A note on Grant Roberston's letter of 10 August 2020 to Alan Mark and Dugald McTavish

Geoff Bertram

24 August 2020

Wise Response wrote to Finance Minister Grant Robertson in May 2020 setting out five reasons in support of direct money financing of the Government's budget deficit. That letter is in Appendix 1 below.

Grant Robertson's reply (Appendix 2 below) is a disappointing mishmash of assertions, ideology, speculative possibilities, dodgy economics and conventional wisdom, all crowded into a page and a half of authoritative-sounding prose. It seems intended not to persuade or engage, but rather just to intimidate potential critics of the position the Minister has chosen to adopt. The Minister's letter gives pride of place to two keystones of the neoliberal case for fiscal austerity: first the supposedly sacrosanct status of "central bank independence" , and secondly the transfer of responsibility for macroeconomic management to the central bank and away from the Treasury.

Two propositions drawn from "Modern Monetary Theory" (but with a much older pedigree in macroeconomic thinking) are attacked in the Minister's **first substantive paragraph**. Those propositions are:

1. A sovereign-currency-issuing Government such as New Zealand's has no need to "raise finance" to fund its expenditure. New money is automatically created and injected by the process of Treasury spending.

   Robertson simply does not accept this. In his first paragraph he baldly states that "to fund new spending increases… the Government is raising debt", and speaks of "raising new funding". The MMT characterisation would be that fiscal spending requires no funding, as it funds itself. The issuing of government debt instruments is a separate decision unrelated to any need to "raise finance", because government is not like a firm or a household. The Minister's position is reflective of an ideological belief that any and every fiscal deficit must be accompanied by an equal amount of new debt issuance.

2. Inflation, MMT argues, is caused primarily by excess aggregate demand in the markets for goods and services, and curbing inflation from this source is most effectively done not by the indirect blunt instrument of "monetary policy" but by a combination of fiscal and monetary measures focused on the demand side.

   Robertson's first paragraph delegates to the Reserve Bank the task of "supporting economic activity and inflation", implicitly denying a central role for fiscal policy on those fronts. While it is certainly true that the RBNZ's frantic buying-up of bonds (much of it to mop up the contractionary consequences of the Treasury's equally frantic bond-selling programme) has kept interest rates low, and consequently has reduced borrowing costs throughout the economy, this does nothing much to "support activity" or raise inflation in the current situation, given that demand for credit has dried up. Conventional monetary policy, which relies entirely on the interest rate, and hence the credit market, to do the heavy lifting, is "pushing on a piece of string" in these conditions and accordingly ineffective. Hiding behind the alleged primary responsibility of the RBNZ to support economic activity is an unhelpful abdication of responsibility by the Minister of Finance.

The **second substantive paragraph** of the Minister's letter flatly rejects the notion that the RBNZ should directly finance Treasury's spending by issuing money, and sticks with the present roundabout route whereby Treasury issues bonds and the RBNZ buys them up, allowing private-sector intermediaries to clip the ticket on the way through. Three points in support of his position are made by the Minister in this paragraph.

- First, "monetary financing" and "social credit" are rolled together, with the evident intention of tarring the first with the politically-toxic social credit brand. That's just a cheap shot that avoids confronting the actual detail of monetary financing proposals.
- Second it is alleged that direct financing "could" (not "would", and it's certainly neither a necessary nor even a very likely outcome) "compromise the independence" of the RBNZ. That overblown claim is embellished in paragraphs 3 and 4 which I discuss below. But Ben Bernanke's 2003 comment holds good: "greater cooperation for a time between the central bank and the fiscal authorities is in no way inconsistent with the independence of the central bank, any more than cooperation between

two independent nations in pursuit of a common objective is inconsistent with the principle of national sovereignty".

- Third, it is claimed that direct monetary financing "would not necessarily" result in better economic outcomes or lower debt servicing cost. The opposite is, of course, equally true: monetary financing would not necessarily result in worse outcomes or higher debt servicing cost. This is just hot air at this stage, but a couple of more substantive arguments about the issue are in paragraphs 5 and 5.

In the **third substantive paragraph** the independence of the RBNZ is alleged to be preserved by the current arrangements, but threatened by direct monetary financing. No real reason why this must be the case is offered – just a series of assertions that I would translate as "it's true because I say it's true". Indeed as the second sentence of the paragraph notes, New Zealand's present arrangement is a matter of choice, and indeed many other countries have made the same choice, in a era when the ideological and cosmetic appeal of "central bank independence" has been strong and group-think has prevailed. The real issues are whether the choice of institutional architecture was sensible then, and whether it is still a sensible choice now. MMT would say that the choice was always unwise, and that exclusive reliance on the central bank to quell inflation inevitably meant resorting to unemployment and an overvalued exchange rate as the main weapons, with rising inequality and de-industrialisation as the inevitable outcomes. I personally would argue that the alleged division between fiscal and monetary policy was never really coherent so long as the issuing of government debt is a responsibility of Treasury rather than the RBNZ, which means that it is Treasury that controls the immediate monetary effects of fiscal policy, leaving the RBNZ only a residual role to pick up the pieces afterwards. Much simpler and more transparent would be for Treasury to focus on managing flows of tax and spending while the RBNZ deals with monetary conditions. That, however, would kill off Treasury's current pre-eminent position. Essentially, the hyperventilating about central bank independence is largely to do with a bureaucratic turf war, with the economy at large held hostage to Treasury's rigid ideologically-driven insistence on "full funding" of any deficit.

The final sentence of that third paragraph is about the RBNZ's "credibility" – or what Paul Krugman memorably calls "the confidence fairy". Somebody somewhere supposedly has to believe in the RBNZ if it is to be able to promote price stability, employment, expectations and "fiscal discipline by exposing the government to market pricing signals". How a non-credible central bank could somehow shield government from exposure to market pricing signals is not explained - here as elsewhere we are dealing with unsupported assertions that largely evaporate if you stop to think about them. But not allowing the reader to stop and think is the essence of the entire letter – the aim is to overwhelm with a dense flood of assertions, not to engage seriously.

The **fourth substantive paragraph** makes this increasingly clear. It a morass of unreasoned and largely unreasoning claims stacked on top of one another. The best advice I can give to readers is that whenever the word "could" appears, the reader should add "or could not". Whenever the word "can" appears, the reader should add "but does not necessarily". Whenever the word "would" appears the reader should ask "why and how?" and if no explanation is forthcoming, should treat the assertion as unsupported and quite possibly wrong. Unpicking this paragraph is simply not worth the large amount of time and effort required. The purely rhetorical component just overwhelms any grains of sensible thinking that may be buried in there.

The **fifth substantive paragraph** is a series of commonplace observations about the nature of settlement balances and the relationship between the interest paid on those balance versus the interest rate on government bonds. Because nobody can forecast how that relationship will pan out in reality – it is a matter of genuine uncertainty - it is clearly possible that the government could end up paying more on settlement balances than on bonds. It is equally possible that the opposite could be true. As an argument against direct monetary financing of government spending this carries no weight. The expression "not necessarily" at the start of the paragraph is just old-fashioned white-anting.

It is noteworthy that the paragraph completely fails to mention an important component of the fiscal cost of using transactions in the open bond market to conceal Treasury's responsibility for money creation. This is that private operators do not engage in bond trading for the public benefit; they are motivated by the quest for gain, much of it in the form of capital gains. The 2020 Budget statement included provision for taxpayers to pick up the cost of possibly a couple of billion dollars' worth of private-sector capital gains (described as RBNZ capital losses).

The **sixth substantive paragraph** raises the important issue of the downstream consequences of direct monetary financing, but instead of thinking the matter through it just resorts to more bluster, again waving the bogey of "central bank independence". There is indeed a real question of how to manage a greatly increased stock of Government financial liabilities following the sort of large-scale deficit spending currently underway. And if the New Zealand Government continues to rely entirely on "monetary policy" and the "policy interest rate" to control macroeconomic outcomes in the longer run, and to insist on perpetual cosmetic "independence" for the RBNZ, then some positive interest rate may indeed get to be paid on settlement cash (but only "may", not "will"). Here is where we might hope to see some actual new thinking – for example about future tax policy - get under way. And the same applies to the question of how much of the adjustment burden should fall on the banks (whose record to date in the New Zealand economy has a large predatory component alongside their constructive role). The question of whether the banks would and should be able (or allowed) to pass any burdens on to households and businesses, rather than wearing a reduction in their notoriously fat profits, certainly deserves more than just passing mention – certainly not use of the issue as a bludgeon to silence critics.

In short, Robertson's letter is simultaneously unhelpfully hostile and insecurely defensive, overweight on ideology and assertion and underweight on genuine engagement with the central issues around the balance of fiscal and monetary tools in macroeconomic management, and the downstream consequences of running large fiscal deficits under an obsolete ideological setup with a fiscal-austerity mindset.

In particular it is noteworthy that issue 3 in the Wise Response letter – the distribution of income and wealth within the community – gets no mention or response from a Minister whose ostensible focus is on a well-being frame of analysis for fiscal policy.

The speech by the Reserve Bank of Australia Governor cited at the end of the Minister's letter provides no solid demonstration of the lack of a "free lunch", but that is irrelevant in the present context. Nowhere in the Wise Response letter was a free lunch suggested. That letter was entirely about minimising cost and unfairness. It is therefore unclear what point Minister Robertson thought he was making here.

<u>Summary points</u>

There are three key issues at stake in this debate:

1) **When a fiscal deficit is 'funded' by money creation, who creates that money**? MMT says it is Treasury, by doing the spending while failing to collect a commensurate amount of tax. I agree. Roberston and Treasury say "no, not us – because we are issuing bonds that exactly 'fund' the fiscal injection. It's the RBNZ (by buying up those bonds) who create the money. So we are not responsible and the RBNZ is", when and if inflationary problems result. Basically, in my view Treasury resists having its spending "funded" directly by an RBNZ overdraft because responsibility for the volume of money creation would then be (as it should be, and should be seen to be) Treasury's, not the RBNZ's.
2) **What are the distributional consequences of different mechanisms for creating and injecting new money**? Robertson is conspicuously silent on this, which ought to be the central consideration if wellbeing is really his goal. Money injected at the bottom of the economy via transfers, wage subsidies and the like, moves the economy towards less unequal wealth distribution. Money injected at the top via QE and other asset-purchasing moves the economy in the other direction. The Minister is leaning <u>against</u> the pro-poor potential of his emergency fiscal responses to COVID.
3) **In what sense is the central bank "independent" or "credible", and how much does it matter**? The much-touted "independence" and "credibility" were central to the particular anti-inflationary stance New Zealand adopted three decades ago, relying heavily on the (justifiably) unpopular weapons of unemployment and exchange rate overvaluation – tools that could be sustainably wielded only if shielded from democratic accountability. Robertson's argument for credibility is exclusively about driving inflation <u>down</u>. Now that the issue is how to drive inflation <u>up</u>, the interest rate is a useless tool and the RBNZ looks, and is, ineffective. The place where credibility is needed is Treasury not the RBNZ. Treasury, not the RBNZ, controls the policy levers that now matter, and the RBNZ's proper role is to support fiscal policy – not to participate in independence charades designed to shield Treasury from accountability.

Appendix 1: Wise Response letter to Grant Robertson dated 20 May 2020

As demand for growth exceeds earth's physical limits causing unprecedented risks,

what knowledge and changes do we need to secure New Zealand's future wellbeing?

wiseresponse.org.nz

Open letter to Hon Grant Robertson, Minister of Finance
Parliament Buildings
Wellington, 6160

20 May 2020

Cc Right Hon Jacinda Ardern

Dear Minister Robertson

Monetary Policy, Government Debt and Bonds

First, let me express our Society's deep appreciation of the overall manner in which your Government is responding to the Covid-19 crisis. We recognise the perfect storm of events you are having to navigate - tourism collapse, drought, volatile commodity prices and epidemic. Under such circumstances we understand the need to run a large fiscal deficit. However, it is the manner in which that deficit is financed that concerns our Society and which is the reason for this letter.

Currently, the Reserve Bank (RBNZ) is buying bonds from the secondary market, so Treasury (or future taxpayers) will be indebted to them and have to honour interest charges for the foreseeable future. At the time of writing, the RBNZ has just doubled its quantitative easing borrowing programme, with a commitment to purchasing up to another $27 billion of bonds over 12 months. This brings the value of the RBNZ's Large Scale Asset Purchase programme from the previous $33 billion limit, up to $60 billion.

The assumption is that at some point in the future, better times will enable the loan to be cleared. However, global debt is continuing to grow and all the while the quantity and quality of our resources is steadily declining, so this prospect is looking increasingly unlikely.

Thus, we think it would be far preferable for the Reserve Bank to purchase bonds directly from Treasury instead and ask that you advise us of the Governments reasoning for not, to date, doing so.

Key reasons why we think it is a prudent course at this time include the following:

1. **Since the loan is from one Government agent to another,** does not impose any burden on society. Such an internal debt is owed by a nation to its own citizens, so can just lie on the books indefinitely and is thus effectively forgiven. Government debt per se is more of an issue for a neoclassical perspective than modern monetary theorists, where government is seen as playing a small role - a view Covid-19 has dramatically exposed.

2. **Right now, the risk of inflation is very low** as we are approaching a deflationary period, so could be managed with taxes if required. There is spare capacity in the form of plant and labour lying idle and the velocity of money has slowed right down. Key to controlling inflation is of course to keep this money supply in

balance with the goods and services available. The time to worry about inflation is when we have fully employed all our labour and resources.

3. **It doesn't result in an unfair transfer of wealth** and disproportionately penalise certain sets of people. Borrowing on the market transfers wealth from younger taxpayers to older individuals and institutions with the largest portion going offshore.

4. **Buying bonds on the secondary market will not promote banks to lend to business.** The interest-free loans that the government is offering appear to be an acknowledgement of this.

5. **It is cheaper.** Treasury can sell bonds at zero interest to the RBNZ whereas the rate at the moment is 0.9% or less. The interest is very low. Even if the Treasury sold bonds to RBNZ at the going rate, legislation requires that the interest payments they received be returned to Government, making the transaction effectively interest-free.

Under current circumstances, it appears to our Society that there is little other than convention preventing Government from borrowing directly from the RBNZ. For example, the Bank of England has purchased 30% of its Government bonds directly from Treasury without linked currency stability issues.

Thus, for the reasons provided above, and particularly to mitigate issues around intergenerational justice, we appeal to you to give the option of borrowing internally your serious consideration.

I wish to acknowledge the following Wise Response supporters in the preparation of this letter – Dr Geoff Bertram, Dr Marjan van den Belt, Dr Robert Howell, Peter Fraser, Deirdre Kent and Cath Wallace. A brief background note to the Wise Response Society is appended.

I look forward to your reply and better understanding your thinking on this matter.

Yours sincerely,

Alan Mark PhD, ΦBK (Duke), Hon DSc (Otago), FRSNZ, KNZM
Chair
Dugald MacTavish, QSM
Secretary

Appendix 2: Grant Robertson reply dated 10 August

Hon Grant Robertson

MP for Wellington Central

Minister of Finance
Minister for Sport and Recreation
Minister Responsible for the Earthquake Commission
Associate Minister for Arts, Culture and Heritage

10 AUG 2020

Alan Mark and Dugald MacTavish
Wise Response Society
secretary@wiseresponse.org.nz

Dear Sirs

Thank you for your letter of 20 May 2020 regarding monetary policy, government debt, and bonds.

I agree that the Government needs to manage its funding in an equitable and cost-effective manner. As you note in your letter, to fund new spending increases associated with Covid-19 relief and recovery, the Government is raising debt by issuing bonds on the open market. At the same time, the Reserve Bank is buying government bonds on the secondary market in order to support economic activity and inflation. The Reserve Bank's monetary policy actions have been successful in lowering interest rates and debt servicing costs throughout the economy. While primarily aimed at supporting price stability and maximum sustainable employment, these settings are also helping us to raise new funding at low cost.

Although the Reserve Bank's policy settings are assisting the Government to borrow at low cost, we are not intending to instruct the Reserve Bank to directly fund our borrowing, such as under a system of monetary financing or social credit. There are two main reasons for this decision. Firstly, to do so could compromise the independence of the Reserve Bank. Secondly, monetary financing would not necessarily result in better economic outcomes or lower debt servicing cost for the New Zealand economy as a whole.

By continuing to fund government debt through open markets, while leaving the Reserve Bank to use monetary policy to influence interest rates as it sees fit, we are able to preserve the Reserve Bank's independence. New Zealand, like most other developed countries, has chosen to separate decisions about monetary policy from decisions about the government's financial position. This arrangement strengthens the Reserve Bank's credibility in promoting price stability and maximum sustainable employment by anchoring inflation expectations, and supports fiscal discipline by exposing the government to market pricing signals.

While the risk of high inflation is low in the near term, the decision to blur the boundaries between fiscal and monetary policy authorities now could negatively impact the Reserve Bank's ability to manage inflation in the future. Removing the Reserve Bank's independence would, over time, increase the risk of inflation becoming high and volatile. Such inflation would diminish the ability of households and businesses to make efficient spending and investment decisions, which can reduce the productive potential of the economy and ultimately reduces the living standards of New Zealanders. Furthermore, if the use of monetary financing was perceived as either a loss of fiscal discipline or an abandonment of mainstream monetary policy, this could lead to an erosion of trust in economic institutions and a downgrade in perceived creditworthiness. These outcomes would see New Zealand's country risk-premium rise, resulting in a higher cost of borrowing in New Zealand.

In addition, funding government spending with Reserve Bank money will not necessarily be cheaper for the government than borrowing in open markets over the coming years. When purchasing a bond, whether on the open market or directly from the government, the Reserve Bank creates new money. Most Reserve Bank money is deposited at the Reserve Bank in settlement cash accounts, and interest is paid to holders of this settlement cash at a rate equal to the official cash rate. The Reserve Bank is fully owned by the Government so any costs the Reserve Bank incurs paying this interest impacts on the Government's net worth. If the official cash rate were to increase in the future, the Government may ultimately pay equal or higher interest on its borrowing than it would have by locking in low long term interest rates in open markets by issuing government bonds now.

If the Reserve Bank were to pay zero percent on settlement cash instead of the OCR (reducing the ability of the Reserve Bank to control its policy rate, undermining independence as discussed above), this would effectively pass the cost of funding the government onto the banking sector. In this case it is possible that banks would attempt to recoup these costs by increasing the interest rates charged to households and businesses, which would offset the positive effects of increased government expenditure.

The Governor of the Reserve Bank of Australia, Dr Phil Lowe, recently gave a speech that you may find useful, available at https://www.rba.gov.au/speeches/2020/sp-gov-2020-07-21.html. He provided a very clear explanation of why there is no 'free lunch' provided by monetary financing.

Thank you for taking the time to write and for sharing your ideas with me.

Yours sincerely

Hon Grant Robertson
Minister of Finance