22 May 2020

Deborah Russell MP
Chair Finance and Expenditure Select Committee
Parliament Buildings
Wellington

Dear Chair

Thank you for your invitation to provide a written submission in relation to the **Petition of Stuart Bramhall and 5,363 others** (the petition).

The Reserve Bank of New Zealand (the Reserve Bank) is aligned with the petitioner's view that New Zealand's monetary system should be structured so as to maximise the prosperity and wellbeing of all New Zealanders. We are open to new ideas and seek continuous improvement in New Zealand's monetary system.

However, in the Reserve Banks' opinion, the proposals contained in the petition would not necessarily achieve better economic, social, environmental, and business outcomes, or deliver the benefits that the petition claims. Therefore, the Reserve Bank does not consider further formal inquiry into this issue to be the optimal allocation of resources. The attached submission outlines the Reserve Bank's reasons.

The Reserve Bank is happy to engage further directly with the petitioners to clarify its views. If the Finance and Expenditure Select Committee decides to hold any inquiry into the proposals contained in within the petition, the Reserve Bank would like to be involved.

Yours sincerely

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Introduction

1. The Finance and Expenditure Select Committee has invited the Reserve Bank of New Zealand (the Reserve Bank) to provide a written submission in response to the Petition of Stuart Bramhall and 5,363 others (the petition). The petition requests:

   - *That the House of Representatives inquire into giving the Reserve Bank of New Zealand the sole ability to issue all New Zealand money, whether notes, coins, or electronic.*

2. To support the Financial Expenditure Committee's deliberation, this paper provides a brief summary of how money and credit are created in New Zealand. The remainder of the paper addresses four distinct issues arising from the petitioner's submission:

   a. Should the Reserve Bank issue a retail central bank digital currency?
   b. Should the Reserve Bank engage in direct monetary financing?
   c. Should some current banking activities be prohibited?
   d. How can policy best support the goals of financial stability, price stability, and housing affordability?

I) Money and money creation in New Zealand

3. The New Zealand banking system operates under a well-established legal framework, in which the Reserve Bank of New Zealand has the sole right to issue legal tender in New Zealand, in the form of bank notes and coins. Banknotes and coins make up just 2 percent of what most people conceive of as money. [1] A common definition of money also includes:

   a. Settlement cash, in the form of account balances within the Reserve Bank's Exchange and Settlement System, ESAS; and
   b. Account balances with banks and other deposit-takers.

4. These other assets derive their value and their status as money from the fact that they can be used as a store of value, a unit of account, and a means of payment. Given this definition, any person or institution can create money by providing an asset that can be readily exchanged for goods and services at par value with legal tender.

5. Deposit accounts at banks are one such asset. Bank deposits represent a contractual obligation on the bank to provide electronic payments and/or cash withdrawals to the depositor in accordance with the stipulated contractual maturity. In simpler language, a deposit is an IOU.

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[1] Broad money (M3) as defined in the Reserve Bank of New Zealand's money and credit aggregates, c-50 data collection.

6. A bank can create a new IOU by granting a loan to a customer and crediting the value of the loan to that customer's deposit account. Because the deposit can readily exchanged for goods and services at par value with legal tender, new money has been created. Building societies, credit unions, and finance companies all create money in the same way as banks. There is no legal restriction on the type of institution that may create money in New Zealand.[2]

7. The rate of credit growth in New Zealand is determined by the balance supply and demand for credit in a competitive market, conditional on the monetary policy of the central bank. While banks influence the total amount of money in the banking system through their lending decisions, they cannot do so freely and without limit, for two reasons:

    a. Firstly, a bank can only create money if it has a customer that wants to borrow money at any given interest rate — meaning the creation of money is limited by the amount of money that people and businesses want to borrow.

    b. Secondly, every deposit created becomes a liability of the bank. The bank is obligated to provide electronic payments and/or cash withdrawals to the depositor in accordance with the terms of the contract. Banks' lending is therefore constrained by the costs of fulfilling these obligations, and their ability to manage the risks associated with lending.

8. The Reserve Bank has significant influence over creation of credit through its monetary policy. The Reserve Bank conducts its monetary policy in order to achieve its inflation and employment objectives, with growth in the money supply as an intermediate outcome. When the Reserve Bank raises interest rates, borrowing becomes more costly, demand for credit falls, and inflationary pressures are reduced. When the Reserve Bank lowers interest rates, the opposite occurs. The Reserve Bank also influences the money supply more directly when it purchases financial assets and small amounts of foreign currency. In New Zealand, the Reserve Bank has recently increased the rate of money creation by purchasing large volumes of New Zealand Government bonds through its large-scale asset purchase programme (LSAP).

II) Should the Reserve Bank issue a retail central bank digital currency?

9. The petitioner's submission proposes that the Reserve Bank issue a central bank digital currency that is widely available to private citizens (CBDC). While the Reserve Bank is open to the idea of exploring the merits of producing a CBDC in the future, it is not in a position to do so at this time.

[2] For a detailed description of how money is created please see Lawrence (2008) 'The Reserve Bank, private sector banks and the creation of money and credit,' Reserve Bank *Bulletin 71,(1).*

10. The Reserve Bank has explored some of the costs and benefits of producing a digital currency in its Bulletin[3] publication. We conclude that there would be both costs and benefits, and that further research would be required to support the establishment of a central bank currency.

11. Contrary to the arguments set out in the petitioners' submission, we find that one of the costs of a CBDC is increased risks for financial stability for a range of reasons. Firstly, the availability of an electronic alternative to bank deposits could increase the probability and severity of bank runs, particularly if a CBDC is perceived as more 'safe' thank bank deposits in times of crisis. Secondly, deposits are a relatively cheap and low-risk source of funding for banks. If these deposits were unavailable to banks, and instead tied up in transactional CBDC accounts, banks would likely turn to overseas wholesale funding, increasing their exposure to downturns in overseas markets. These findings are aligned with a similar investigation by the Bank for International Settlements Committee on Payments and Market Infrastructures.[4]

12. A number of central banks around the world have investigated the possibility of producing a CBDC. Some jurisdictions, including Denmark and Switzerland, have determined that, currently, the costs of a retail CBDC would outweigh the benefits.[5] Others continue to actively develop prototype CBDCs. However, around the world, this research is still in its infancy, and a widespread retail CBDC has not been tested in any country.

13. Importantly, in the Reserve Bank's research, as well as in international examples, the CBDC is intended to circulate concurrently with other means of payment, including bank deposits and cash. To our knowledge, there are currently no central banks with plans to issue CBDC as a complete replacement for conventional bank deposits.

III) Should the Reserve Bank directly finance Government expenditure?

14. The petitioner's submission recommends that the Reserve Bank maintains growth in the money supply by creating new money and crediting it to the Government's accounts. This mechanism is commonly referred to as direct monetary financing. Monetary financing involves financing a fiscal deficit by an increase in the non-interest-bearing monetary base, rather than the issuance of interest-bearing debt.

15. In the short term, monetary financing can support aggregate demand by easing financial conditions, similar to the effect of monetary easing via lower interest rates or Large Scale Asset Purchases (LSAPs) funded by an increase in interest-bearing settlement balances. In the long run, any extended period of ongoing monetary financing, without any indication that it was 'one-off', for a 'specific use' and subject to strict 'activation triggers' would result in higher inflation, all else equal. In that sense, there is no 'free lunch' from

[3] Wadsworth (2018). The pros and cons of issuing a central bank digital currency. Reserve Bank of New Zealand *Bulletin*, 81(7). See also Bascand (2018) In search of gold: Exploring central bank digital currency. Speech delivered to The Point Conference, Auckland.

[4] Central Bank Digital Currencies, (March 2018), Bank for International Settlements Committee on Payments and Market Infrastructures

[5] Auer, Cornelli, and Frost (2020). Taking stock: ongoing retail CBDC projects. BIS Quarterly *Review*. March

ongoing direct monetary financing, with any perceived ‘savings’ on interest likely borne by taxpayers through inflation and/or higher interest rates elsewhere in the economy.

16. Direct monetary financing carries some risks. For example, if the use of monetary financing was perceived as representing either a loss of fiscal discipline or an abandonment of mainstream monetary policy, the impact is highly uncertain but could lead to rising inflation expectations, an erosion of trust in economic institutions, and/or a downgrade in credit ratings. Any of these outcomes could see New Zealand’s country risk-premium rise, resulting in a higher cost of borrowing in New Zealand. Carefully designed institutional arrangements would be needed to mitigate these risks.

17. The current institutional arrangement is for the Monetary Policy Committee (MPC) of the Reserve Bank to make decisions on the stance of monetary policy to achieve its inflation and employment objective. Since March this year, the MPC has decided to provide monetary stimulus through the undertaking Large Scale Asset Purchases (LSAPs) of New Zealand government bonds in the secondary market, funded by an increase in interest-bearing settlement balances.

IV) Should some banking activities be prohibited?

18. There is some ambiguity as to the intention of the petitioners request in relation to “*giving the Reserve Bank of New Zealand the sole ability to issue all New Zealand money, whether notes, coins, or electronic*.” As outlined in *section I* of this document, under the current legal framework, the Reserve Bank of New Zealand has the sole right to issue legal tender in New Zealand, which takes the form of bank notes and coins. There is no restriction as to what type of institution can provide IOUs in the form of deposit accounts.

19. One possible interpretation of this proposal is that that private institutions be prohibited from establishing on-call deposit accounts. This interpretation is consistent with the role of banks as financial intermediaries as described in *‘Section 3: How the positive Money proposal would work’* of the petitioner’s written submission. Banks use on-call deposit account to provide valuable payment and store of value services to society. In return, banks use on-call deposits as a relatively stable and cheap source of funding. Without on-call deposits, banks would be driven to less stable and more-costly forms of funding, resulting in higher prices for bank customers and greater risk to financial instability. At the same time, banks could continue to lend and create money as they currently do, by crediting the value of new loans to term deposit accounts, or by making equivalent payments into CBDC transactional accounts. Therefore, the prohibition of private on-call deposit accounts would have significant costs, and would not materially change the mechanics of the monetary system or the creation of money by banks.

20. Another interpretation of the proposal is that banks should be prohibited from creating new money through lending. In order to prevent banks and other financial institutions from creating new money through lending, banks would need to be required to hold settlement cash reserves or CBDC equal to the full value of their lending at all times. This type of regulation is sometimes referred to as ‘full-reserve banking.’

21. If banks were required to pre-fund all new lending with settlement cash or CBDC, and new settlement cash could not be created by the central bank, the availability of private

sector credit would be significantly constrained. While banks could continue to act as intermediaries between savers and borrowers under the proposed new monetary system, their ability to adapt flexibly to changes in demand would be diminished.

V) How can policy best support the goals of financial stability, price stability, and housing affordability?

Maintaining price stability and supporting employment near its maximum sustainable level

22. The petition asserts that price stability could be achieved by carefully controlling growth in the money supply. Stabilising inflation through control of monetary aggregates was a popular concept in the highly-regulated economy of the 1970s and 1980s. However, the Reserve Bank's experience of targeting the quantity of money in the post-liberalisation period is that it resulted in unnecessary volatility in interest rates and exchange rates. Furthermore, our experience has been that is interest rates are a more effective means of stabilising employment and inflation than direct control of monetary aggregates. For almost 30 years, this strategy has been successful in meeting the Reserve Bank's objectives of low and stable inflation and, more recently, support for employment near its maximum sustainable level.

Preventing bank failure and financial crises

23. Banks can fail for one of two reasons; either because the bank takes on liabilities greater than the value of their assets (the bank becomes insolvent); or because a maturity mismatch between the banks income and outflows means that the bank is unable to fulfil its obligations as they arise (the bank has insufficient liquidity). This happens when a bank either overestimates expected returns, or underestimates risks. The holding of term deposits in Reserve Bank CBDC accounts would do nothing to change this. Banks have numerous financial liabilities that are not associated with their on-call deposits, such as term deposits, domestic wholesale and offshore funding. The Reserve Bank considers on-call deposits to be a relatively low-risk source of bank funding. Therefore, all else equal, restricting the use of on-call deposits for lending could increase the probability of a bank failure.

24. The Reserve Bank has a well-established framework for ensuring that banks operate prudently, and that the cost of bank failures is borne primarily by investors with a sound understanding of the associated risks, rather than depositors. The wide range of tools the bank uses to reduce the probability of bank failures, and to reduce the costs when they occur, are summarised in its Bulletin.[6]

Protecting deposits in transactional accounts

25. A key benefit of the petition's CBDC proposal is that deposits in CBDC accounts would be completely risk-free. While we acknowledge the benefits of providing public access to a risk-free asset, we note that the reduction is risk is not costless. The cost of protecting deposits by holding them in Reserve Bank CBDC accounts is the opportunity cost of deploying these funds more productively.

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[6] See Hunt (2017). Independence with accountability: financial system regulation and the Reserve Bank. Reserve Bank *Bulletin.* *80,*(11) and Hunt (2016). A short history of prudential regulation and supervision at the Reserve Bank. Reserve Bank *Bulletin* *79,*(14)

26. Deposit insurance, whether privately or publically funded, provides a more efficient mechanism for mitigating risk. In 2019, the Government announced its intention to insure bank deposits up to a value of $50,000 via a new 'Deposit Takers Act.'[7]

Improving housing affordability

27. The petition argues that the current monetary system has been a key driver of high house price inflation relative to generalised inflation throughout the economy. This claim is not supported. Because banks can only create money where there is demand for loans, the primary drivers of house price inflation are demand for and supply of housing. A wide range of factors have contributed to house price inflation including population growth, capacity constraints in the construction sector, taxation policy, low interest rates, and expectations of future house price inflation.

28. If the level of house prices is a primary concern for the submitters, then there are other, more efficient ways to improve housing affordability. The Productivity Commission recently completed an inquiry into housing affordability in New Zealand, and found measures to improve land availability and reduce the costs of planning and building houses to be the most effective way of improving housing affordability in New Zealand.[8]

[7] More information about the Reserve Bank Act Review (Phase 2) is available at the Treasury's website

[8] More information about the inquiry is available at the Productivity Commission's website.