

RESTORING LIQUIDITY AND GROWTH IN THE NEW ZEALAND ECONOMY

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February 28th 2009

EXECUTIVE BRIEFING FOR RT HON. JOHN KEY, PRIME MINISTER; HON. BILL ENGLISH, MINISTER OF FINANCE

While month to month falls in Domestic Credit have often occurred in the past, the latest large fall of NZ\$5.5 billion in January 2009 is very worrying because it comes on top of already declining system liquidity.

After peaking at around NZ\$47 billion in 2005, the system liquidity¹ has, for the moment at least, fallen to about NZ\$31 billion, the level it was around the time of the September 2001 attack in the US. Meanwhile, the nominal GDP is some 60% larger than it was in 2001. We believe the present level of system liquidity is far too low.

Lack of liquidity is strangling the productive economy. The banking system, despite large profits in NZ in 2008, is not lending enough to keep the NZ economy stable, let alone growing. We consider the primary cause for this relates to losses or provision for future losses incurred elsewhere by the foreign banks. Lack of sufficient excess reserves means they can't lend what the economy needs to function properly.

Pending a more permanent solution², a profitable remedy is available for immediate use. That remedy involves injecting new capital in Kiwibank to enable it to "take on" the foreign banks.

We propose injecting capital in tranches of about NZ\$ 0.5 billion each. Each tranche will enable Kiwibank to lend about NZ\$5.5 billion into the economy. This will add just under 3% to nominal economic activity and provide perhaps NZ\$2 billion in total taxation THIS YEAR. That means a profit to the Government of around NZ\$ 1.5 billion/tranche. This is in addition to renewed business confidence and reduced demand on social transfers.

The new Kiwibank lending would be on normal terms and conditions, operating on its normal bank spread. The lending would need to continue until the foreign banks return to the market place and economic growth has been permanently restored. We consider at least four tranches will be needed to do this, giving the government a profit of NZ\$6.0 billion, delivered through higher tax receipts. We believe the profit should be used to stimulate consumption.

Four tranches over the next few months would, on current trends, be enough to restore growth to the economy. The calculation is given in appendix A.

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28/2/09

¹ Mcd in debt model currently with you for consideration

² As set out in the theory and model you are presently considering

APPENDIX A

ECONOMIC IMPACT OF CAPITAL INJECTION TO KIWIBANK

According to the Debt Model you have before you:

$$dMd/dt = d/dt(Dca+Ddc-R) = d/dt[PQ(d)/Vp + Ms] \quad \text{equation (16)}$$

where Md = total debt
Dca = accumulated current account deficit
Ddc = domestic credit
R = central bank Reserves³
PQ(d) = GDP created through the use of debt
Ms = accumulated unearned income from deposit interest.
Vp = the speed of circulation of productive debt (Md-Ms)

Rearranging the equation:

$$d/dt PQ(d) = d/dt (Dca+Ddc-R-Ms)*Vp$$

Take Vp= 1, d/dt R = 0 d/dt Dca = say,6%* gdp189 /12 = + NZ\$ 0.95 billion/month
d/dt Ddc = NZ\$ -5.5 billion, d/dt Ms = 0.0519% (deposit interest RBNZ table C10)*444.8 (total debt)/12 = NZ\$ 1.93 billion/month

For January 2009,
d/dt PQ(d) = +0.95-5.5-1.93 = -6.5
Notional *fall* in nominal GDP = 6.5/189 = 3.4%⁴ (In one month!)

Adding Ddc of NZ\$5.5 simply adds almost NZ\$ 5.5 billion or almost 2.9% to nominal GDP⁵.

The first two tranches replace GDP lost in January and February 2009.

The third and subsequent tranches have to offset:

- (a) Further declines in foreign bank lending (presently unknown)
- (b) Funding for growth, say 4%, and inflation 1%, = 0.05*189/year = NZ\$0.8b/month

The third tranche can be expected to last for about 2 months while subsequent ones will depend on what the foreign banks do.

³ R is a second order effect added in as a minor revision on 23/2/09 because changes in the central bank reserves can have a significant effect on monthly and quarterly figures, though relatively little impact over longer periods.

⁴ December tends to be a "bad" month because of debt retirement after Christmas sales and because many businesses are closed for holidays. January is usually OK. You have to go back to January 1996, when there was a fall in domestic credit of nearly 2% for anything remotely comparable to the January 2009 figure.

⁵ As at January 2009, deposit interest was 5.19%/year, so 0.0519/12*5.5 billion = NZ\$b 0.024/month is transferred to Ms from each tranche of Kiwibank lending.