

How do central banks create money?

And what are the implications?

Executive summary

- The RBNZ has two functional roles - banker to the Government and banker to the banks.
- Not only do these roles allow it to implement monetary policy, but also to create money.
- Since February 2020, it is estimated that the RBNZ has created an additional \$20 billion of new money.
- This new money sits on banks' balance sheets as an asset.
- This could create a crowding out of other loans, resulting in lower investment.
- Lower investment means lower growth, but inflationary risks remain.
- Stagflation is a possibility.
- The 1970s revisited?

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RBNZ settlement account balances



Source: RBNZ

The New Zealand Government is now running a large fiscal deficit and the Reserve Bank of New Zealand (RBNZ) is buying Government and corporate bonds. These purchases are helping to fund the Government deficit. So how does the RBNZ create money? This research note discusses how the RBNZ creates money, the long-term implications, and how NZ Funds is responding to this.

Unique position of the RBNZ

The RBNZ has two functional roles in the banking system - banker to the Government and banker to the banks. These roles allow the RBNZ to not only implement monetary policy but also to create money.

The Government has an account at the RBNZ. This account reflects the net balance between the Government and the private sector. Typically the balance on this account is around zero, with the

Government issuing debt if they are running a fiscal deficit. However, the Government can run this account in overdraft.

Each of the major registered banks also has an account at the RBNZ. These are known as settlement accounts. They facilitate the movement of money between the banks.

The banking system is a closed system. When the Government makes a payment (say teachers' salaries) this payment is always redeposited back into the banking system. This payment in turn ends up back in a bank's settlement account at the RBNZ. Normally this would be seen by the RBNZ as a reduction in the balance in the Government's account and an increase in the bank's settlement account.

However, there is nothing stopping the RBNZ from expanding its balance sheet, and the RBNZ can do this without the typical credit consequences. In fact, very few people ever look at the RBNZ's balance sheet to see how leveraged they

are. As at the end of February 2020, the RBNZ had assets of \$31 billion and liabilities of \$28 billion, including \$8 billion in the settlement accounts.

In March and April 2020, the Government made large unexpected payments, including nearly \$10 billion in wage subsidies. Tax revenue is also lower than expected. To make the payments the Government appears to have run its account at the RBNZ into overdraft. Consequently, the settlements account balances have increased to \$29 billion as at 22 April. Other things being equal, this suggests the RBNZ has increased the size of its balance sheet by around \$20 billion. That is, they have created new money.

In time, we would expect the Government to issue Government bonds to repay their overdraft at the RBNZ. But they could just turn it into a long-term loan. That would be the monetarisation of debt the Governor of the RBNZ discussed.

What are the implications of this money creation?

As discussed, in **Gold – the currency of last resort**, we do not think this will create hyperinflation as experienced during the 1920s in Germany unless we see a scarcity of goods. We see this as unlikely as the COVID-19 crisis has not destroyed the existing productive capacity of the world.

However, there is more money in the system. This additional money sits as an asset on the banks' balance sheets and crowds out other lending. This is likely to mean that new private sector investment spending is low. This implies lower growth and higher inflation i.e. stagflation.

A rerun of the 1970s

The 1970s were characterised by an increase in the money supply and an oil supply shock. The 2020s could well be characterised by a demand shock and an increase in money supply. During the 1970s, a passive 40% fixed interest/60% share portfolio performed poorly. We estimate that a United States based 40%/60% portfolio would have returned around -2%p.a. after inflation. Other asset classes such as commodities performed very strongly. This is one of the reasons we recently added gold to the growth portfolios. We are also looking to add additional inflation hedges as the global economy recovers.

It is fair to say that our views are still evolving as to the full implications of this money creation. That is why we believe it is important to be an active manager, altering our views and the Portfolios' exposure as events unfold. Passively investing in what worked last decade is not necessarily a recipe for success.



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Dave handles the day-to-day management of global inflation and growth portfolios at NZ Funds. He also undertakes macro-economic research on currencies, global equity markets and interest rates.

Dave has worked at NZ Funds since 1997. Prior to that he was Economist and Strategist at JB Were. Dave started his career at the Reserve Bank of New Zealand.

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