shrinking its balance sheet after this crisis and before the next one.

The fiscal prudence provisions in the Public Finance Act requires governments to provide a plan for restoring fiscal surpluses to get public debt back to prudent levels. The 2020 Budget promises to be a major test for these provisions and this government.

New Zealanders may have to wait until then to see how the government is planning to fund the ongoing operating deficits beyond June 30 and what its planned timetable is for returning to offsetting operating surplus if it has one.

The government's credibility as an economic manager is at risk. If it gets these decisions wrong, New Zealand governments will be crippled by debt for the foreseeable future and central bank legitimacy could be compromised.

[28] The Governor of the Reserve Bank is encroaching on fiscal policy when he commented this week that "I can see the Government being an equity owner in a lot of businesses under a few scenarios" https://www.stuff.co.nz/business/121162343/business-and-government-will-need-to-join-hands-to-steer-clear-of-dark-places?cid=app-iPad This is not a monetary policy matter