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Submission to the New Zealand Productivity Commission

Low - emissions economy inquiry

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The biggest bar to implementing many of the suggestions in the report, and the one that will cause delays and even failure to do so is not willingness to make change, but the financial burden involved in doing so.

No where does the Issues paper canvas any innovative funding mechanisms for research and development, development of new technology, implementation of new processes or strategies for moving from the current state of emissions to new lower targets.

The major unexplored funding mechanism is that of government or central bank created money – not borrowed from any other source. It is a mechanism that was used very successfully by the government elected in New Zealand in 1935 following the great depression.

As a report written in 1949 by the Ministry of Works states*: "To finance its comprehensive proposals, the Government adopted the somewhat unusual course of using Reserve Bank credit, thus recognising that the most important factor in housing costs is the price of money - interest is the heaviest portion in the composition of ordinary rent. The newly-created Department was able therefore, to obtain the use of funds at the lowest possible rate of interest, the rate being 1per cent for the first £5,000,000 advanced and 1.5 per cent on further advances.*

The sums advanced by the Reserve Bank were not subscribed or underwritten by other financial institutions. This action showed the Governments intention to demonstrate that it was possible for the State to use the country's credit in creating new assets for the country".

This allowed Michael Joseph Savage's government to build 30,000 houses, and at the same time fund the dairy board and other producer boards from that same Reserve Bank source.

There is significant support locally and internationally for that funding mechanism to be used again for similar asset and infrastructure building projects.

Former Vice Chancellor of Waikato University, Bryan Gould, wrote a column on that subject just this month as follows:

"New Zealanders like to think that we are, in most respects, up with - if not actually ahead of – the play. Sadly, however, as a new government is about to emerge, there is no sign that our politicians and policymakers are aware of

recent developments in a crucial area of policy, and that, as a result, we are in danger of missing out on opportunities that others have been ready to take.

The story starts, at least in its most recent form, with two important developments. First, there is the now almost universal recognition that the vast majority of money in circulation is not – as most people once believed – notes and coins issued on behalf of the government by the Reserve Bank, but is actually created by the commercial banks through the credit they advance, using bank entries rather than cash, and usually on mortgage.

The truth of this proposition, so long denied, is now explicitly accepted by the Bank of England, and was – as long ago as 1994 – explained in a letter written by our own Reserve Bank to an enquirer, and stating in terms that 97% of the money included in the usually used definition of money known as M3 is created by the commercial banks.

The proposition is endorsed by the world's leading monetary economists – Lord Adair Turner, the former chair of the UK's Financial Services Authority and Professor Richard Werner of Southampton University, to name but two. These men are not snake-oil salesmen, to be easily dismissed. They have been joined by leading financial journalists, such as Martin Wolf of the Financial Times.

The second development was the use by western governments around the world of "quantitative easing" in the aftermath of the Global Financial Crisis. "Quantitative easing" was a sanitised term to describe what is often pejoratively termed "printing money" – but, whatever it is called, it was new money created at the behest of the government and used to bail out the banks by adding it to their balance sheets.

These two developments, not surprisingly, generated a number of unavoidable questions about monetary policy. If banks could create billions in new money for their own profit-making purposes, (they make their money by charging interest on the money they create), why could governments not do the same, but for public purposes, such as investment in new infrastructure and productive capacity?

And if governments were indeed to create new money through "quantitative easing", why could that new money not be applied to purposes other than shoring up the banks?

The conventional answer to such questions (and the one invariably given in New Zealand by supposed experts in recent times) is that "printing money" will be inflationary – though it is never explained why it is miraculously non-inflationary when the new money is created by bank loans on mortgage or is applied to bail out the banks.

But, in any case, the master economist, John Maynard Keynes, had got there long before the closed minds and had carefully explained that new money could not be inflationary if it was applied to productive purposes so that new output matched the increased money supply. Nor was there any reason why *the new money should not precede the increased output, provided that the increased output materialised in due course.*

Those timorous souls who doubt the Keynesian argument might care to look instead at practical experience. Franklin Delano Roosevelt used exactly this technique to increase investment in American industry in the year or two before the US entered the Second World War. It was that substantial boost to American industrial capacity that was the decisive factor in allowing the Allies to win the war.

And the great Japanese (and Keynesian) economist, Osamu Shimomura, (almost unknown in the West), took the same approach in advising the post-war Japanese government on how to re-build Japanese industry in a country devastated by defeat and nuclear bombs.

The current Japanese Prime Minister, Shinzo Abe, is a follower of Shimomura. His policies, reapplied today, have Japan growing, after years of stagnation, at 4% per annum and with minimal inflation.

Our leaders, however, including luminaries of both right and left, some with experience of senior roles in managing our economy – and in case it is thought impolite to name them I leave it to you to guess who they are - prefer to remain in their fearful self-imposed shackles, ignoring not only the views of experts and the experience of braver leaders in other countries and earlier times, but – surprisingly enough – denying even our own home-grown New Zealand experience.

Many of today's generation will have forgotten or be unaware of the brave and successful initiative taken by our Prime Minister in the 1930s – the great Michael Joseph Savage. He created new money with which he built thousands of state houses, thereby bringing an end to the Great Depression in New Zealand and providing decent houses for young families (my own included) who needed them.

Who among our current leaders would disown that hugely valuable legacy?

Amongst the eminent international support for Mr Gould's contentions is a report from senior researchers at the International Monetary Fund. Authors of the report, The Chicago Plan Revisited, Michael Kumhof (now Senior Research Advisor at the Bank of England's Research Hub), and Jaromir Benes, have the following to say in its conclusion –

"This paper revisits the Chicago Plan, a proposal for fundamental monetary reform that was put forward by many leading U.S. economists at the height of the Great Depression. The critical feature of this model is that the economy's money supply is created by banks, through debt, rather than being created debt-free by the government.

Our analytical and simulation results fully validate Fisher's (1936) claims. The Chicago Plan could significantly reduce business cycle volatility caused by *rapid changes in banks' attitudes towards credit risk, it would eliminate bank runs, and it would lead to an instantaneous and large reduction in the levels of both government and private debt. It would accomplish the latter by making government-issued money, which represents equity in the commonwealth rather than debt, the central liquid asset of the economy.*

This ability to generate and live with zero steady state inflation is an important result, because it answers the somewhat confused claim of opponents of an exclusive government monopoly on money issuance, namely that such a

monetary system would be highly inflationary. There is nothing in our theoretical framework to support this claim. And as discussed in Section II, there is very little in the monetary history of ancient societies and Western nations to support it either.

Further support comes from Martin Wolf - Associate Editor and Chief Economics Commentator at the Financial Times, London. He was awarded the CBE (Commander of the British Empire) in 2000 for services to financial journalism. He was made a Doctor of Science (Econ), *honoris causa*, by the London School of Economics in December 2006. Mr Wolf was appointed a member of the UK government's Independent Commission on Banking in June 2010.

In articles in the Financial Times in 2014 he wrote:

"A final instrument is "helicopter money" - permanent monetary emission for the purpose of promoting purchases of goods and services either by the government or by households.

The central bank would create new money as needed to promote non-inflationary growth. Decisions on money creation would, as now, be taken by a committee independent of government.

From a monetary point of view, this is the equivalent of intentionally permanent Quantitative Easing.

The new money would be injected into the economy to finance government spending, in place of taxes or borrowing;"

Lord Adair Turner concurs. He was Chairman of Britain's Financial Services Authority, the British Pensions Commission, the Committee on Climate Change, Director-General of the Confederation of British Industry, and former vice chairman of Merrill Lynch Europe.

The following is taken from his book "Between Debt and the Devil" published in 2017 and from a paper delivered to an IMF conference in 2015:

There exist some circumstances in which the government should have a tax cut or public expenditure and it should be funded by permanent money creation by the central bank.

The central bank directly credits the government current account and records it as an asset - a non - interest - bearing non - redeemable "due from government" receivable.

And the government is thus able to cut taxes or increase expenditure without

incurring any future liability to pay more interest, or to redeem the capital value of the money created.

In this section I argue that the technical case for monetary finance is clear and undeniable.

Milton Friedman is rightly seen as a central figure in the development of free market economics and in the definition of policies required to guard against the dangers of inflation. But Friedman argued in an article in 1948 not only that government deficits should sometimes be financed with fiat money but that they should always be financed in that fashion with, he argued, no useful role for debt finance.

Under his proposal, "government expenditures would be financed entirely by tax revenues or the creation of money, that is, the use of non-interest bearing securities" (EXHIBIT 1) (Friedman, 1948). And he believed that such a system of money financed deficits could provide a surer foundation for a low inflation regime than the complex procedures of debt finance and central bank open market operations which had by that time developed.

There are numerous international supporters, and to quote them all would make this a very lengthy submission. Amongst them are :-

Professor Richard Werner, a German academic, economist and professor at the University of Southampton. In 1991, he became European Commission-sponsored Marie Curie Fellow at the Institute for Economics and Statistics at Oxford. He became the first Shimomura Fellow at the Research Institute for Capital Formation at the Development Bank of Japan. His doctorate in economics was conferred by Oxford University.

Professor Steve Keen, an Australian-born, British-based economist and author. He completed his PhD in economics at the University of New South Wales in 1998. He is Head of the School of Economics, History and Politics at Kingston University in London. He is also a fellow at the Centre for Policy Development.

There is local support for the concept too. Bernard Hickey is a leading financial journalist and editor with over 23 years' experience including roles with Reuters, the Financial Times Group and Fairfax Media in Wellington, Canberra, Sydney, London and Singapore. He is a senior contributing editor for interest.co.nz, and writer for Newsroom and the Herald.

In a column "Power of printing money" for the Herald in 2012, he wrote

"I am about to commit economic heresy, but at least I'm in auspicious company and it's something our own Reserve Bank and government has done before.

It's time the Reserve Bank of New Zealand started printing money and lending to our government to build houses and infrastructure, particularly in Christchurch.

Even a couple of years ago, this would have been unthinkable to say, even treasonous. I'm sure many readers will still believe such money-printing is dangerous madness guaranteed to debase the currency, create hyper-inflation and empower politicians to go on an even bigger spending spree.

But we've been here before and right now our major trading partners are doing exactly this. We should at least be talking about it.

Back in the very early days of the Reserve Bank, shortly after the first Labour Government was elected in 1935, the bank lent money created out of thin air to the government and producer boards. It was used to build state houses and help fund exports of meat, wool and dairy products.

This first bout of quantitative easing helped pull the New Zealand economy out of the Great Depression of the 1930s although, to be fair, many other policy actions taken by the previous centre-right United-Reform coalition helped rebuild the economy and reduce unemployment.

New Zealand benefited with the rest of the British Empire when the British pound was removed from the gold standard and the local economy rebounded after it devalued its currency against the pound in 1933.

But the creation of the Reserve Bank in 1934 and the drive, led by Labour's John A. Lee, for a state house-building programme led to the Reserve Bank being nationalised and starting to lend to the government.

Fast-forward to the global financial crisis. Now central banks throughout the Northern Hemisphere are doing similar things.

The United States Federal Reserve, the Bank of Japan, the Bank of England, the Peoples' Bank of China and the European Central Bank have printed a combined US$10 trillion ($12 trillion) in the past four years and spent it on all manner of bonds and cash injections into banking systems.

This process, known as "quantitative easing", is often a last resort after interest rates have been cut to almost zero.

Many argue it has been ineffective because the money went straight into the banking system and parked there, or was used to pump up the prices of various assets, including shares, gold and bonds.

Lending this new money directly to governments to spend immediately on infrastructure, goods and services would have been a much wiser idea. China did this most effectively.

However, this also only works when it doesn't create inflation.

This is the crucial question that is now being debated by a relatively new brand of economics known as "modern monetary theory", which says deficit spending from newly printed money is unlikely to create inflation as long as there are unemployed people and assets such as buildings and machinery sitting around doing nothing.

The Reserve Bank has already said such a quantitative easing could be considered, but not yet because it has room to cut its official cash cate further towards 0 per cent from 2.5 per cent.

But isn't it better for our Government to be borrowing from its own central bank than from foreign banks and pension funds? Wouldn't it be better employing the unemployed to build new houses and repair Christchurch's infrastructure than to just sit back and let it happen? Wouldn't it be better to print the money to fund the deficit than choose to sell public assets to do it? It would devalue our currency, but is that such a bad thing when we need to boost our exports?

The big question concerns inflation. At present, New Zealand's inflation is under control and the experience in Japan is that money-printing over decades has not created inflation.

Neither is it creating inflation in Europe or the US at the moment.

Here endeth the heresy and the history lesson."

This was followed by "Money-printing will work if controlled"

"I argued last week that New Zealand should again look at printing money to build houses and infrastructure in Auckland and Christchurch. We did it in 1936 and we could again as long as it doesn't create inflation.

It sparked a firestorm of commentary and criticism. Money-printing, or quantitative easing, would have to occur with a range of responses.

First, there's a risk of generating inflation - but only if resources are fully employed. Building houses, bridges, motorways, broadband, water treatment and electricity networks takes all sorts of resources, some imported.

One claim is that a burst of extra spending would boost wages and construction material prices. That is true if there are shortages of skilled tradespeople and a lack of production capacity for materials.

Skill shortages must be addressed, but there is something wrong if we can't train the unemployed. Or we could increase immigration, which would also boost the economy.

Construction material inflation is another issue. The Productivity Commission has said that the concentration of ownership of construction material companies (Carter Holt and Fletcher Building) may be a factor in materials costing more here than in Australia.

But it said it was unclear extra competition would cut costs. The report shows

material inflation has been marginally ahead of consumer price inflation in the past 15 years, but not greatly so. There is plenty of capacity around at present.

The real problem has been an escalation of building consent costs, driven largely by councils. Therefore, any move to print and build would require central Government to more closely monitor and reform the way local *governments charge. Wage inflation is also a risk, but again there are few signs that it is out of control.*

Second, there is a risk that money-printing empowers politicians to go on a giant lolly scramble or, even worse, funnel money to "friends" in the large companies that dominate our construction and infrastructure industries.

This would have to be addressed by an independent commission. It would mean any surge in spending with printed money was directed to useful infrastructure that generated economic returns in the long run.

The third criticism is that money-printing would cause a balance of payments crisis as imports jumped, as happened in the 1930s.

But this time we have a floating currency. Money-printing would drive the dollar lower, making imports more expensive and generating extra export revenues.

Some say it would also drive up interest rates. That hasn't happened in America, Japan and Europe."

Conclusion

Government has, through its ownership of the central bank (the Reserve Bank) the power to create new money, without the bank needing to get it from anywhere else, and to spend it into the economy. There is not unlimited capacity to do this, but there is significant capacity to do so without inflationary consequences, especially if the new money is invested in creating assets or developing production.

That capacity could be used to fund research and development, development of new technology, and incentivise the implementation of new processes or strategies for moving from the current state of emissions to new lower targets.

Other funding mechanisms such as additional taxes on businesses will result in higher prices for consumers as those taxes are costed into the price of products.

This, or additional taxes on the public, or commercial bank borrowing by the government (the interest on which, and the loan itself, will have to be paid for by taxpayers) will impose further heavy burdens on the public, many of whom are barely surviving economically now.

There is both local and international support, from highly qualified economists, academics, and commentators, for using this funding mechanism.

We submit the Productivity Commission recommend the use of new central bank created money to fund the transition to a new low carbon economy.

Chris Leitch

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