ONWARD

NEW ZEALAND

REPORT

OF THE

ROYAL COMMISSION

ON

MONETARY, BANKING, AND CREDIT SYSTEMS

1956

BY AUTHORITY:
R. E. OWEN, GOVERNMENT PRINTER, WELLINGTON, NEW ZEALAND—1956

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Royal Commission on Monetary, Banking, and Credit Systems

Presented to the House of Representatives by Command of His Excellency

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Royal Commission to Inquire Into and Report Upon Matters Concerning the Monetary, Banking, and Credit System of New Zealand

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ELIZABETH THE SECOND, by the Grace of God of the United Kingdom, New Zealand and Her Other Realms and Territories Queen, Head of the Commonwealth, Defender of the Faith:

To Our Trusty and Well-beloved the HONOURABLE MR JUSTICE ARTHUR TYNDALL, C.M.G., of Wellington, Judge of the Court of Arbitration; WILLIAM GORDON VICTOR FERNIE, of Christchurch, Company Manager; RONALD MACGREGOR HUTTON-POTTS, of Invercargill, Managing Editor; CLEMENT GEORGE TROTTER, of Hawera, Managing Director; GORDON GRAHAM GIBBS WATSON, of Wellington, Barrister; and ERNEST DAWSON WILKINSON, of Auckland, Public Accountant: GREETING:

KNOW Ye that we, reposing trust and confidence in your integrity, knowledge, and ability, do hereby nominate, constitute, and appoint you, the said

Arthur Tyndall,
William Gordon Victor Fernie,
Ronald Macgregor Hutton-Potts,
Clement George Trotter,
Gordon Graham Gibbs Watson, and
Ernest Dawson Wilkinson

to be a Commission to receive, inquire into, and report upon the matters hereinafter set forth with a view to fostering a greater degree of stability in prices, maintaining full employment of labour, ensuring the healthy development of natural resources, and promoting generally the economic, financial, and social welfare of the people of New Zealand, that is to say, to receive, inquire into, and report upon representations regarding:

(a) Any monetary, banking, and credit proposals that may be suggested as suitable for application in New Zealand;

(b) The present monetary, banking, and credit system in New Zealand and the advisability or otherwise of any changes in that system; and

(c) Any associated matters which should be deemed by you to be relevant to the general objects of the inquiry:

And we do hereby appoint you, the said

Arthur Tyndall,

to be Chairman of the said Commission:

And for the better enabling you to carry these presents into effect you are hereby authorised and empowered to make and conduct any inquiry under these presents at such time and place as you deem expedient, with power to adjourn from time to time and place to place as you think fit, and so that these presents shall continue in force, and the inquiry may at any time and place be resumed although not regularly adjourned from time to time or from place to place:

And you are hereby strictly charged and directed that you shall not at any time publish or otherwise disclose save to His Excellency the Governor-General, in pursuance of these presents or by His Excellency's direction, the contents of any report so made or to be made by you, or any evidence or information obtained by you in the exercise of the powers hereby conferred upon you except such evidence or information as is received in the course of a sitting open to the public:

And it is hereby declared that the powers hereby conferred shall be exercisable notwithstanding the absence at any time of any one or any two of the members hereby appointed so long as the Chairman, or a member deputed by the Chairman to act in his stead, and three other members be present and concur in the exercise of such powers:

And we do further ordain that you have liberty to report your proceedings and findings under this Our Commission from time to time if you shall judge it expedient so to do.

And, using all due diligence, you are required to report to His Excellency the Governor-General in writing under your hands and seals not later than the 31st day of August 1955, your findings and opinions on the matters aforesaid, together with such recommendations as you think fit to make in respect thereof:

And, lastly, it is hereby declared that these presents are issued under the authority of the Letters Patent of His late Majesty King George the Fifth dated the 11th day of May 1917, and under the authority of and subject to the provisions of the Commissions of Inquiry Act 1908, and with the advice and consent of the Executive Council of the Dominion of New Zealand.

In witness whereof we have caused this Our Commission to be issued and the Seal of Our Dominion of New Zealand to be hereunto affixed at Wellington, this 16th day of March in the year of Our Lord one thousand nine hundred and fifty-five, and in the fourth year of Our Reign.

Witness Our Trusty and Well-beloved Sir Charles Willoughby Moke Norrie, Knight Grand Cross of Our Most Distinguished Order of Saint Michael and Saint George, Knight Grand Cross of Our Royal Victorian Order, Companion of Our Most Honourable Order of the Bath, Companion of Our Distinguished Service Order, upon whom has been conferred Our Decoration of the Military Cross and Bar, Lieutenant-General on the retired list of Our Army, Governor-General and Commander-in-Chief in and over New Zealand; acting by and with the advice and consent of Our Executive Council.

[L.S.] C. W. M. NORRIE, Governor-General.

By His Excellency's Command—

S. G. HOLLAND,
for the Minister of Finance.

Approved in Council—

T. J. SHERRARD,
Clerk of the Executive Council.

Extension of Time Within Which the Royal Commission to Inquire Into Matters Concerning the Monetary, Banking, and Credit System of New Zealand May Report

---

ELIZABETH THE SECOND, by the Grace of God of the United Kingdom, New Zealand and Her Other Realms and Territories Queen, Head of the Commonwealth, Defender of the Faith:

To Our Trusty and Well-beloved the HONOURABLE MR JUSTICE ARTHUR TYNDALL, C.M.G., of Wellington, Judge of the Court of Arbitration; WILLIAM GORDON VICTOR FERNIE, of Christchurch, Company Manager; RONALD MACGREGOR HUTTON-POTTS, of Invercargill, Managing Editor; CLEMENT GEORGE TROTTER, of Hawera, Managing Director; GORDON GRAHAM GIBBS WATSON, of Wellington, Barrister; and ERNEST DAWSON WILKINSON, of Auckland, Public Accountant: GREETING:

WHEREAS by Our Warrant dated the 16th day of March 1955, issued under the authority of the Letters Patent of His late Majesty King George the Fifth dated the 11th day of May 1917, and under the authority of and subject to the provisions of the Commissions of Inquiry Act 1908, and with the advice and consent of the Executive Council of the Dominion of New Zealand, you were appointed to be a Commission to inquire into and report upon the matters in Our said Warrant set out being matters concerning the Monetary, Banking, and Credit System of New Zealand:

And whereas by Our said Warrant you were required to report to His Excellency the Governor-General not later than the 31st day of August 1955 your findings and opinions on the matters aforesaid, together with such recommendations as you might think fit to make in respect thereof:

And whereas it is expedient that the time for so reporting should be extended as hereinafter provided:

Now, therefore, we do hereby extend until the 30th day of November 1955 the time within which you are so required to report without prejudice to the continuation of the liberty conferred upon you by Our said Warrant to report your proceedings and findings from time to time if you should judge it expedient so to do.

And we do hereby confirm Our said Warrant and the Commission thereby constituted save as modified by these presents:

And it is hereby declared that these presents are issued under the authority of the said Letters Patent of His late Majesty and under the authority of and subject to the Commissions of Inquiry Act 1908 and with the advice and consent of the Executive Council of the Dominion of New Zealand.

In witness whereof we have caused these presents to be issued and the Seal of Our Dominion of New Zealand to be hereunto affixed at Wellington this 17th day of August in the year of Our Lord one thousand nine hundred and fifty-five, and the fourth year of Our Reign.

Witness Our Trusty and Well-beloved Sir Charles Willoughby Moke Norrie, Knight Grand Cross of Our Most Distinguished Order of Saint Michael and Saint George, Knight Grand Cross of Our Royal Victorian Order, Companion of Our Most Honourable Order of the

Bath, Companion of Our Distinguished Service Order, upon whom has been conferred Our Decoration of the Military Cross and Bar, Lieutenant-General on the retired list of Our Army, Governor-General and Commander-in-Chief in and over New Zealand; acting by and with the advice and consent of Our Executive Council.

[L.S.] C. W. M. NORRIE, Governor-General.

By His Excellency's Command—

JACK T. WATTS,
Minister of Finance.

Approved in Council—

T. J. SHERRARD,
Clerk of the Executive Council.

Second Extension of Time Within Which the Royal Commission to Inquire Into Matters Concerning the Monetary, Banking, and Credit System of New Zealand May Report

ELIZABETH THE SECOND, by the Grace of God of the United Kingdom, New Zealand and Her Other Realms and Territories Queen, Head of the Commonwealth, Defender of the Faith:

To Our Trusty and Well-beloved the HONOURABLE MR JUSTICE ARTHUR TYNDALL, C.M.G., of Wellington, Judge of the Court of Arbitration; WILLIAM GORDON VICTOR FERNIE, of Christchurch, Company Manager; RONALD MACGREGOR HUTTON-POTTS, of Invercargill, Managing Editor; CLEMENT GEORGE TROTTER, of Hawera, Managing Director; GORDON GRAHAM GIBBS WATSON, of Wellington, Barrister; and ERNEST DAWSON WILKINSON, of Auckland, Public Accountant: GREETING:

WHEREAS by Our Warrant dated the 16th day of March 1955, issued under the authority of the Letters Patent of His late Majesty King George the Fifth dated the 11th day of May 1917, and under the authority of and subject to the provisions of the Commissions of Inquiry Act 1908, and with the advice and consent of the Executive Council of the Dominion of New Zealand, you were appointed to be a Commission to inquire into and report upon the matters in Our said Warrant set out being matters concerning the Monetary, Banking, and Credit System of New Zealand:

And whereas by Our said Warrant you were required to report to His Excellency the Governor-General not later than the 31st day of August 1955 your findings and opinions on the matters aforesaid, together with such recommendations as you might think fit to make in respect thereof:

And whereas by Our Warrant issued on the 17th day of August 1955 we did extend until the 30th day of November 1955 the time within which you were so required to report:

And whereas it is expedient that the time for so reporting should be further extended as hereinafter provided:

Now, therefore, we do hereby extend until the 31st day of January 1956 the time within which you are so required to report without prejudice to the continuation of the liberty conferred upon you by Our said Warrant of the 16th day of March 1955 to report your proceedings and findings from time to time if you should judge it expedient to do so:

And we do hereby confirm Our said Warrant of the 16th day of March 1955 and the Commission thereby constituted save as modified by Our said Warrant of the 17th day of August 1955 and by these presents:

And it is hereby declared that these presents are issued under the authority of the said Letters Patent of His late Majesty and under the authority of and subject to the Commissions of Inquiry Act 1908 and with the advice and consent of the Executive Council of the Dominion of New Zealand.

In witness whereof we have caused these presents to be issued and the Seal of Our Dominion of New Zealand to be hereunto affixed at Wellington this 22nd day of November in the year of Our Lord one thousand nine hundred and fifty-five, and the fourth year of Our Reign.

Witness Our Trusty and Well-beloved Sir Charles Willoughby Moke Norrie, Knight Grand Cross of Our Most Distinguished Order of Saint Michael and Saint George, Knight Grand Cross of Our Royal Victorian Order, Companion of Our Most Honourable Order of the Bath, Companion of Our Distinguished Service Order, upon whom has been conferred Our Decoration of the Military Cross and Bar, Lieutenant-General on the retired list of Our Army, Governor-General and Commander-in-Chief in and over New Zealand; acting by and with the advice and consent of Our Executive Council.

[L.S.] C. W. M. NORRIE, Governor-General.

By His Excellency's Command—

JACK T. WATTS,
Minister of Finance.

Approved in Council—

T. J. SHERRARD,
Clerk of the Executive Council.

Third Extension of Time Within Which the Royal Commission to Inquire Into Matters Concerning the Monetary, Banking, and Credit System of New Zealand May Report

---

ELIZABETH THE SECOND, by the Grace of God of the United Kingdom, New Zealand and Her Other Realms and Territories Queen, Head of the Commonwealth, Defender of the Faith:

To Our Trusty and Well-beloved the HONOURABLE SIR ARTHUR TYNDALL, C.M.G., of Wellington, Judge of the Court of Arbitration; WILLIAM GORDON VICTOR FERNIE, of Christchurch, Company Manager; RONALD MACGREGOR HUTTON-POTTS, of Invercargill, Managing Editor; CLEMENT GEORGE TROTTER, of Hawera, Managing Director; GORDON GRAHAM GIBBS WATSON, of Wellington, Barrister; and ERNEST DAWSON WILKINSON, of Auckland, Public Accountant: GREETING:

WHEREAS by Our Warrant dated the 16th day of March 1955, issued under the authority of the Letters Patent of His late Majesty King George the Fifth dated the 11th day of May 1917, and under the authority of and subject to the provisions of the Commissions of Inquiry Act 1908, and with the advice and consent of the Executive Council of New Zealand, you were appointed to be a Commission to inquire into and report upon the matters in Our said Warrant set out being matters concerning the Monetary, Banking, and Credit System of New Zealand:

And whereas by Our said Warrant you were required to report to His Excellency the Governor-General not later than the 31st day of August 1955 your findings and opinions on the matters aforesaid, together with such recommendations as you might think fit to make in respect thereof:

And whereas by Our Warrant issued on the 17th day of August 1955 we did extend until the 30th day of November 1955 the time within which you were so required to report:

And whereas by Our Warrant issued on the 22nd day of November 1955 we did further extend until the 31st day of January 1956 the time within which you were so required to report:

And whereas it is expedient that the time for so reporting should be again extended as hereinafter provided:

Now, therefore, we do hereby extend until the 31st day of March 1956 the time within which you are so required to report without prejudice to the continuation of the liberty conferred upon you by Our said Warrant of the 16th day of March 1955 to report your proceedings and findings from time to time if you should judge it expedient to do so:

And we do hereby confirm Our said Warrant of the 16th day of March 1955 and the Commission thereby constituted save as modified by Our said Warrants of the 17th day of August 1955 and 22nd day of November 1955 and by these presents:

And it is hereby declared that these presents are issued under the authority of the said Letters Patent of His late Majesty and under the authority of and subject to the Commissions of Inquiry Act 1908 and with the advice and consent of the Executive Council of New Zealand.

In witness whereof we have caused these presents to be issued and the Seal of New Zealand to be hereunto affixed at Wellington this 9th day of January in the year of Our Lord one thousand nine hundred and fifty-six, and the fourth year of Our Reign.

Witness Our Trusty and Well-beloved Sir Charles Willoughby Moke Norrie, Knight Grand Cross of Our Most Distinguished Order of Saint Michael and Saint George, Knight Grand Cross of Our Royal Victorian Order, Companion of Our Most Honourable Order of the Bath, Companion of Our Distinguished Service Order, upon whom has been conferred Our Decoration of the Military Cross and Bar, Lieutenant-General on the retired list of Our Army, Governor-General and Commander-in-Chief in and over New Zealand; acting by and with the advice and consent of Our Executive Council.

[L.S.] C. W. M. NORRIE, Governor-General.

By His Excellency's Command—

JACK T. WATTS,
Minister of Finance.

Approved in Council—

T. J. SHERRARD,
Clerk of the Executive Council.

ROYAL COMMISSION OF INQUIRY INTO MONETARY, BANKING, AND CREDIT SYSTEMS

To His Excellency Sir Charles Willoughby Moke Norrie, Knight Grand Cross of Our Most Distinguished Order of Saint Michael and Saint George, Knight Grand Cross of Our Royal Victorian Order, Companion of Our Most Honourable Order of the Bath, Companion of Our Distinguished Service Order, upon whom has been conferred Our Decoration of the Military Cross and Bar, Lieutenant-General on the retired list of Our Army, Governor-General and Commander-in-Chief in and over New Zealand.

May it Please Your Excellency,—

We, the undersigned Commissioners appointed by Warrant dated 16 March 1955, have the honour to present to Your Excellency our report under the terms of reference stated in that Warrant. We were originally required to present our report by 31 August 1955, but this date was extended by later Warrants to 31 March 1956.

We have the honour to be,

Your Excellency's most obedient servants,

A. Tyndall, Chairman.
William G. V. Fernie, Member.
R. M. Hutton-Potts, Member.
C. G. Trotter, Member.
G. G. G. Watson, Member.
E. D. Wilkinson, Member.

Dated at Wellington this 28th day of March 1956.

Note—Mr G. G. G. Watson was not present when this report was signed. Before he departed from New Zealand on 17 February 1956 he requested that the following statement made by him should be appended to the report:

"I have read carefully all papers for this report and discussed them with my colleagues. We have agreed in principle on all matters of importance and accordingly I have authorised the Chairman on my behalf to sign my name to the final document."

Pursuant to the foregoing authority the report has been signed by the Chairman on behalf of Mr Watson.

REPORT

Section One

PREFACE

1. At an initial meeting held in Wellington on 31 March 1955 the Commission decided that a general invitation should be extended to all interested persons or organisations to place their views or proposals before the Commission. It was also decided that interested persons or organisations should be given the opportunity of appearing personally or of being represented at public hearings conducted by the Commission if they so desired. Suitably worded advertisements were accordingly inserted in all daily newspapers, and copies of the advertisement were sent by letter to all organisations considered to be interested in making submissions.

2. As a first step in the public inquiry the Commission invited the Reserve Bank, the Treasury, and the Associated Banks in New Zealand (the trading banks' organisation) to prepare and submit statements covering the present monetary, banking, and credit systems. Subsequently, similar invitations were extended to other organisations dealing or connected with particular portions of the present systems.

3. In Appendix A we list the seventy-two witnesses and the counsel who appeared at the public hearings. Thirteen of the witnesses appeared in response to direct invitations from the Commission. The other fifty-nine witnesses volunteered personal submissions or presented the views of organisations which desired to make submissions.

4. In view of the specific wording of its terms of reference, the Commission considered that its primary duty was to report upon *representations received* regarding any monetary, banking, and credit proposals. After broad outlines of the present system had been presented by the respective institutions concerned, early steps were taken to hear such representations in public, and accordingly the hearing of a number of invited statements covering many aspects of the existing system was delayed till a later stage in the proceedings.

Procedure

5. Public hearings began on 28 April 1955 with a statement by the Commission on the procedure it intended to adopt. The more important sections of the statement read:

> The Commission does not propose to recognise any parties to the inquiry, as no person or institution is on trial or in jeopardy.
>
> The Commission is not being supplied with any form of legal assistance, but expert personnel is attached to the Commission to help it in elucidating the various matters falling within the scope of the order of reference.
>
> Persons appearing before the Commission will be expected to read any written submission.
>
> Any person wishing to cross-examine a witness before the Commission should apply to the Commission for permission to do so, and at the same time should give the grounds for or the purpose of his application.

As a general guiding principle the Commission, in the light of the foregoing statements and having regard to the shortness of the period available for its work, proposes to limit the right of cross-examination as far as possible to the following cases:

(a) Where the person applying or an institution which he represents has been attacked or criticised by a witness; and

(b) Where statements made during the course of the proceedings by or on behalf of the person applying have been challenged in any way by the witness or the person calling him.

Any witness who is being cross-examined will be permitted if he so desires to take time to give a considered answer to any questions at a later stage of the public hearings.

Persons appearing as advocates and calling witnesses in support of their submissions will not be subject to cross-examination, which will be reserved for the witnesses they call.

Advocates who do not propose to call witnesses and who do not themselves take the witness stand will be in the position of having no evidence to support their submissions.

Rights of Cross-examination

6. At the opening of the public hearings it was suggested by certain advocates and counsel that the rights of cross-examination were too restrictive, and that the Commission did not possess sufficient powers to enable the inquiry to be as thorough as was desirable. So far as the rights of cross-examination are concerned, the Commission has formed the opinion that the procedure adopted provided every reasonable facility for interested persons and organisations to examine witnesses. As an indication of the extent to which witnesses were cross-examined, it is pointed out that approximately one-quarter of the total time taken up by public hearings was devoted to such cross-examination.

Power to Require the Production of Information

7. The second point raised before the Commission at its first public sitting concerned the powers of the Commission to require the production of certain information. Reference was made to section 21 of the Banking Act 1908, which provides that, on the application of any party to a legal proceeding, a Court or Judge may order that such party be at liberty to inspect and take copies of any entries in the books of a bank for any of the purposes of such proceeding. Some persons who initially appeared before the Commission therefore sought to be joined as "parties" to the proceedings, and indicated their intention to apply for orders under section 21 of the Banking Act. At the same time it was submitted that the Commission did not possess adequate powers to make such orders in that the Chairman of the Commission was not a Judge of the Supreme Court and consequently could not exercise the powers vested in a Judge of that Court by section 21 of the Banking Act and by section 13 of the Commissions of Inquiry Act 1908. Certain suggestions were made under which it was contended the powers of the Commission should be extended.

8. After immediate consideration of these issues, the Commission asserted that it proposed to give all reasonable opportunity, within the scope of the terms of reference, to all persons appearing before it; that it adhered to its decision not to recognise parties to the inquiry; and that if any lack of necessary powers to perform its functions became apparent it would consider the situation further and would take any steps necessary to enable it adequately to fulfil its purpose.

9. Reference was made at various stages of the public proceedings to this alleged lack of powers, but the Commission wishes it to be placed clearly on record that at no stage of its hearings or subsequent deliberations has the situation arisen where any additional powers have proved to be necessary to obtain essential information. A number of confidential questions was directed by the Commission to the trading banks, and these were always answered promptly in written form and as frankly as the Commission could wish. Viewing the situation since the conclusion of our hearings, we are satisfied that all information that could reasonably be sought was obtained by the Commission. Further, we are satisfied that the persons appearing before the Commission had adequate opportunity of eliciting all the information that could be regarded as reasonably necessary for the proper presentation of their views. Indeed, we are strongly of the opinion that the procedure adopted by the Commission under which representatives of the Reserve Bank, the Associated Banks, and the Treasury initially presented informative statements at the public hearings and submitted to cross-examination was of great value and assistance to all who followed.

Confidential Nature of Advice Given to Government

10. During the course of the proceedings a further important point arose concerning communications between the Reserve Bank, the Government, and the Treasury, and concerning advice given by the Reserve Bank to the Government. The Governor of the Reserve Bank declined to answer questions relating to those matters, on the grounds that the Reserve Bank was banker for the Government and the Treasury, and that it would be a breach of confidence on his part to disclose communications that might have passed between bank and customer over a period of years. The Commission was asked to give a direction that the witness should answer such questions.

11. In its decision on this point the Commission held that the objection to a possible breach of confidence between banker and customer was a perfectly proper objection for the Governor of the Reserve Bank to raise, but that the point did not need to be decided on that ground alone. The Commission was concerned with the monetary, banking, and credit systems, and it had emerged in evidence that, under the existing systems, consultations and discussions took place before decisions were made. The decisions themselves were important, but the Commission was not concerned with the details of the discussions which may have led to those decisions.

12. In the Commission's view it would have been most improper that details of advice tendered to the Government by persons holding responsible positions such as Governor of the Reserve Bank and Secretary to the Treasury should be disclosed and discussed in public when the knowledge of the details would not assist the Commission in the performance of its functions.

Details of Public Hearings

13. As previously noted, the public hearings began on 28 April 1955, and continued until 30 September 1955, with short adjournments from time to time. Eighty-seven sitting days were involved. The transcript of proceedings covered 4,926 single-space foolscap sheets of typing. With the

written submissions included, this made a total of nearly 7,000 sheets, containing some 2,250,000 words. Most of the hearings were held in Wellington, but the Commission also travelled to Auckland for a sitting of nine days, and to Christchurch for a sitting of two days. Reasonably adequate opportunity to appear before the Commission was afforded to all persons who desired to do so. Special procedures were adopted in a number of cases to shorten the time of the public hearings, e.g., by taking as read certain documents which had been submitted in advance.

Written Submissions

14. In addition to the representations and proposals of the many witnesses who appeared in person, the Commission received and considered eighty-nine written submissions where no appearance was sought. Appendix B to this report contains the names of the persons who made such submissions, together with a brief note of the major proposals made.

General

15. The great variety of subjects covered in the submissions reflects the wide scope of the terms of reference. The Commission found that some of the representations made were clearly irrelevant but, as it adopted a liberal interpretation of the terms of reference and as practically every witness readily co-operated, very little difficulty was experienced in this aspect of the Commission's work.

16. In this report we use statistics, where available, up to 31 December 1955. It will be noticed that yearly figures quoted are sometimes those of calendar years, sometimes of financial years, and sometimes are taken to another point in each year. Further, when comparisons are made between years the base period selected is not always the same. In each instance we have selected the time of termination of each year's figure, and the basic period for comparisons, which are most appropriate to the study then being undertaken. In this way it is possible to avoid complications such as occur, for example, through seasonal movements in trade or finance. In some instances the statistics we would have liked to use were not available, and, in some tables, rounding off results in totals disagreeing slightly with the total of individual items shown in the tables.

17. Our comments, criticisms, findings, and recommendations are based on the evidence and submissions made to us and on our knowledge of events up to 31 December 1955. Where matters arising since that date are relevant to any section of our report, they are recorded by way of a note inserted at the appropriate point.

18. Short quotations taken from statements, submissions, and examination of witnesses are set in the text in italics within quotation marks. Lengthy quotations are set in smaller type in block form. We consider it very desirable in these instances to quote the actual words used so that no question of misquotation can arise.

Staff Assistance

19. We wish to record our deep appreciation of the services rendered by the staff attached to the Commission. In particular we would warmly commend the great assistance given by Messrs A. McGregor and F. W. Holmes, whose services were made available to the Commission

in a technical capacity. We would also specially mention our indebtedness to the Secretary, Mr J. C. Redward. Both he and the reporting and administrative staff under his control performed their arduous and exacting duties in an exemplary manner and thereby facilitated the work of the Commission.

Form of This Report

20. In this report we adopt the following general approach to our consideration of the submissions received:

(a) Examination of the economic objectives as outlined in our terms of reference.
(b) A general economic review of the period 1934 to 1955.
(c) An analysis of the nature of "money" and a review of the monetary, banking, and credit systems from 1934 to 1955.
(d) A discussion of the causes of the inflation which has been experienced over recent years.
(e) Consideration of the Welfare State and its effects on the economy.
(f) General comments on the present monetary, banking, and credit systems.
(g) An examination of the question of State monopoly of credit creation.
(h) Reviews of the submissions made by Social Credit advocates, by Mr H. J. Kelliher and the Mirror Publishing Co. Ltd., and by Mr Colin Clark.
(i) Views on reform of the present systems, and comments on proposals made for reform.
(j) To keep the main body of the report within reasonable compass, a number of subjects have been dealt with in greater detail in appendices.
(k) Statistical tables appear in Appendix H.

Section Two

OBJECTIVES OF ECONOMIC POLICY

21. Before discussing the general objectives of economic policy laid down in our terms of reference it is necessary to mention some of the basic geographical and other conditions which govern very broadly the lines of economic development in this country.

22. New Zealand is geographically isolated from the main centres of world population, yet her economy is closely interdependent with that of the United Kingdom and with the other countries which buy her exports and supply her imports.

23. Apart from coal and lime, New Zealand's known mineral resources are meagre. It follows that her manufacturing and processing industries are heavily dependent on imported raw materials, except where they are based upon agricultural and pastoral production, or upon forests.

24. New Zealand is very largely dependent on overseas markets for the sale of her wool, dairy produce, meat, forest products, and other exports. She is also dependent on overseas countries for a wide range of imports, including consumer goods, industrial and other machinery, phosphatic fertilisers, industrial raw materials, and motor spirits and oils. More than a quarter of all goods and services used in New Zealand is imported.

25. Of New Zealand's area of 66 million acres, only 20 million acres can be described as "improved" land. About 2 million acres consist of field crops, gardens, orchards, and plantations. The other 18 million acres of improved land are in sown pasture. Of this 18 million acres about 6½ million acres of flat or low contour country have been cultivated and ploughed before sowing pasture. It is from this area, representing only 10 per cent of the total land in New Zealand, that by far the greatest part of farm production is derived. The natural fertility of most of this land is relatively low. Its very high productivity is the result of skilful farming and of scientific land use including the extensive application of fertilisers.

26. New Zealand's economy is thus to a major extent based upon agriculture and especially upon grasslands farming. It has been said that her most important resource is her climate, which includes an ample rainfall well distributed throughout the year.

27. New Zealand's total population, at present 2,165,000, has shown a rapid rate of increase in recent years. Of her total labour force (about 802,000) only 152,000 are engaged in farming and other primary industry. Over 90 per cent of the population is of British descent. Between 6 and 7 per cent is Maori.

28. The form of government is parliamentary with only one chamber, the House of Representatives. The Government has full sovereignty and there is no written constitution. General elections are normally held at intervals of three years.

29. The basic facts of geographical isolation, favourable conditions for agriculture, dependence on overseas trade, relative smallness of population and internal market, and the institutions of parliamentary government, comprise the broad framework within which the objectives of our economic policy must be pursued.

Objectives Set Out in Commission's Terms of Reference

30. Under its terms of reference the Commission was required to have regard to these general objectives in the course of its inquiry:

(a) The fostering of a greater degree of stability in prices.
(b) The maintaining of full employment of labour.
(c) The ensuring of the healthy development of natural resources.
(d) The promoting generally of the economic, financial, and social welfare of the people of New Zealand.

31. Our terms of reference do not refer to stability in prices in the absolute sense, but to a greater degree of stability in prices. In a country such as New Zealand, the level of prices is affected to a major degree by changes in prices overseas. Policies designed to secure a greater measure of stability in New Zealand should therefore be directed towards correcting price instability arising from causes in New Zealand, and towards limiting the effects in New Zealand of price changes occurring outside New Zealand.

32. "Maintaining full employment of labour" is not an expression capable of precise interpretation. There is no generally accepted definition of full employment. The term does not mean that no one should ever be out of employment, because in any progressive industrial economy there will always be a number of workers in the process of changing from one employment to another. A reasonable approach to this objective would be to aim at a state of affairs where the interval between leaving one job and beginning in another need not be prolonged, and where the number of employment vacancies approximates the number of persons seeking employment.

33. "Ensuring the healthy development of natural resources" includes encouragement of farm production and utilisation of forest, mineral, and other natural resources. Because of the importance to New Zealand of her export trade, this objective must also include keeping production costs in our export industries at least competitive with those in other primary producing countries. A necessary corollary of this objective is the promotion of manufacturing and other secondary industries on an economic basis and the provision of adequate power, transport, and other services.

34. "Promoting generally the economic, financial, and social welfare of the people of New Zealand" is a very wide purpose. We interpret it as including the objectives of increased productivity leading to higher living standards, the promotion of overseas trade (including the maintenance of adequate reserves of overseas exchange to cushion the effects of fluctuations in overseas earnings), and the fostering of arrangements designed to facilitate international trade and to remove trade barriers. Broad social objectives also fall under this heading – the equitable distribution of the national income and the relief of the individual from some of the financial burdens of family responsibility, sickness, old age, and unemployment.

Conflicts Between Objectives

35. A policy designed to further any one of these ends may at the same time adversely affect some of the other objectives. For example, over-emphasis on full employment of labour may cause inflation and so frustrate the achievement of greater stability in prices. Similarly, conflict may arise between the objectives of developing natural resources and of maintaining adequate reserves of overseas funds. A further conflict may arise between the desire for higher living standards immediately and the need to divert resources to capital expenditure and so build up productive capacity in the future.

36. It follows that, in considering its economic, monetary, and fiscal policies, the Government must from time to time balance the favourable effects of any proposal on one objective against its unfavourable effects on one or more of the other objectives.

37. The manner in which the objectives of price stability, full employment, economic development, productivity, external trade, and social welfare have been given different emphasis in the changing conditions of war and peace is shown in the next Section which traces the main trend of economic events in New Zealand over the last twenty-one years.

Section Three

ECONOMIC REVIEW, 1934 TO 1955

38. It is about twenty-one years since the last general inquiry into monetary and banking systems in New Zealand. The report of the 1934 Parliamentary Committee reviews events prior to 1934 and the operation of the banking system before that time. In 1934 the Reserve Bank of New Zealand, established by the Reserve Bank of New Zealand Act 1933, began business and the New Zealand banking system took its present general form. It seems appropriate, therefore, to confine this review to the period since 1934.

39. During this period Governments have accepted in varying degrees and in different ways much wider responsibility for management of the whole economy in the national interest. In New Zealand the establishment of the Reserve Bank as part of this development gave the Government the means to co-ordinate monetary policy with its own fiscal policies. A notable change reflecting the acceptance of this wider responsibility in New Zealand was the establishment of the social security scheme, with its provisions designed to assist the discharge of family responsibilities and to give protection against vicissitudes of unemployment, prolonged illness, and old age. Other legislation made provision for a guaranteed price for the dairy industry and the forty-hour week.

40. This new responsibility has had to be discharged in circumstances of particular difficulty. Like other countries, New Zealand had to take the strain of a major war just as her economy had emerged from a depression and had then to face the problems of post-war readjustment. And New Zealand has also her own special problems. Because she is highly dependent on overseas trade her economy is very susceptible to influences beyond her own control. Over the last twenty-one years rising prices in overseas markets have been reflected in buoyant incomes in New Zealand and in a rising internal price level. As a young country New Zealand has to face the problem of two conflicting demands on her resources of labour, materials, and overseas exchange; that is, the demand created by her standard of living, and the demand for capital development to meet the needs of a growing population and an expanding economy.

41. Problems such as arise from the fall in the purchasing power of the New Zealand pound, from the impossibility of meeting all demands for imports, and from the shortage of labour in New Zealand, should all be examined in the light of the circumstances of the last twenty-one years.

42. The general outline of economic events for the greater part of that period has been set out in *The New Zealand Economy 1939 to 1951*, the first of the official Economic Surveys, and in the subsequent annual

surveys. There is therefore no need for a detailed account of economic events since 1934. Those events and changes have been selected which seem useful in making clear the broad economic background against which our monetary, banking, and credit systems have operated and developed. And an assessment has been made of the main economic forces operating in the last twenty-one years with an analysis of the measures taken to control and influence the economy during that period. The development of the monetary, banking, and credit systems since 1934 is dealt with in Section Four of this report.

43. In this review the period since 1934 is treated in four main sections:

(a) 1934–35 to 1938–39: Recovery from depression.
(b) 1939–40 to 1945–46: World War II.
(c) 1946–47 to 1948–49: Post-war reconstruction and recovery.
(d) 1949–50 to 1954–55: The recent period of accelerated population increase and higher capital investment.

1934–35 to 1938–39: Recovery from Depression

44. Already in 1934 there had been some recovery from depression. Unemployment had fallen considerably. Meat and wool prices had improved. The index of export prices on a New Zealand currency basis had risen by 12 per cent compared with 1931, and the index of value in New Zealand currency of total exports had risen by 35 per cent. Between 1931 and 1934 the index of volume of exports rose by 25 per cent. New Zealand's recovery between 1931 and 1934 was therefore aided by substantially increased production for export as well as by higher prices for exports. In 1933–34, value of factory production rose by 8·6 per cent and in the following year it increased by a further 10·5 per cent. Recovery was also aided by Government expenditure on public works, on employment subsidies, and on housing and social services, including unemployment benefits.

45. The next few years saw further gradual recovery, due chiefly to rising overseas prices for New Zealand exports, and to the continuation and expansion of the deliberate policy of increased Government spending and increased lending by the State Advances Corporation.

46. The following figures of gross capital investment (excluding changes in value of stocks) point to the degree of recovery by 1939.

Year Ended March	Private	Government	Total	Percentage of Gross National Income
	£ million	£ million	£ million	
1933	4	6	10	9
1939	17	22	39	17

47. Between 1933–34 and 1938–39 the volume of factory production rose by 69 per cent. In 1938–39 unemployment had been greatly reduced although some 24,000 men were in subsidised full-time employment. (Earnings of overseas exchange rose from £49 million in 1933–34 to £69 million in 1937–38, then fell to £63 million in 1938–39.)

48. In 1936 the Government took full control of the Reserve Bank. In this way it acquired, as the then Minister of Finance later explained, *"full control of banking and currency within the Dominion"*. In the same year the forty-hour week was introduced. In 1937 the Government introduced the guaranteed price scheme for dairy produce, and in 1939 the social security scheme began to operate.

49. Most of the increasing Government spending in the four years up to 1938–39 was financed by taxation and by borrowing from the public. But in 1938–39 the Government was unable to obtain enough money from non-banking sources to finance its expenditure, including its expanding works programme, and therefore its net indebtedness to the banking system rose by nearly £18 million.

50. The following extract from the 1939 Budget shows that, although expanded Government expenditure (partly financed from bank credit) assisted in overcoming unemployment, it also led to balance of payments difficulties: *"Action along the lines indicated produced quick results, but in the absence of an equally rapid expansion in production it led to an increase in imports and a drain upon the sterling resources of the Dominion"*.

51. In the calendar year 1938 the net overseas assets of the banking system fell from £23 million to £7½ million. Among causes of this serious deterioration in the country's reserves of overseas funds were a fall in export income accompanied by higher demand for imports, Government borrowing from the banking system, and substantial capital remittances from New Zealand.

52. To meet this balance of payments crisis comprehensive import and exchange controls were introduced in December 1938.

1939–40 to 1945–46: World War II

53. The import and exchange controls introduced in 1938 stopped the drain on overseas funds by restricting the supply of imports. But since there was no corresponding reduction in purchasing power in New Zealand it also accentuated the internal inflationary pressures. From this and other causes, including the enlarged Government spending, there now existed a greater demand than could be met for locally produced and imported goods and services. The war brought a diversion of labour, materials, and industrial capacity from production of consumer goods and services in New Zealand to war production. A similar diversion of resources dried up the supply of imports from the United Kingdom and other countries. Yet, at the same time, incomes in New Zealand were maintained and increased through spending on war production. The result of all these factors was to build up inflationary pressures still further. An excess of overseas receipts over payments of £28 million for the calendar year 1944 and of £43 million for 1945 generated strong inflationary pressures in those years.

54. The national income statistics illustrate the diversion of resources to war purposes between 1939 and 1945. Personal consumption fell from 70 per cent of gross national income in 1938–39 to 47 per cent in 1943–44. Current Government expenditure on goods and services in that period increased from 13 to 43 per cent, including an increase from 1 to 35 per cent for war purposes.

55. Wartime budgets were designed to absorb as much as possible of the surplus purchasing power, a policy described in one Budget as *"to tax to the economic limit for war purposes and borrow for essential production works and for any balance of war requirements"*. The objective was to finance at least half of the cost of the war from taxation. This objective was more than achieved with total taxation for war purposes at £263 million (including £38 million transferred from the Consolidated Fund to the War Expenses Account) and net borrowing for war purposes £239 million. A remarkable and commendable feature of New Zealand war finance was the relatively minor use of bank credit by the Government. Between August 1939 and August 1945 net Government indebtedness to the banking system rose by only £23 million or about 3 per cent of the total Government expenditure for war purposes.

56. The lend-lease scheme considerably eased some of the problems associated with war finance. New Zealand received goods and services valued at £112 million as reciprocal aid and provided to the United States and Canadian authorities assistance valued at £82 million. If New Zealand had been required to pay in overseas funds for lend-lease assistance from the United States and Canada, the position of her external reserves, which rose from £10 million to £87 million at the end of the war, would at that time have been much less favourable.

57. Price control and other measures introduced up to the end of 1941 proved ineffective in preventing price increases. A more extensive stabilisation scheme, including additional price controls, control of maximum salaries and wages, and price subsidies, was therefore introduced in 1942. In the same year Government control of industrial manpower commenced. Stabilisation was considerably assisted by international schemes for controlling raw material prices and supplies and by the co-operation of all sections of the community.

58. Early in the war the Government adopted the policy of compulsory bulk purchase of the main exports which were sold to the United Kingdom on a Government to Government basis. From 1943, payments to primary industry stabilisation accounts ensured that increased export incomes received under those agreements were not spent by the farmers, but were set aside for later use for the benefit of the industries. These industry accounts became an important source of Government borrowing during the war and post-war years.

59. Apart from the effects of the stabilisation scheme and of fiscal policies, an important contribution to stability in the war years was the high level of private savings. Small savings, including savings in the Post Office and trustee savings banks, and national savings accounts and bonds, increased by £92 million during the war.

60. Between 1939 and 1945 the retail prices index rose from 990 to 1170 (1926–30 = 1000), i.e., by approximately 18 per cent or about 3 per cent per annum. This was a relatively small increase compared with the rise of 35 per cent, or an average of about 9 per cent per annum, in New Zealand retail prices during the 1914–18 war. During World War II retail prices rose by 28 per cent in the United Kingdom, 29 per cent in the United States, and 22 per cent in Australia compared with the 18 per cent in New Zealand.

1946–47 to 1948–49: Post-war Reconstruction and Recovery

61. The years immediately following the war brought their own difficulties. Labour, materials, and industrial capacity had to be devoted in large part to capital works such as hydro-electric schemes and housing which it had been impossible to undertake in wartime conditions. As a result, sufficient goods and services for everyday use could still not be provided to match the available spending power which included substantial accumulations of wartime savings.

62. The increasing diversion of resources to meet the need for capital works is shown by the fact that the total of Government and private capital investment programmes rose between 1946 and 1949 from £49 million to £87 million. The percentage of gross national income absorbed by capital works increased from 12 per cent in 1946 to 18 per cent in 1949. In 1933 the corresponding figure was 9 per cent and in 1938 it was 15 per cent. In 1943 diversion of resources to war purposes and shortages of imports of capital goods had reduced the percentage of gross capital investment to 5 per cent.

63. Some man-power controls were released in 1945, and those remaining were lifted in June 1946. Most of the wartime direct controls remained until 1947, and held in check the tendency to increasing prices and to a high demand for imports, so that monetary policy played only a minor part in management of the economy. Selective control of bank advances channelled some investment according to Government policy. Increases in the farm industry stabilisation accounts continued to provide an important source for Government borrowing.

64. In 1946 the family benefit of 10s. per week was made universal. The Government reduced purchasing power in the hands of the public and restrained inflationary pressures by taxation and borrowing in New Zealand to repay overseas loans. For example, during the three years ended March 1948, the Government in this way financed repayment of £62 million in New Zealand currency. The repayments in London had to be made in United Kingdom currency (£50 million), which came from the accumulated overseas funds held by the Reserve Bank.

65. However, in 1948–49 this substantial reduction in overseas indebtedness was followed by an increase of £18 million in Government indebtedness to the banking system in New Zealand. This arose because in 1948–49 overseas transactions showed a deficit, trading-bank advances decreased slightly, small savings fell, and the money market became tight. The Government was then unable to attract sufficient savings to finance its capital works programme.

66. The extent to which the New Zealand price level was held down during the war and early post-war periods by the stabilisation scheme and other measures is illustrated by the fact that, by the middle of 1948, the cost of imported items in the wholesale prices index had risen by over 90 per cent since 1939, whereas wholesale prices of locally produced items had risen by a little more than 40 per cent and retail prices by about 33 per cent. In 1948 the New Zealand retail prices index stood at 1314 compared with 990 in 1939. During the calendar years 1946 to 1948 retail prices index figures were as follows:

Calendar Year	Index (Base: 1926–30=1000)	Percentage Increase Compared With Previous Year
1946	1180	0·9
1947	1217	3·1
1948	1314	8·0

67. The success of the war and post-war stabilisation programme was an important factor in making possible the appreciation of the New Zealand pound in August 1948. Until then £100 United Kingdom currency had been equivalent to £125 New Zealand currency. Before the appreciation, exporters received £125 in New Zealand currency for each £100 United Kingdom currency from sale of exports and New Zealand importers had to pay £125 in New Zealand currency for imports costing £100 in United Kingdom money. After the appreciation, transactions were conducted approximately at £100 New Zealand currency equals £100 United Kingdom currency.

1949–50 to 1954–55: A Period of Accelerated Population Increase and Higher Capital Investment

68. As the war and post-war stabilisation scheme was gradually dismantled, prices rose. The index of retail prices moved as follows:

Calendar Year	Index (Base: 1926–30=1000)	Percentage Annual Increase Over Previous Year
1949	1336	1·7
1950	1411	5·6
1951	1566	11·0
1952	1688	7·8
1953	1765	4·6
1954	1847	4·6
1955	1892	2·4

69. Before 1948 a variety of direct controls prevented inflationary pressures from having their full effect on prices. In the years following removal of these controls, price increases were more pronounced than they otherwise would have been because the previously suppressed pressures were then allowed to be fully reflected in price increases.

70. The 1948 adjustment of the exchange rate reduced the amount of annual accretions to the primary industry stabilisation accounts. The diminution of this source of borrowing, combined with the decline in saving and other factors already discussed, led to an increase of £15 million in Government indebtedness to the banking system in 1949–50.

71. In 1950–51 the Korean War brought a remarkable increase in demand for international commodities including wool and, as a result, incomes in general in New Zealand increased substantially. But imports

did not immediately rise sufficiently to absorb all this additional purchasing power. To reduce the sudden increase of purchasing power it was agreed between the wool growers and the Government that one-third of the gross realisation, with some minor exceptions, should be frozen in individual accounts of the growers at the trading banks or with stock and station agents. However, although spending by individual growers was curbed by the wool retention scheme, no special steps were taken to restrict the lending capacity of the trading banks by raising the reserve ratio and thus immobilising part of the additional bankers' cash held by them at the Reserve Bank.

72. The extra overseas exchange arising from the high wool prices enabled the Government to dispense with a wide range of import controls, particularly on imports from sterling area countries.

73. The very high wool prices did not last long and the average price of wool fell from 138d. in February 1951 to 38d. in August 1951. But other causes of inflation remained. Export incomes other than for wool rose considerably.

74. Private investment showed a marked increase from £57 million or 11 per cent of the gross national income in 1949–50 to £101 million or 13 per cent of the much higher gross national income in 1952–53 and further increased to £129 million or 14 per cent of the gross national income in 1954–55.

75. After the wool boom in 1950–51 private imports rose from £125·5 million in the year ended June 1950 to £148·3 million in 1951 and £249·4 million in 1952. Between the June years 1950–51 and 1951–52 the balance of external trade and other overseas transactions changed from a surplus of £39 million to a deficit of £51 million, a total change of £90 million. The following table summarises New Zealand's external receipts and payments for the three years ended 30 June 1952:

(£ million)

	Year Ended June		
	1950	1951	1952
RECEIPTS			
Wool	63·4	116·2	96·2
Other exports	104·3	107·1	140·5
Receipts other than for exports	21·1	20·0	28·7
Total receipts	188·9	243·3	265·4
PAYMENTS			
Private imports	125·5	148·3	249·4
Government imports	17·8	21·9	25·0
Other payments	39·3	34·0	42·3
Total payments	182·6	204·2	316·6
Surplus (+) or deficit (−)	+6·3	+39·1	−51·3

76. The very substantial deficit in overseas transactions in 1951–52 led to the exchange allocation scheme, operated by the Reserve Bank from April 1952 until December 1954, but latterly with reducing severity.

77. In 1953–54 the economy showed an easing of the employment situation. Recorded vacancies for employment in industry had fallen from 34,000 in 1950 to 20,000 in April 1953. In 1954, however, the pressure returned. Payments for private imports had averaged £15·7 million per month for the first half of 1954. This figure rose to £20·6 million for the second half of 1954 and was £19·8 million for the first half of 1955. From June 1955 to December 1955 the average monthly rate was £21·2 million. Ruling wage rates and employment vacancies both rose. In 1955, imports and other external payments exceeded overseas earnings (including Government overseas borrowing of £7·3 million) by £26·5 million.

Significant Developments, 1934 to 1955

78. The foregoing is a review in broadest outline of economic trends in the twenty-one years between 1934 and 1955, divided into significant periods. A number of other developments and changes can be more appropriately examined over the whole twenty-one years.

Population

79. For our purposes the most important aspects of population are its annual rate of growth from natural increase and from immigration, and its division into age groups. Between 1934 and 1939 total population rose from 1,552,000 to 1,629,000, an increase of 5 per cent in five years. In the five years to December 1955 the increase was from 1,909,000 to 2,139,000, an increase for the five years of 12 per cent. This change in rate of increase has an economic significance because of the consequent high demand for a wide range of capital works, including housing, schools, transport facilities, and industrial buildings and machinery to meet the needs of a rising population.

80. The annual rate of population increase of over 2 per cent in the five years to December 1955 is a very high rate of population increase compared with population growth in other countries. On page 31 of the 1955 *New Zealand Official Year Book* there is a table showing the average annual percentage increase in population for some twenty-one countries for recent intercensal periods. The average annual percentage increase for New Zealand is greater than for any of the other countries shown in the table except Australia.

81. Two main factors are directly responsible for the rising rate of population increase. The birth rate has shown a rising tendency since 1935, and net migration has become important in the post-war years. The change in the birth rate per 1,000 of European population since 1935 is illustrated by this table:

Calendar Year	Birth Rate Per 1,000 of Mean Population	Calendar Year	Birth Rate Per 1,000 of Mean Population
1935	16·17	1950	24·67
1940	21·19	1954	24·63
1945	23·22	1955	24·85

82. Migration as compared with natural increase has had a relatively small effect on recent population growth in New Zealand, as the following figures show:

Year Ended March	Natural Increase		Migration Increase	
	Number	Percentage of Population	Number	Percentage of Population
1939	15,164	0·93	5,071	0·31
1952	31,731	1·60	15,479	0·78
1953	33,158	1·63	20,334	1·00
1954	34,136	1·64	15,047	0·72
1955	35,380	1·66	7,376	0·35

83. Even in the year ended March 1953, a year of exceptionally high immigration, the increase in population from migration did not reach two-thirds of the natural increase, while in 1954–55 the proportion was about one-fifth. Although migration has a relatively small effect on total increase in population, it makes its own special demand on the economy, because the adult migrant must immediately have somewhere to live, and very often some place to work in and some industrial equipment to use. In this way immigration adds directly to the demand for capital expenditure, and adds temporarily to inflationary pressure.

84. Changes in the age distribution of the population – particularly the proportion of the population in the fifteen to sixty-four age group – have had important economic effects. In 1934 this age group (which is generally taken as an indicator of the potential labour force) comprised 67 per cent of the population, compared with 60 per cent in 1954. The following table shows the changes which have taken place:

Population (Age Group)	Calendar Year, 1934		Calendar Year, 1954	
	Mean Number	Per Cent	Mean Number	Per Cent
	Thousands		Thousands	
0 to 14	419	27	648	31
15 to 64	1,039	67	1,257	60
Over 64	92	6	190	9
	1,550	100	2,095	100

85. The provision of universal and other age benefits becomes a greater burden on the rest of the community as the proportion of the population over sixty-four years of age increases. However, that burden is reduced to some extent if more people continue working after the age of sixty-four, as many now do. The higher birth-rate since 1935 may be expected to result in a higher proportion of population in the fifteen to sixty-four age group in the next few decades.

Labour Force

86. The following table compares the labour force and its estimated distribution in 1939 with the estimate for October 1955:

	1939		1955 (October)	
	Number	Per Cent	Number	Per Cent
	Thousands		Thousands	
Primary industries (mostly farming) ..	179	27	152	19
Secondary industries (mostly manufacturing and building construction)	187	28	278	35
Tertiary industries	284	42	362	45
Armed Forces	3	..	10	1
Unemployed	19	3	..	..
	672	100	802	100

87. The proportion of the labour force employed in farming and related industries has fallen from 27 per cent in 1939 to 19 per cent in 1955, while the percentage employed in secondary industry has risen from 28 to 35. Over the last five years the number employed in primary industries has been virtually stationary at about 150,000.

The National Income

88. The national income is the total of all labour and property income earned in producing the national output of goods and services. It is the total incomes earned by wage and salary earners, plus interest, profits, rents, and royalties. From another viewpoint it is the net value of goods and services produced in a year, valued at the prices ruling in that year.

89. Since 1935 the national income of New Zealand has risen through increases in two important elements, the volume of goods and services produced in New Zealand and the prices of those goods and services.

90. The following table shows the gross national income(1), both at current prices for the respective years and converted to the basis of 1954–55 prices, at five-yearly intervals since 1935:

(£ million)

Year Ended March	Gross National Income(1) at—	
	Current Prices for Respective Years	1954–55 Prices
1935	136	310
1940	248	463
1945	379	606
1950	552	763
1955	927	927

(1) NOTE.—The gross national income is the national income as defined above, together with depreciation allowances and indirect taxes (minus subsidies).

91. The figures for gross national income at current prices reflect both increases in production and price increases, while in the column headed "1954–55 Prices" a rough attempt has been made to eliminate the effect of price increases by correcting the annual totals for changes in the retail prices index number. Gross national income in 1954–55 at current prices is about seven times what it was in 1934–35. Corrected for price changes in this way the gross national income is three times what it was in 1934–35.

Volume of Production

92. Since 1935 farm production in New Zealand has risen by about one-third. The most pronounced increase has been in the last decade and especially in the last five years. Between 1934 and 1939 volume of factory production rose by two-thirds. Since 1939 the total increase has been 111 per cent and in the last ten years the increase in volume of factory production has been 64 per cent.

93. The following index numbers of volume of total production per head were supplied by the Government Statistician:

Year	Per Head of Population (Converted to Base: 1946–47 = 100 from Base: 1938–39 = 100)	Per Head of Labour Force (Base: 1946–47 = 100)
1946–47	100	100
1947–48	103	102
1948–49	106	107
1949–50	109	110
1950–51	110	113
1951–52	110	113
1952–53	110	114
1953–54(1)	110	115

(1) Provisional

94. In considering the relative stability of the volume of production per head of population between 1949–50 and 1953–54 allowance should be made for the fact that these are years of rapid population increase and of a high birth rate.

95. The following table shows the farm livestock population in New Zealand, at intervals since 1930, expressed in terms of livestock units (a statistical unit devised to measure total livestock population). The human population and the number of livestock units per head of population are also shown:

Year	Livestock Units	Population	Livestock Units Per Head of Population
	Thousands	Thousands	
1930	7,323	1,493	4·9
1935	7,607	1,562	4·9
1940	8,054	1,637	4·9
1945	8,510	1,695	5·0
1950	8,801	1,909	4·6
1955	10,278	2,139	4·8

96. It would seem that the productive flocks and herds of New Zealand have been well maintained in proportion to the human population over the last twenty years.

97. During the last five years particularly, increased carrying capacity has caused the farmer to withhold from the market stock which could otherwise have been sold. The country, therefore, has not yet had the full benefit of the increased carrying capacity through higher exports, except in the case of wool.

External Trade

98. During the past twenty-one years there have been times when changes in overseas transactions have exercised a powerful influence upon incomes and prices in New Zealand. It has already been remarked that during the war and early post-war years substantial surpluses of exports and other receipts over imports and other payments arose because it was impossible to secure a flow of imports corresponding to buoyant export incomes. A similar surplus arose from the wool boom in 1951. The following figures show the fluctuations during the six years ended June 1955:

Year Ended June	Surplus (+) Deficit (−)	Year Ended June	Surplus (+) Deficit (−)
1950	+ 6·3	1953	+34·7
1951	+39·1	1954	+25·2
1952	−51·3	1955	−42·3

99. The following table shows that since 1935 the volume of New Zealand's external trade has risen by approximately 76 per cent:

Volume Index of External Trade

(Base: 1936–38 = 100)

Calendar Year	Imports	Exports	Total Trade
1935	72	96	85
1940	79	108	95
1945	64	94	80
1950	141	122	131
1953	133	129	131
1954	175	128	150

100. Between 1935 and 1954 the index of the volume of imports has risen by 143 per cent while the index of the volume of exports has increased by $33\frac{1}{3}$ per cent – a much smaller proportionate increase.

101. The main reason why New Zealand has been able to expand the volume of her imports without a fully commensurate increase in the volume of her exports is that, over the whole period since 1935, export prices have risen proportionately more than import prices. In other words, New Zealand's terms of trade with the rest of the world have improved considerably since 1935. This is shown by the following table:

Index Numbers of Import and Export Prices and Terms of Trade
(Base: 1954 = 100)

Calendar Year	Import Prices	Export Prices	Terms of Trade
1935	35	25	73
1940	43	36	83
1945	62	44	71
1950	84	92	110
1954	100	100	100

102. New Zealand's terms of trade deteriorated substantially during the depression years, reflecting the marked slump in prices for agricultural and pastoral produce. In 1933 the index (base: 1954 = 100) was 59; it improved considerably to 92 by 1937 but declined again during the war to 67 in 1944. Since 1948 there has been substantial improvement, as follows:

Index of Terms of Trade
(Base: 1954 = 100)

Calendar Year	Index Numbers	Calendar Year	Index Numbers
1948	80	1952	81
1949	85	1953	96
1950	110	1954	100
1951	111		

The years 1950 and 1951 reflect the effect of the wool boom.

Retail Prices

103. Much attention was focused during the sittings of the Commission on the rise in retail prices, the index of which has more than doubled since 1935. The following table shows the movement in five yearly periods:

Calendar Year	Retail Prices Index (Base: 1926–30 =1000)	Increase Per Cent During Five Years	Average Annual Percentage Increase for Five Years
1935	837		
		24	4·8
1940	1035		
		13	2·6
1945	1170		
		21	4·2
1950	1411		
		34	6·8
1955	1892		

104. The two periods where the least increase is shown are the war and post-war reconstruction periods, during the greater part of which relatively rigid price and other direct controls were operating.

Wage Rates

105. A survey of the economic history of New Zealand during the past two decades would be incomplete without an examination of wage rates. Statistics are available showing the changes in minimum wage rates fixed by awards made by, and industrial agreements filed in, the Court of Arbitration, and fixed by orders of certain other tribunals having jurisdiction to determine rates of wages.

106. The following table shows index numbers of annual averages of nominal minimum weekly wage rates for adult male workers from 1935 to 1955, and also index numbers of effective weekly wage rates for adult males which are derived by dividing the index numbers of nominal wage rates by the corresponding all-groups index numbers of retail prices and multiplying by the base value of 1000.

(Base : 1926–30 = 1000)

Calendar Year	Index Numbers of Nominal Minimum Weekly Wage Rates (Adult Males) All Industrial Groups	Index Numbers of Effective Weekly Wage Rates (Adult Males)
1935	858	1025
1940	1130	1092
1945	1381	1180
1950	1793	1271
1951	2039	1302
1952	2143	1270
1953	2284	1294
1954	2459	1331
1955	2545	1345

107. In 1931, pursuant to the Finance Act of that year and as a consequence of the depression, rates of remuneration prescribed in awards and industrial agreements were reduced by 10 per cent under a general order made by the Court of Arbitration and operating from the first week in June 1931.

108. From 1 July 1936 wage and salary rates were in general restored to pre-depression levels by the Finance Act 1936.

109. In 1937 the Court of Arbitration made a wage pronouncement fixing new standard hourly rates for skilled, semi-skilled, and unskilled adult male workers. This pronouncement had no immediate effect on wage rates, but during the ensuing two years the minimum rates prescribed in new awards and industrial agreements were progressively brought into line with the Court's standard rates.

110. Following upon the outbreak of war, and with the object of providing machinery to enable minimum wage rates to be adjusted promptly to meet rapid economic changes, the Rates of Wages Emergency Regulations 1940 were brought into operation. These regulations empowered the Court, after taking into account the economic and financial conditions affecting trade and industry in New Zealand and the cost of living, to make general orders increasing or reducing all rates of remuneration prescribed in awards and industrial agreements for the time being in force. Two general orders were made by the Court

under the regulations, one which increased all rates by 5 per cent and operated from 12 August 1940, and the other which also involved an increase of 5 per cent, but with certain limiting conditions, and which operated from 7 April 1942.

111. The Rates of Wages Emergency Regulations were superseded on 15 December 1942 by the Economic Stabilisation Emergency Regulations 1942. Under these regulations all rates of remuneration were stabilised, but the Court of Arbitration was empowered under certain conditions to make general orders increasing or reducing minimum rates. Later the Court was also authorised to make standard wage pronouncements. Such pronouncements had no operative effect in themselves, but the regulations empowered the Court to vary immediately all awards and agreements by individual amendments to bring the minimum rates prescribed therein into line with the standard rates named in a pronouncement. This system enabled a reasonable relationship to be maintained between the minimum rates of remuneration prescribed in approximately 550 awards and agreements. Standard wage pronouncements were made in 1945, 1947, 1949, and 1952. General orders were made in 1950, 1951, 1953, and 1954. The 1951 General Order prescribing an increase of 15 per cent incorporated the 1950 General Order which was of an interim nature and which provided for an increase of 5 per cent with limitations following upon the withdrawal of Government subsidies on several classes of widely used goods.

112. An increase of 10 per cent with certain limitations was awarded in the 1953 General Order to operate from 15 September 1953, and in 1954 this figure was increased to 13 per cent with similar limitations to operate from 18 November 1954.

113. The regulations were amended on numerous occasions. In 1950 they were revoked, and their place was taken by the Economic Stabilisation Regulations 1950 made under the Economic Stabilisation Act 1948. These regulations abolished the power of the Court to amend all awards and industrial agreements simultaneously with the making of a standard wage pronouncement and at the same time abolished control of maximum rates. The former power was restored by the Economic Stabilisation Regulations 1952, but was again withdrawn by the Economic Stabilisation Regulations 1953 which are still in operation.

114. In making general orders increasing or reducing rates of remuneration under the current regulations, the Court is directed to take into account:

(a) Any rise or fall in retail prices as indicated by any index published by the Government Statistician;
(b) The economic conditions affecting finance, trade, and industry in New Zealand;
(c) Any increase or decrease in the volume and value of production in primary and secondary industries of New Zealand;
(d) Relative movements in the incomes of different sections of the community;
(e) All other considerations that the Court deems relevant.

115. In reviewing our economy, however, it is not sufficient to examine the changes in minimum wage rates only. Total wage costs which have ultimately to be met by consumers are a reflection of the actual earnings of workers. It is well known that actual wages paid in

industry have advanced more rapidly since the end of the war than minimum prescribed rates. Statistics disclosing the exact position are not available; but it is believed that the general trends are roughly indicated in the following tabulation which compares the average prescribed minimum rates for adult male workers with the average weekly payout to all classes of workers:

Average Prescribed Minimum Rates of Adult Male Workers Compared With Average Weekly Payout to All Classes of Workers (Males, Females, and Juniors)

Half Year Ending	Average Weekly Wages: Nominal Minimum Weekly Wage for Adult Males as Prescribed in Awards and Industrial Agreements as at End of Preceding Month	Average Weekly Wages: Average Weekly Payout (Including Overtime) for Male, Female, and Junior Workers Combined in a Week Ending in the Mid-month Pay Period
	£	£
April 1946	6·250	6·292
October 1946	6·375	6·416
April 1947	6·433	6·663
October 1947	6·492	6·954
April 1948	6·950	7·375
October 1948	7·008	7·388
April 1949	7·150	7·733
October 1949	7·613	8·071
April 1950	7·625	8.225
October 1950	8·042	8·788
April 1951	8·982	9·758
October 1951	9·196	10·154
April 1952	9·300	10·392
October 1952	9·725	10·650
April 1953	9·746	11.071
October 1953	10·741(1)	11·104(2)
April 1954	10·748	12·121
October 1954	10·818	12·350
April 1955	11·230	12·758
October 1955	11·286	13·200

(1) Includes retrospective payments following Court's General Order of 1953.
(2) Excluding retrospective payments following Court's General Order of 1953.

116. In April 1946 there were many workers receiving wages in excess of the prescribed minimum rates and an appreciable amount of overtime was being worked. It happened that at that date these factors were just sufficient in their effect to bring the average earnings of all workers (males, females, and juniors) up to a point very slightly in excess of the average minimum prescribed weekly wage rate for adult males.

117. Since that date, however, an ever-increasing margin has been established by the average actual weekly payout for all workers over and above the adult male rate. It will be seen that, whereas in April 1946 the margin was 10d. per week, by October 1955 it had expanded to £1 18s. 3d. per week. This amount does not represent the average additional sum being earned today in excess of minimum prescribed rates, because, as has already been mentioned, many workers were, in April 1946, receiving wages in excess of minimum rates, and also working overtime.

118. From a close examination of the foregoing table it will also be seen that the widening of the margin between the two sets of figures has been spectacular during the past eighteen months.

From April 1954 to October 1955: While adult male rates rose by 10s. 9d. per week, average actual payout increased by 21s. 7d. per week.

From October 1954 to October 1955: While adult male rates rose by 9s. 4d. per week, average actual payout increased by 17s. per week.

From April 1955 to October 1955: While adult male rates rose by 1s. 1½d. per week, average actual payout increased by 8s. 10d. per week.

119. It is very significant to find that during the last six months average actual payout has increased eight times as fast as prescribed minimum adult rates despite the fact that a credit squeeze is declared to be in operation. We do not think that much of this increase can be ascribed to working more overtime.

120. The sum of £1 18s. 3d. per week, referred to above, when spread over all employees in the country represents over £50 million per annum, a sum equal to about 11 per cent of the total wage bill for 1954–55.

121. It is obvious that the outstanding feature of the wage situation during the post-war period has been the progressive increase in the size of the margin between prescribed minimum rates and actual rates, and that the latter at the moment are increasing much faster than the former. No doubt the position is directly due to over-full employment which, in turn, is due to factors other than the operations of wage-fixing authorities.

122. Wages being the principal constituent of costs, it is manifest that, while such conditions continue, it is impossible to expect stability in prices of locally produced consumer goods and services.

Capital Investment

123. This table illustrates the marked changes in the level of capital investment since 1933:

Gross Capital Investment (Excluding Changes in Stocks) as a Percentage of Gross National Income

Year Ended March	Private	Government, Including Local Authority	Total
1933	4	5	9
1938	7	8	15
1943	2	3	5
1948	9	7	16
1953	13	10	23
1955	14	9	23

124. Here is shown the recovery from the depression, the fall in capital investment during the war, the recovery during the post-war years, and the comparatively higher rate of capital development in recent years. The table also shows the relatively greater growth since 1938 of private compared with Government and local authority expenditure.

The Building and Construction Industries

125. Already in 1937 there was evidence of shortage of skilled labour in the building industry. The 1938 Budget contained this comment about the State housing scheme:

> It was realised at the commencement that the progress of the housing scheme would depend very largely on the availability of skilled labour. The operations of the Department are, at the moment, being seriously delayed on account of this factor. The average number of artisans employed by the contractors is only 1·8 (per house). This figure explains the long period required by many builders to finish their contracts.

In November 1938 the figure of 1·8 had fallen to an average of 1·5 artisans per house under construction. To remedy this situation, special arrangements were made to recruit building artisans in the United Kingdom and Australia.

126. Since 1938 the building and construction industry has been under considerable pressure and, at times, very great pressure of demand for its services. The increased demand was reflected in higher prices and, to some extent, the higher demand led to an increase in the labour force employed in the industry.

127. From 1946–47 to 1954–55 the labour force employed in the building and construction industry increased from 49,300 to 69,200 or by approximately 40 per cent. In the same period the total labour force increased by 14 per cent. In 1946–47 some 7 per cent of the labour force was employed in the building and construction industry, and in 1954–55 the percentage was 8·6.

128. The changes in the volume of house building, an important section of the building industry, are a striking indication of economic conditions generally. These changes are illustrated in the following table of building permits for urban districts:

Year Ended March	Number	Year Ended March	Number
1933	1,496	1953	11,700
1938	6,043	1954	12,596
1943	863	1955	15,443
1948	9,854		

Savings

129. There is no one statistical total of savings entirely suitable for use as an indicator of the general level of savings in the community over the last twenty-one years. The main components of total private savings are:

(a) Small savings – i.e., Post Office Savings Bank, trustee savings banks, national savings, etc.

(b) Corporate savings – i.e., undistributed profits of companies.

(c) Contractual savings – life insurance provisions, superannuation, mortgage repayments, net repayments under hire-purchase agreements, etc.

(d) Accumulations in farm industry accounts and wool retention accounts.

(e) Savings of farmers and unincorporated businesses apart from those included in (a) to (d) above.

130. The following table shows the movement in "small savings" since 1934–35 as a percentage of gross national income:

Year Ended March	Amount of Increase	Percentage of Gross National Income
	£ million	
1935	5·0	3·67
1940	—2·7	−1·07
1945	26·8	7·07
1950	12·4	2·24
1955	14·0	1·51

131. Details of corporate savings (i.e., undistributed profits of companies) are not available except for the following years:

Year Ended March	Corporate Savings	Percentage of Gross National Income
	£ million	
1950	19	3·4
1951	26	3·7
1952	25	3·5
1953	20	2·7
1954	30	3·6

132. Retention of profits is particularly important when the cost of replacement of capital equipment is rising and when normal depreciation rates may not ensure adequate finance for replacements. Because the necessary data is not available it is not practicable to compare recent undistributed profits with those of pre-war years.

133. Nor is there sufficient information available to enable a comprehensive comparison to be made of the present level of contractual savings with that of earlier periods. However, a major part of these savings consists of repayments of table mortgages. The following table shows the total amount of repayments to the State Advances Corporation at intervals since 1939–40 in respect of residential mortgages:

Year Ended March	Total	Percentage of Gross National Income
	£ million	
1940	1·17	0·47
1945	1·80	0·48
1950	2·28	0·41
1955	5.80	0·63

134. Life insurance premiums contain important elements of saving. The following table shows the total life insurance premiums payable in respect of life policies in existence at the end of the year at five yearly intervals since 1935:

Calendar Year	Total Premiums	Percentage of Gross National Income
	£ 000	
1935	3,466	2·6
1940	4,756	1·9
1945	6,546	1·7
1950	10,936	2·0
1953	15,134	2·0

135. For a time accumulations in the farm industry reserve accounts made an important contribution to total savings in New Zealand. The following statement (which also includes the wool retention accounts) shows the position during the war and post-war years:

Farm Industry Reserves (Including Wool Retention Accounts)

Year Ended July	Total	Increase for Year	Increase as Percentage of Gross National Income
	£ 000	£ 000	
1942	750	750	0·26
1943	1,884	1,134	0·34
1944	5,384	3,500	0·94
1945	13,835	8,450	2·23
1946	16,905	3,071	0·77
1947	23,249	6,344	1·50
1948	39,837	16,589	3·45
1949	54,254	14,416	2·95
1950	72,283	18,030	3·27
1951	118,823	46,539	6·68
1952	118,804	−19	..
1953	114,014	−4,790	−0·64
1954	108,832	−5,182	−0·62
1955	102,229	−6,603	−0·71

136. The decline in small savings and the cessation of accumulations in farm industry reserves have been offset by a growth in Government savings through a surplus of revenue over expenditure on current account. The estimates of national income published by the Department of Statistics show that in 1938–39 the Government surplus on current account was £1·5 million or 0·6 per cent of the gross national income. In 1954–55 the surplus on current account was £54 million or 5·8 per cent of the gross national income.

137. The Commission does not consider that the detailed statistics of private savings are sufficiently comprehensive to enable general conclusions to be drawn, but there are indications of substantial decreases during the post-war period in the proportion which certain classes of savings, notably "small savings" and, in recent years, accretions to farm industry accounts, bear to the gross national product. This decrease has taken place during a period of high and increasing investment programmes when a high level of savings is essential to offset the inflationary effects of capital expenditure.

Summary of Main Periods

1934 to 1939

138. New Zealand's recovery in the years from 1934 to 1939 was part of a world recovery; it was assisted by internal policies including increased Government spending. By 1938 unemployment had been very substantially reduced. The expansion of Government and other spending brought its own problems; production lagged behind expanded incomes and the demand for imports exceeded export earnings. The drain on overseas funds resulting from this increased demand and from substantial remittances of capital from New Zealand led to the imposition of import and exchange control in December 1938. Although the Reserve Bank began business in 1934 and passed into full Government ownership and control in 1936, no significant Government borrowing from the bank took place until 1938.

1940 to 1945

139. The inflationary situation of 1939 was soon worsened by war expenditure; by the diversion of labour, materials, and industrial capital to war purposes; and by lack of imports for civilian use. During the war years the general stabilisation scheme (in which all sections of the community co-operated under the spur of war conditions) and sound budgetary policies did much to curb the tendency for prices to increase. Government borrowing from the banking system was comparatively slight in the circumstances. Throughout the war, partly because of lack of goods and services available for purchase, the level of savings was high.

1946 to 1949

140. The period 1946 to 1949 began with a shortage of houses and a backlog of Government and private capital works which had been necessarily postponed during the war. Both Government and private capital expenditure expanded quickly. Some surplus purchasing power was withdrawn from the public by high taxation and Government borrowing, partly to finance purchase by the Government of sterling funds for repayment of overseas debt. Price increases were limited by subsidies and by continuing some direct controls, which were also used to limit imports. Compared with other countries New Zealand was very successful in restraining price increases between 1939 and 1948. The restoration of the New Zealand pound to parity with the United Kingdom pound was a timely adjustment which curtailed rising export incomes and limited the effects in New Zealand of rapidly rising import prices.

1950 to 1955

141. In the period 1950 to 1955 price increases were steeper than in previous periods. Part of this increase arose from removal of stabilisation measures which previously had restrained price increases. Other potent factors were rising prices overseas and high and increasing public and private capital investment for which an adequate supply of savings was not always forthcoming. During this period and especially towards its end

this lack of savings, coupled with the demand for loan moneys, led to an upward pressure on interest rates. The wool boom of 1951 expanded wool-growers' incomes, and brought an accession of overseas exchange which enabled control of imports to be dispensed with until April 1952, when the flood of imports led to exchange allocation.

142. In 1953–54, partly as a sequel to and as a result of the wool boom during which some people had spent very heavily and others had over-imported in relation to the immediate demand, there was a lull in business. This was followed by a fall in demand for imports and by a drop in the number of vacancies for employment in industry. About mid-1954 there was a renewed demand for imports; there were increased industrial vacancies for employment; and there were widening margins between award rates and wages paid or offered by employers.

General

143. Using the base 1926–30 = 1000, the index of retail prices in 1934 had fallen to 808. This represented an increase in the value of the pound from 20s. in 1926–30 to 24s. 9d. in 1934. Between 1934 and 1955 the index rose to 1892 and the retail purchasing power of the pound therefore fell to 10s. 7d. on the 1926–30 basis of computation.

144. The Commission considers that the use of 1926–30 as a base gives a more reasonable comparison than that given by certain witnesses who compared the present purchasing power of the pound with that of 1934 and put it at only 8s. 5d. compared with 20s. in 1934.

145. Over the period 1934–35 to 1954–55 the gross national income increased from £135·6 million to £926·8 million or from an average of almost £80 per head in 1934–35 to £440 per head in 1954–55. It would seem, therefore, that the increase in average incomes per head far more than offset the fall in purchasing power since 1934–35.

Conclusion

146. The foregoing summarises the events of the twenty-one years during which New Zealand emerged from a depression, and shared the burden and stresses of a world war. Throughout almost the whole of this period the country had the benefit of rising export prices. During that time New Zealand's economy was adjusted to meet the needs of a rapid increase in population, and at the same time major social reforms were effected. In spite of the difficulties peculiar to a young country dependent on overseas markets for its few principal products all this was accomplished with orderly development. The principal strains evident in the last few years have been those associated with a high degree of prosperity and with buoyant export and other incomes.

147. In 1934, as in the four preceding years, capital investment, both public and private, was very low. Because there were 50,000 unemployed, total earnings were insufficient to provide an effective demand for all that could have been produced or imported. Although export prices had only slightly recovered from the very low level in 1931, overseas funds had been accumulated owing to the lack of demand for imports. Public confidence in the economic future was at a low ebb.

148. In 1955, on the contrary, capital investment is at a high level, and there are vacancies in industry for some 25,400 more people than are available. The level of incomes is so high that there is a demand for imports greater than can be met from available overseas funds. Export incomes are buoyant; there is confidence in future prospects. In short, the outlook has changed from depression to prosperity, from severe unemployment to over-full employment, and from deflation to inflation.

149. We turn now to an examination of what constitutes "money" and to an historical analysis of the monetary, banking, and credit systems of New Zealand during the past twenty-one years.

Section Four

THE MONETARY, BANKING, AND CREDIT SYSTEMS, 1934–55

Introduction

150. In Appendix C we examine in detail the definition of "money" and how it is created and controlled, the causes of changes which have taken place in the money supply in recent years, and the structure and operation of the monetary, banking, and credit systems in New Zealand, with particular reference to the period since 1934. In this section of our report, we provide only a necessary outline.

Money and Credit

151. Money is anything which is immediately available and generally acceptable in payment for goods and services or in settlement of a debt. In New Zealand, there are three things which appear to us to satisfy these criteria of immediate availability and general acceptability:

(a) The coin and notes in circulation:

(b) The deposits on current account standing to the credit of the customers of the trading banks, or to the credit of the Government and various marketing authorities at the Reserve Bank:

(c) The unexercised portion of overdraft authorities granted to customers by the trading banks.

152. The two latter types of money are entries in the books of a bank, recording the obligation of the banker to his customers, but the banker, when he is directed to do so by cheque, will immediately transfer to other people a sum up to the amount which stands to each customer's credit or up to the amount by which he has authorised each customer to overdraw his account. Nowadays, a very large proportion of payments is made by cheques drawn against demand deposits or against overdraft limits.

153. It should be noted that there is no universally accepted definition of money. The Reserve Bank, for instance, includes notes and coin in circulation, demand deposits of customers at the trading banks, and deposits of the Government and marketing authorities at the Reserve Bank, but does not include unexercised overdraft authorities in its definition. The Australian authorities include all savings-bank deposits as money. For reasons given in Section One of Appendix C, we believe that the items listed in paragraph 151 above, and these alone, should be regarded as money for statistical purposes in New Zealand. However, since this view has not as yet been accepted, we shall adhere to the Reserve Bank definition of the money supply in this report, although we shall examine from time to time the importance of unexercised overdraft authorities as a means of payment.

154. To grant credit is to make available money, goods, or services now, in return for a promise to pay or repay in the future. Usually a charge is made for the credit, in the form of an agreed rate of interest to be paid by the debtor on the sum lent.

Changes in the Money Supply in Recent Years

155. As the following table shows, the volume of money, as defined by the Reserve Bank, rose from £46 million at the end of June 1935 to £317 million at the end of June 1955, an increase of £271 million, or about 600 per cent. If unexercised overdraft authorities are included, the volume of money rose from £77 million in 1939 to £417 million in 1955.

Volume of Money in New Zealand, Together with Unexercised Overdraft Authorities, 1935 to 1955

(£ million)

(Last balance day in June)

—	1935	1939	1943	1945	1949	1951	1952	1954	1955
Coin in circulation ..	0·9	1·4	2·3	2·7	3·2	3·6	3·8	4·1	4·3
Notes held by public ..	6·1	11·5	27·5	34·5	42·3	48·4	50·1	57·1	59·0
Demand Deposits at—									
Reserve Bank	13·3	2·5	23·7	15·3	8·1	13·5	12·0	10·5	15·1
Trading banks	25·9	37·3	79·0	96·9	153·6	211·9	192·2	240·6	238·6
Total (Reserve Bank definition)	46·2	52·7	132·5	149·4	207·2	277·4	258·0	312·3	317·0
Unexercised overdraft authorities	N.A.	24·0	36·2	38·8	58·7	76·4	68·8	111·7	100·1
Total (including unexercised overdraft authorities)	N.A.	76·7	168·7	188·2	265·9	353·8	326·8	424·0	417·1

156. The table shows that the largest part of the supply of money is that held by customers of the trading banks in their current accounts. In addition, customers of the trading banks throughout the period have had available for spending substantial amounts in the form of unused authorities to overdraw their accounts. These two items together totalled nearly £339 million in June 1955.

Causes of Changes in the Money Supply: General

157. The volume of money (on the Reserve Bank definition) is increased:

(a) When a customer of the Reserve Bank or a trading bank lodges, to the credit of his account, foreign exchange received from the sale of goods or services beyond New Zealand, from gifts or legacies from persons overseas, or from the proceeds of a loan raised with an overseas lender.

(b) When the Reserve Bank or a trading bank buys securities or other assets from an individual or firm and the proceeds are lodged to the credit of the seller's account at a bank.

(c) When the Reserve Bank makes a loan to the Government or to marketing authorities. At first, the borrower's deposits at the Reserve Bank are increased, and when this money is spent, the recipients may lodge part of it in their accounts at the trading banks and retain part of it in circulation in the form of notes and coin.

(d) When the customer of a trading bank draws on an overdraft limit granted by the bank and the recipient of his cheque lodges it to the credit of his account at a bank.

158. Conversely the volume of money (on the Reserve Bank definition) is reduced:

(a) When a customer of the Reserve Bank or a trading bank buys, with a deposit in his name at the bank concerned, foreign exchange to meet obligations overseas.

(b) When the Reserve Bank or a trading bank sells part of its holdings of securities or other assets to persons with credit accounts at a bank.

(c) When the advances of the Reserve Bank are reduced, by the lodgment of notes, coin, or cheques drawn on credit accounts.

(d) When the advances of the trading banks are reduced, by the lodgment of notes, coin, or cheques drawn on credit accounts.

159. For the sake of clarity, it has been assumed in each of the transactions in paragraph 157 above that the customer making the lodgment at a bank was making it in a credit account. The position would be different if he were working on a bank overdraft, for if he used the funds to reduce his overdraft (or to buy overseas exchange) there would be no increase in demand deposits and therefore no increase in the volume of money. Similarly, the transactions outlined in paragraph 158 would not result in a reduction of the supply of money if the funds used to buy the exchange, securities, or other assets, or to reduce the advances, had come from an overdraft account or from the lodgment of foreign exchange.

160. If unexercised overdraft authorities were included in the definition of the supply of money, as we suggest, the supply of money would be increased immediately a customer was granted an overdraft limit, for the customer would then be in a position to draw cheques against the overdraft authority to the amount of the limit granted to him. Again, the transactions outlined in paragraph 157 would increase the volume of money, even if the customer making the lodgment were working on overdraft, as long as his overdraft limit was not reduced. For to the extent that he repaid an advance, the unexercised portion of his overdraft limit would be correspondingly increased. On the other hand, on the suggested definition, the supply of money would be reduced immediately if customers' overdraft limits were reduced.

161. It is important to recognise the difference in the effect on the volume of money between lending by or the purchase of assets by a bank on the one hand, and lending by or the purchase of assets by an individual or firm on the other. In the latter case, the individual or firm making the loan or buying the asset parts with his money to the borrower or seller; when a bank lends or buys assets, however, none of those who already held demand deposits before the transaction took place gives up his right to use that deposit when he wishes; i.e., no part of the supply of bank money existing before the transaction is withdrawn, but the borrower, or the seller of the asset bought by the bank, usually receives new bank money in the form of a deposit or of an increase in his unexercised overdraft limit at the bank. An increase in bank lending or purchase of assets therefore normally involves an increase in the total volume of money available to the public.

162. Thus, during any period, the volume of money is likely to increase:

(a) If the trading banks and/or the Reserve Bank increase their lending, or purchase more assets, during the period; and/or

(b) If there is an excess of export earnings and other receipts from persons overseas over import and other payments to persons overseas (i.e., if there is a surplus in our balance of payments).

163. Conversely, the volume of money is likely to fall if lending, or purchase of assets, by the Reserve Bank and trading banks declines, or if there is a deficit in our balance of payments.

Creation of Money by the Trading Banks

164. The fact that a large proportion of our money supply comes into existence as a result of the operations of the trading banks obviously disturbed many witnesses who appeared before us. A number seemed to think that this "creation of credit" by the banks was a relatively recent phenomenon. In fact, the fundamental principles of our banking system have remained much the same since at least the seventeenth century. Nor is the fact that this "creation" takes place a very recent discovery, as some witnesses implied. The quotations cited in Appendix D, Part II, show this clearly.

165. Trading banks cannot increase their lending, and thus create money, without limit and at no cost to themselves. Even if there is no control by the Government or by a central bank, a trading bank obviously cannot increase its lending if there are insufficient credit-worthy persons seeking loans. But an even more important limitation on the expansion of trading-bank lending is the necessity for each bank to keep an adequate reserve of "bankers' cash" (i.e., notes, coin, or balances at the Reserve Bank) and/or of overseas exchange. This reserve must be sufficient not only to meet any conceivable demands by its customers for notes, coin, or overseas exchange, but also to preserve their confidence in its ability to meet their requirements immediately at all times. Many banks – fortunately mainly outside New Zealand – have been forced in the past to close their doors because large numbers of customers, having lost faith in a bank's ability to meet their requirements, began a "run on the bank", seeking more legal tender money or overseas exchange for their deposits than the bank could immediately supply.

166. An expansion of lending is almost certain to lead to a withdrawal of bankers' cash from the banks concerned. This is particularly true in the case of an individual bank competing with several others. If this one bank does, say, one-fifth of the banking business of the country, it is probable that four-fifths of any extra amounts which it lends will be paid by cheque by the borrowers to customers of other banks. When these other banks present the cheques to the original bank for payment, the latter will have to transfer to them part of its reserve of bankers' cash. Therefore, if one bank expands its lending more rapidly than its competitors, it is almost certain to lose considerable amounts of bankers' cash to them.

167. But even if one trading bank had a monopoly of the banking business of the country, or all the trading banks acted in collusion, there would still be limits to an expansion of their lending. For as their advances increased, so directly or indirectly would their customers' demand for overseas exchange to buy imports. Also, since the expansion of advances would stimulate business activity generally, more notes and coin would be required for wage and salary payments and retained in circulation outside the banks. Both developments would reduce their reserves of bankers' cash and overseas exchange.

168. The primary duty of a banker – and a basic necessity if lending is to be possible at all – is to safeguard the deposits entrusted to his care. To this end, he must so restrict his lending that he retains a reserve which bears a reasonable proportion to his customers' deposits.

169. The Chairman of the Associated Banks informed the Commission that, in his opinion, under existing conditions, a reserve of "bankers' cash" equal to about 20 to 25 per cent of his customers' deposits was a "comfortable" reserve for a New Zealand banker to hold. This means that a New Zealand bank can make loans and/or buy investments up to a value equal in total to several times its reserve of cash. The banks can hold a reserve which is only a fraction of their liabilities to their customers primarily because, in the absence of abnormal economic developments, customers as a group tend to retain at the banks a reasonably stable volume of deposits, even though they have the right to withdraw legal tender money on demand in exchange for their deposits at any time. The volume of deposits remains relatively stable largely because the bulk of the business transactions of the country is financed by the transfer of deposits by cheque. Thus, payments made by a customer of a bank tend to return as a deposit at the same or another bank. On balance, deposits and withdrawals from each bank over any short period tend to offset one another, so that there is no net drain of cash into circulation. If the banks' deposit liabilities had not become the primary means of settling accounts in the economy, their ability to lend would have been severely limited, for any expansion of lending would have resulted in a substantial loss of legal tender money into circulation. In other words, the trading banks' power to "create money" depends on the fact that a large section of the community uses the banks' liabilities as money.

170. Given the proportion of the customers' deposits which they deem it prudent to keep as reserves of bankers' cash and foreign exchange, the extent to which the banks may lend is dependent upon the amount of reserves which they can acquire. This depends:

(a) On the balance of payments. The banks' reserves rise when there is a surplus and fall when there is a deficit in the balance of payments.

(b) On the extent of the lending of the Reserve Bank. The trading banks' reserves rise when the Reserve Bank increases its lending and fall when the Reserve Bank reduces its lending.

(c) On the proportion of the country's supply of money which the community is prepared to keep in the form of deposits with the banks, rather than in the form of notes and coin in circulation outside the banks.

171. The attraction of the deposits which provide the bank with the basis for its lending is not a costless process, even though the banks pay no interest on deposits on current account. People place deposits on current account primarily because the bank provides them with the safe and convenient facility of being able to transfer their funds to other people by cheque. In New Zealand, this service is rendered at a charge which by no means covers the direct costs involved, which are substantial. (See paragraph 65 of Appendix C.)

Control of Trading-bank Lending

172. In New Zealand, lending by the trading banks is also subject to control by the Reserve Bank and by the Government.

173. The Reserve Bank has power to require the banks to keep a minimum reserve balance at the Reserve Bank and, subject to the consent of the Minister of Finance, to vary from time to time the minimum proportion which this reserve balance must bear to the demand and time deposits of customers of the banks, provided that the proportions are not reduced below 7 per cent of demand deposits and 3 per cent of time deposits. If the Governor of the Reserve Bank thinks that the banks are lending too freely, he is in a position, with the authority of the Minister of Finance, to raise the minimum reserve requirements, so that the banks are forced to borrow money from the Reserve Bank to maintain the required minimum reserve. The Reserve Bank also has power to vary the rate of interest at which it will lend to the banks. It can be seen that these powers could be used, if the authorities wished, to make an unwanted expansion of advances completely unprofitable to the banks and to provide them with a direct financial inducement to keep advances within desired limits.

174. The Government can also reduce the trading banks' reserve balances, and therefore their ability to lend, by collecting from the public by taxation and borrowing during any period more than it spends during the same period; for the cheques drawn on the trading banks by taxpayers or subscribers to Government loans are paid by the Government into the Reserve Bank, which takes payment from the trading banks by reducing their deposits (i.e., reserve balances) at the Reserve Bank.

175. During and since the war, the Government has taken other steps to control the level and direction of lending by the trading banks. First, since 1942, with the co-operation of the trading banks themselves, a policy of selective control by the Reserve Bank of bank advances has been in operation. Secondly, from 1943 onwards, as a matter of Government policy, purchases of Government securities by the trading banks have been restricted. (See paragraphs 188 to 190 below.)

176. To sum up, the extent to which the trading banks can lend or buy assets, and increase the supply of money, depends on several factors:

(a) The amount of bankers' cash (i.e., notes, coin, and balances at the Reserve Bank) and foreign exchange which they can obtain, for they must keep a prudent relationship between these assets and their liabilities to their customers. (In turn, their holdings of cash and foreign exchange are influenced by the country's balance of payments, the Government's fiscal policy, and the extent to which the public wish to hold notes and coin in circulation.)

(b) The proportions of their customers' deposits which they are required under the reserve ratio system to maintain as balances at the Reserve Bank.

(c) The other controls over advances and investments imposed by the Reserve Bank and the Government.

(d) The demand by credit-worthy members of the public or by the Government for bank credit. A bank cannot lend if nobody wants to borrow.

The Government and the Creation and Destruction of Money

177. It can be seen from the above that the Government, working through the Reserve Bank, has far-reaching powers to curb unwanted bank lending. Through its ownership of the Bank of New Zealand, which in 1954 handled about 40 per cent of the advances and deposit business of the trading banks in New Zealand, it can also, if it so desires, reinforce its general policy as regards bank lending, and influence bank charges by specific instructions to the Bank of New Zealand. Bank overdraft rates have been fixed by agreement between the Government and the Associated Banks since 1941.

178. If the Government considers at any time that the supply of money is inadequate, and the trading banks cannot or will not increase their lending, it may itself borrow from the Reserve Bank, and no doubt, in practice, set its own terms as to interest charges and repayment. Indeed, if it wished, it could ensure, with its existing powers, that the trading banks did not initiate any expansion of the money supply required in the future, and that all new money was advanced by the Reserve Bank to the Government. As we point out elsewhere in this report, we consider that this would be most undesirable. However, the above remarks indicate the extent of the Government's power to control the supply of money and the terms on which it is issued.

179. Two factors which have always had to be taken into account in determining to what extent bank lending should be expanded in New Zealand are the country's overseas trade position and the level of its exchange reserves. Before the Reserve Bank was set up in 1934, it could be said that these were the primary factors governing the lending policy of the trading banks, and, therefore, the supply of money in New Zealand. Inevitably, in a dependent economy, they must remain major factors in the monetary policy of the Government and its Reserve Bank. If the money supply is expanded, whether by trading-bank or by Reserve Bank credit, it is probable that the community's spending will increase. If persons are free to spend money overseas as they wish, New Zealand's imports and other overseas payments may be expected to rise by an amount equivalent to about 30 to 40 per cent of any increase in total spending. This sets obvious limits to the extent to which the money supply can safely be expanded, especially if the Government wishes to permit a reasonable degree of freedom to citizens in their overseas transactions.

180. The experience of the past two decades, when the supply of money (on the Reserve Bank definition) has been expanded by £271 million without disastrous results, may seem at first sight to be inconsistent with this conclusion. But it must be remembered that, during this period, annual export earnings also increased by over £200 million; that there were recurrent shortages of imports during the war and early post-war years; and that a comprehensive system of import and exchange control was in operation between 1939 and 1950, and exchange allocation between 1952 and 1954. Balance-of-payments difficulties were encountered in 1938, and (despite very high export earnings) in 1951–52 and 1954–55. These difficulties bear witness to the continued need for the monetary authorities to prevent an unwarranted expansion of the money supply and more important, of domestic spending, if external trade is to be left relatively free of restriction and our reserves of overseas exchange are to be maintained at an adequate level.

Causes of Changes in the Money Supply in New Zealand Since 1935

181. The main direct causes of the increases which have taken place in the volume of money (as defined by the Reserve Bank) in New Zealand during selected periods between June 1935 and June 1955 are given in the following table:

Causes of Change in the Volume of Money
(£ million)

Years Ended June	Total Change	Overseas Transactions	Government Borrowing from Banks	Trading Bank Advances and Discounts	Shifts in Wool Retention Accounts	Other
1935 to 1939 ..	+ 6·5	−36·5	+17·0	+ 9·9	..	+16·1
1939 to 1943 ..	+ 79·8	+33·8	+56·2	− 13·1	..	+ 2·8
1943 to 1945 ..	+ 16·9	+39·3	−24·8	+ 10·6	..	− 8·1
1945 to 1949 ..	+ 57·8	+16·8	+ 6·7	+ 27·5	..	+ 6·8
1949 to 1951 ..	+ 70·2	+43·3	−14·5	+ 52·7	−20·9	+ 9·6
1951 to 1952 ..	− 19·3	−48·7	− 6·0	+ 40·3	− 7·8	+ 2·9
1952 to 1954 ..	+ 54·3	+64·6	− 7·6	− 23·6	+12·0	+ 8·9
1954 to 1955 ..	+ 4·6	−35·5	− 7·5	+ 34·8	+ 5·8	+ 7·0
	+270·8	+77·0	+19·5	+139·1	−10·9	+46·0

182. The major increases in the money supply occurred during the war years, mainly as a result of an excess of receipts over payments in our external transactions, and in the period since 1950, mainly from increases in trading-bank advances. An outline of the changes within each period appears in Section Two of Appendix C.

183. Over the period as a whole, just over one-half of the increase in the volume of money (£271 million) can be ascribed to increases of £139 million in the level of trading-bank advances and discounts. The second most important factor has been the surplus in overseas transactions during the period which has expanded the money supply by £77 million or 28 per cent of the increase. However, it is necessary to be cautious in the use of these figures. First, when the level of bank credit and the balance of payments are fluctuating markedly, the passing of one year may make a considerable difference to the picture. For instance, if we exclude the year 1954–55, and look at the causes of the rise in the volume of money between June 1935 and June 1954, we find that the surplus in external transactions is responsible for 42 per cent and the rise in trading-bank advances for only 39 per cent of the increase. Secondly, the major items mentioned as separate causes of the rise in the volume of money are, as we shall see below, interrelated, a change in one tending to give rise to a change in another.

Government Borrowing from the Banking System

184. The table above gives a slightly misleading picture of the extent to which Government borrowing has contributed to the increase in the money supply, in that its indebtedness at the end of June 1955 was unusually low in relation to its indebtedness for the rest of the year. The following table shows the Government's average indebtedness to the Reserve Bank and the trading-banks during the calendar years concerned:

Government Borrowing from the Banking System(1)
(£ million)

Calendar Year	Total Borrowing From Reserve Bank	Trading-bank Investments in Government Securities	Total Borrowing From Banking System
1935	1·5	4·8	6·3
1936	1·8	5·2	7·0
1938	5·4	7·6	13·0
1939	16·1	11·3	27·4
1944	43·9	36·1	80·0
1947	29·6	20·9	50·5
1950	79·1	11·7	90·8
1952	61·3	11·7	73·0
1953	70·5	11·7	82·2
1954	46·0	23·0(2)	69·0(2)
1955	43·3	23·1(2)	66·4(2)

(1) Balances in the Public Account at the Reserve Bank are not taken into account.
(2) Including holdings of State Advances Corporation stock of £11 million in 1954 and £11·5 million in 1955.

185. The most striking increase in Government borrowing from the banking system took place between 1938 and 1944. There was a fairly sharp rise in 1939 when the Government found itself unable to obtain enough money from non-banking sources to finance its expenditure, including its expanding works programme. Again, during the early years of the war, it was found impracticable to avoid resort to the banking system to pay for the Government's greatly expanded commitments, especially for defence. After 1943, the Government set its face against reliance on bank credit. By 1947, it had reduced its indebtedness to the banking system by £30 million from the peak of £80 million reached in 1944.

186. However, this reduction was more than offset in the next two or three years, and, by 1950, the Government's debt to the banking system had risen to over £90 million. £20 million of the increase can be attributed to an issue of Government securities to the Reserve Bank as compensation for a loss which the bank incurred on its holdings of foreign exchange as a result of the appreciation of the exchange rate in 1948. This merely provided the bank with an interest-bearing security and did not add to the volume of money in New Zealand. The bulk of the remainder of the increase took place in the financial year 1949–50 to finance part of the Government's works programme, due to a shortage of investment money after the exchange adjustment of 1948.

187. Since then, with the exception of 1952–53, when the Government decided not to raise a public loan in an endeavour to relieve pressure on the limited funds then available, the Government's debt to the banking system has been consistently reduced. Its average indebtedness in 1955 was £66 million, about £25 million below the average for 1950.

188. As the table above indicates, there have been important changes in Government policy towards borrowing from the trading banks during the period considered. Up till 1943, it was normal practice for the trading banks to invest in Government loans, and from 1936 to 1943 their investments in Government securities rose from £5·2 million to £36·1 million. As from 1943, the Government decided not to permit the trading

banks to subscribe to Government loans and repaid their existing securities as they matured. As a result of this policy, the banks' holdings of Government securities had fallen to £11·7 million by 1950, a figure very little above that ruling in 1939.

189. The new Government continued the policy of preventing the banks from subscribing to Government loans, but permitted them to maintain their existing holdings at a level of about £11·7 million. Apart from a temporary investment of £0·5 million by one of the banks in 1954, there has been only one departure from this policy since 1950. In January and March 1954 the banks were invited to invest a total of £12 million in State Advances Corporation stock to assist in financing the Government's housing programme.

190. The relative effects on the supply of money of borrowing from the Reserve Bank and from the trading banks are considered in Section Five of this report, and in Section Two of Appendix C. It will be noted that additional borrowing from the Reserve Bank not only increases directly the supply of money in New Zealand, but also, by adding to the reserve balances of the trading banks, makes it possible for them to increase their lending, unless prompt and appropriate increases are made in the minimum reserve ratio requirements.

Trading-bank Credit and Its Control

191. In the light of the banks' relatively low holding of securities, and in the absence of any short-term money market which would enable them to invest in commercial or Treasury bills as can banks in countries with more highly developed money markets, the banks have to rely heavily on advances to customers as an earning asset.

192. We indicated in the previous section that trading-bank advances had been responsible for £139 million or just over one-half of the total increase in the volume of money of £271 million between June 1935 and June 1955. The following table shows that the bulk of the increase in trading-bank advances has taken place since 1949:

Year Ended June	Change in Trading-bank Advances and Discounts (£ million)	
1935 to 1939	+ 9·9	
1939 to 1943	− 13·0	+ 34·9
1943 to 1945	+ 10·5	
1945 to 1949	+ 27·5	
1949 to 1951	+ 52·7	
1951 to 1952	+ 40·3	+ 104·2
1952 to 1954	− 23·6	
1954 to 1955	+ 34·8	
	+ 139·1	

193. We have seen that the extent to which banks can lend depends on these factors:

(a) The ratio which the banks' basic reserves bear to their deposit liabilities to customers.

(b) The ratio which they are required to keep between their balances at the Reserve Bank and their deposit liabilities.

(c) The tightness of any other controls by Government or Reserve Bank over their lending.

(d) The availability of credit-worthy borrowers wanting bank advances at the ruling rates of interest.

194. The question arises why trading-bank advances were responsible for only £35 million or 22 per cent of the increase of £161 million in the volume of money between June 1935 and June 1949. No shortage of reserves prevented a substantial expansion of bank advances during this period. Over the whole period 1935 to 1949 the banks' holdings of cash and overseas assets rose by £70 million, but bank advances rose by only about £35 million and securities by about £10 million. Thus there was no multiple expansion of bank credit on the basis of the increased reserves; in fact, the banks expanded their lending by an amount equivalent to only two-thirds of their increased holdings of cash and overseas funds.

195. Nor was their lending restrained by the level of the statutory minimum reserve ratios set by the Reserve Bank. The minimum balances required to be kept at the Reserve Bank remained throughout at 7 per cent of demand liabilities and 3 per cent of time liabilities respectively. The actual ratio maintained by the banks was always well above these figures.

196. The policy of selective advance control probably exerted some restrictive influence, but the main reason for the relatively moderate expansion of bank advances during the period 1938 to 1949 was undoubtedly lack of demand for them. Several factors were responsible for this. First, the normal volume of imports for civilian consumption was not available during the war and early post-war periods and the Government took a much larger share of the imports than before the war; secondly, during the same period, the Reserve Bank took over the financing of the marketing of many primary products; thirdly, as men were drafted into the forces, the level of business activity in New Zealand declined to some extent and many firms engaged on war contracts received advance payments from the Government; fourthly, many activities were subject to direct controls (e.g., the demand for advances for private building purposes was low because building controls prevented an undue diversion of scarce resources into this field); and fifthly, the overall stabilisation policy prevented any marked rise in prices, wages, and other costs, which, if it had occurred, would have necessitated higher advances.

197. Advances rose between 1946 and 1948 as imports increased, the banks regained the finance of wool exports, business returned to a peacetime basis, and controls were to some extent relaxed. But, even in 1948, fairly comprehensive import controls, controls over domestic prices and incomes, and building controls remained; and the financing of meat, dairy produce, and several other primary products remained with the Reserve Bank, thus restraining the demand for trading-bank credit. And in 1948–49, a small decline occurred in trading-bank advances, probably due to the general disinflationary effect and, in particular, the temporary lowering in the domestic value of imported goods, caused by the exchange appreciation of 1948.

198. The situation ruling in 1949, then, was that the banks were holding large reserves of cash and foreign exchange in relation to their deposit liabilities, were subject to no restriction through the reserve

ratio system, and had been unable to expand their advances greatly, partly because of the selective advances control policy, but primarily because of lack of demand for bank credit in the prevailing circumstances.

199. There has been a very great increase in the demand for trading-bank credit since 1949, and the trading banks have had cash reserves adequate to permit a rise in advances and discounts of £104 million between June 1949 and June 1955.

200. The Reserve Bank has been counselling restraint in the provision of credit throughout the period. Up till August 1952 it relied entirely on its selective advances control policy and therefore on the voluntary co-operation of the banks in achieving this end, but in spite of appeals for caution in the granting of credit from October 1950 onwards, advances increased by £93 million between June 1949 and June 1952.

201. There were many reasons for the upsurge of demand for bank advances during this period. Import prices and export prices, particularly the price of wool, rose considerably, and wages were subsequently increased as a result of intensified competition for labour and general increases granted by the Court of Arbitration. Many controls over domestic spending, incomes, and prices, and over imports, were removed or relaxed. As costs rose, manufacturers and traders sought more accommodation from the banks. The prolonged waterfront dispute of 1951 also forced some industries to hold produce in store for a considerable time and increased the demand for finance from the banks. Moreover, there was a general tendency for all producers and traders to expand their businesses and increase their stocks to take advantage of the prevailing buoyant demand. Bank overdrafts were the cheapest and most convenient means of financing expansion. Finally, in the latter part of 1951 and early 1952, imports became available in unexpectedly large amounts, due to increased production overseas and to the closing of alternative markets by credit restraints and import controls. Without assistance from their banks, many traders could not pay for goods which they had expected to arrive over a long period in the future. In the interest of New Zealand's credit standing overseas, the banks were officially requested to provide such assistance.

202. The banks were able to expand their lending to such a considerable extent because they had large reserves of cash in 1949 which were maintained, despite their increased lending, by surpluses in the balance of payments between 1949 and 1951. However, by March 1952, after a substantial deficit in the balance of payments, their reserves had fallen to a relatively low level in relation to their customers' deposits, and restraint in lending had become necessary in their own interests.

203. Advances fell by about £50 million between April 1952 and April 1953, partly due to a more restrictive lending policy by the banks, but mainly due to a decline in the demand for advances, as traders reduced their excess stocks and the flow of imports was held back to some extent by a system of exchange allocation introduced in April 1952.

204. From August 1952, use was made of the power to vary the minimum reserve ratios, but until the second quarter of 1954 the banks were left with wide margins of free cash, so that no restraint on their lending capacity was imposed by this means.

205. The demand for bank credit began to increase again towards the end of 1953. At that time the banks were holding relatively high reserves in relation to their customers' deposits and to the minimum reserve requirements, and were therefore in a position to meet this demand. The overdraft limits granted, and later bank advances, began to rise.

206. The ratios were raised to 25 per cent and 12½ per cent in May 1954, and from then until February 1955 were varied to leave the banks with a fairly narrow margin of free cash as their reserves fell, due to a balance of payments deficit. The Reserve Bank's lending rate was also raised twice, reaching 4 per cent in November 1954. However, advances continued to rise, and by February 1955 were £36 million greater than they had been a year previously. Up till this time, borrowings from the Reserve Bank were small, and practically all confined to the Bank of New Zealand.

207. The banks were assisted in meeting a substantial drain of cash in March 1955 by special deposits by the Treasury and by a lowering of the reserve ratios to 15 per cent and 7½ per cent. From then until December 1955 the ratios were gradually raised to 24 per cent and 7½ per cent and the Reserve Bank's lending rate increased by three steps to 7 per cent. This forced three banks to borrow continuously from the Reserve Bank throughout 1955, and pay it £139,000 in interest between 1 April and 31 December. Some banks also borrowed in London or sold sterling assets to the Reserve Bank to maintain the required statutory balance. The interest paid or foregone by the banks was small in comparison with their increased interest earnings on the higher advances which they were now granting. But the Reserve Bank's policy towards the banks was certainly firmer than it had ever been in the past. It is impossible to say how far this firmer policy was responsible for the gradual downward trend of bank credit which occurred during the remainder of 1955; the banks' reserves of bankers' cash and overseas funds were, in any case, such as to induce them to adopt a relatively restrictive policy.

Overseas Transactions

208. As described in paragraph 162 above, the volume of money is increased in New Zealand when there is a surplus in the balance of payments and reduced when there is a deficit. Overall, New Zealand has had a substantial surplus in its balance of payments since 1935, and this has added a large amount to the volume of money. The trends in the balance of payments during the period are indicated in the following table which shows the effect of overseas transactions on the volume of money in the years concerned.

Effects of Changes in the Balance of Payments on the Volume of Money, 1935 to 1955

June Years	£ million
1935 to 1939	−36·5
1939 to 1947	+99·3
1947 to 1949	− 9·4
1949 to 1951	+43·3
1951 to 1952	−48·7
1952 to 1954	+64·6
1954 to 1955	−35·5

209. The causes of these changes in the balance of payments position are examined in Section Three of this report. A surplus in the balance of payments not only directly increases the volume of money, but also, by adding to the basic reserves of the trading banks, makes possible a multiple expansion of trading-bank credit. A deficit reduces bankers' cash and, unless the banks are holding excess cash reserves, forces them to reduce credit by a multiple of the reduction in their reserves. The expansion of bank advances which has occurred during the period which we have surveyed would not have been possible in the absence of the large additions which have been made to banks' reserves through surpluses in the balance of payments.

210. Overseas transactions also have other indirect effects on the volume of money in New Zealand. Even if overseas receipts and overseas payments remain in balance, a rise in export and import prices is likely, in the absence of State intervention, to lead to an increase in the volume of money. For those handling exportable or imported goods, or goods in the production of which exports or imports play a considerable part, are likely to require an increase in overdraft accommodation to cover increased costs. And if, as often happens, wages are increased as a result of the increases in incomes of primary producers and rises in the consumers' price index generated by price increases overseas, there will be a further general demand for advances to pay the extra wages. If the banks meet this higher demand, the volume of money will be correspondingly increased. Since 1935 export and import prices have increased by 300 per cent and 186 per cent respectively. In view of the large part which imports and exports play in the economy there is no doubt that these price increases have been an important cause of the expansion of bank advances and the volume of money since 1935. (A fall in export and import prices would, of course, have the opposite effect in the absence of State intervention.) Not only the prices, but also the quantities of exports and imports, have increased since 1935. The total value of external trade rose from £83 million in 1935 to £479 million in 1954. This being so, a large increase in bank advances to persons directly or indirectly involved in external trade was inevitable and essential. Whether, in fact, the increases in bank advances and in the supply of money which have taken place have been excessive is the subject of discussion in a later chapter.

211. The measures taken by the Government to attempt to counter some of the effects of rising overseas prices are considered in Section Five of this report and in Section Two of Appendix C.

New Zealand's Credit System

212. Any reasonably advanced economy, especially one based primarily on the institutions of private ownership and enterprise, requires a large volume of credit (and therefore debt). Credit is necessary to enable private individuals or firms to obtain the expensive buildings, equipment, and stocks necessary for modern production and sale; to facilitate the transfer of land and other assets from one person to another; and to enable individuals to obtain houses and household equipment and their local governments to obtain all the costly facilities necessary in an urban area, without waiting until they have saved sufficient from their own incomes to pay for them. The Central Government usually also chooses to borrow, although it has the power to finance all its requirements by

taxation or by requiring the Reserve Bank to issue new money to it. Excessive use of the latter method would result in disastrous inflation; and it is often more convenient and expedient for a Government to raise part of its requirements through a voluntary loan than to raise all by compulsory taxation.

213. In Appendix C we study in detail such information as can be obtained on changes in the indebtedness of the major borrowers in the New Zealand credit system and changes in the volume of credit granted by the major financial institutions which transfer to the borrowers the savings of persons or institutions who wish to put aside temporarily some part of their income. We also survey briefly the structure and operations of some of these institutions and of some of the bodies which have been set up to control the granting of credit. Here we shall merely summarise the main conclusions of the more detailed study.

Borrowing by the Government

214. The total indebtedness of the Government rose from £313 million in March 1934 to £731 million in March 1955, £281 million of the increase taking place between 1939 and 1946. However, between 1934 and 1955, its overseas debt fell from £174 million to £100 million. As a percentage of the country's export income, interest payments overseas fell from 13·3 per cent to 1·1 per cent during the same period. Interest paid on the total debt rose from £11·6 million to £20 million during the period; but as a percentage of the gross national income it fell from 9·1 per cent to 2·2 per cent.

215. The bulk of the public debt in New Zealand is held by Government-owned institutions, by savings banks and insurance companies, and by reserve accounts set up for the benefit of the primary industries. Interest payments on the debt, therefore, benefit, directly or indirectly, a very large number of people.

Borrowing by Local Bodies

216. The total indebtedness of local bodies fell from £78 million in March 1934 to £62 million in March 1950, and thereafter rose to £91 million in March 1955. Their overseas indebtedness has been continuously and substantially reduced – from £25 million in 1934 to just under £4 million in 1955. Interest payments on loans and overdrafts have declined markedly as a proportion of the total revenue of the local bodies – from nearly 25 per cent in 1934 to just over 5 per cent in 1955.

217. Recurrent difficulties have faced local bodies since 1951 in raising the finance required for their expanding works. A major reason for the difficulties faced by the local bodies would appear to be that the increases in interest rates approved for local body loans have not been in line with the increased returns available from other avenues of investment. As a consequence, the local bodies have not obtained as much as they would have wished from some of the institutions, especially the insurance companies to which they have traditionally looked for funds.

Private Borrowing

218. Information on borrowing by private individuals and firms is limited and we make suggestions later in this report as to statistics which might be collected and research which might be done in this field. A summary of the information which is available is to be found in Section Three of Appendix C, where there is an examination of the extent of borrowing by industrial and commercial firms, by farmers, by individuals requiring finance for housing, and by individuals requiring finance for various consumer goods.

The Sources of Credit

219. The table given in paragraph 250 of Appendix C gives some indication of the relative amounts of credit extended by major financial institutions and the changes which have taken place since 1934.

220. The following notable features are shown by the table:

(a) There has been a considerable expansion of lending by practically all the institutions, especially since 1950.

(b) Government-owned or Government-controlled institutions are responsible for a very large proportion of total lending and investment in New Zealand. The Reserve Bank, the Post Office Savings Bank (including national savings), the Government Superannuation Fund, the National Provident Fund, the Earthquake and War Damage Fund, the State Advances Corporation, and the Public Trust Office are all Government institutions; the Government has a voice in the disposal of the primary industry reserve accounts; it owns a trading bank which does 40 per cent of the advances and deposit business of the trading banks as a whole; and it also owns important life and fire insurance offices.

(c) The loans and investments of the trading banks are significantly less than the total of those of the institutions collecting small savings and, in most years, less than the total of the loans and investments of the institutions providing facilities for insurance and superannuation.

221. The importance of lending by the trading banks lies primarily in the fact that an expansion of their lending normally leads to an expansion of the supply of money. When other financial institutions expand their lending, the existing supply of money is not increased; part of the supply is transferred from one person, through the financial institutions, to another person. However, an expansion of the borrowing and lending activities of some of these other financial institutions does increase the volume of "near moneys" available to the community. For example, when there is an excess of lodgments over withdrawals in the Post Office or other savings banks, total savings bank deposits increase. This excess is nearly all lent by these savings banks, but no depositor forgoes his right to draw out deposits on demand.

222. The reason why an expansion of trading-bank deposits has greater economic significance than an expansion of savings-bank deposits is shown in the following table, which gives a rough indication of the extent to which the average amounts standing to the credit of customers at different savings institutions and at the trading banks are used during the year:

Turnover of Amounts Available to Customers in Various Financial Institutions, 1954–55

Institution	Amounts Available to Customers at 31 March 1954	Withdrawals in Year Ended March 1955	Ratio of Withdrawals to Amounts Available to Customers
	£ million	£ million	Per Cent
Post Offi_e Savings Bank ..	205·9	112·8	55
Trustee savings banks	41·1	26·2	64
National Saving	65·5	10·3	16
Trading banks—			
Total deposits	282·3	4,577(1)	1,621
Total deposits as above plus unexercised overdraft authorities	385·8		1,186

(1) Value of debit transactions.

223. It can be seen that sums lodged in the savings banks tend to remain there for a relatively long period, e.g., the withdrawals from the Post Office Savings Bank during 1954–55 were equivalent to little more than one-half of the amounts to the credit of customers at the beginning of the year. On the other hand, withdrawals from the trading banks during the year were equivalent to over sixteen times the deposits standing to the credit of customers at the beginning of the year. Since cheques may be drawn against unexercised overdraft authorities, it perhaps gives a fairer comparison to include these unexercised authorities among the amounts available to customers; even then, withdrawals were nearly twelve times the amounts available to customers at the beginning of the year. Sums lodged in trading banks, therefore, are intended for use in the main in the near future, because trading banks are the channel through which day-to-day payments are made. In other words, a given amount of trading-bank deposits (and unexercised overdraft authorities), because it is turned over so rapidly, finances during a year a much greater volume of expenditure than does an equivalent amount of savings-bank deposits.

224. The structure and operation of the various institutions providing credit in New Zealand are more fully examined in Appendix C.

Interest Rates

225. Interest is the price which is paid for credit. If loan money becomes scarcer, rates of interest generally tend to rise; conversely, if loan money becomes more plentiful, they tend to fall. The rates of interest charged to different borrowers vary according to the lenders' assessment of the relative risks involved in lending, the relative costs involved in making the loans and collecting payments on them, and so on.

226. Since the Government is the major borrower in the credit system in New Zealand, changes in the rate of interest at which it can borrow give a broad indication of the relative ease or difficulty of obtaining loan money. Government public loan issues between the years 1922 and 1932 were made at rates of interest varying between 5 and 5½ per cent. The conversion loan of 1933 was made in the main at 4 per cent. Subsequent issues between the years 1934 and 1939 were made at 3½ per cent and

4 per cent. Soon after the outbreak of the second world war, the rate for long-term Government borrowing fell to 3 per cent, and continued at that figure until about 1950. Controls and shortages during the war and early post-war periods both held down effective demands for loan money and gave many people no alternative but to save large amounts of their expanding money incomes. In these circumstances it is not surprising that interest rates remained generally low.

227. After 1950, for reasons outlined previously, the demand for loan money rose substantially. So did the supply of money, but from 1952 onwards, the demand for loan money has tended to rise more rapidly than the supply, and interest rates generally have increased (e.g., the 1955 Government loan of £10 million was issued on terms which offered investors a return of nearly 4⅛ per cent together with tax concessions attractive to the larger investor, yet it was slightly undersubscribed). Mortgage rates have followed a similar rising trend.

228. Since 1941, trading-bank overdraft rates have been fixed by agreement between the Government and the trading banks at between 4 and 5 per cent. The average rate of interest earned by the banks in 1954–55 was £4 11s. 8d. as against an agreed maximum of £4 15s.

[NOTE.—In February 1956 the maximum and minimum limits were removed, and the banks were given discretion to fix interest rates for individual transactions, provided that the average return to the banks over all transactions did not exceed 5 per cent.]

The Government has also for many years maintained direct controls over the maximum rates which may be charged or paid for loans, or paid for deposits, by several types of institutions. For example, the rate of interest which local bodies may pay for loans is subject to regulation, and has been maintained at levels which have made it difficult for a number of local bodies in the last three or four years to raise adequate finance. Maximum rates payable on deposits made with the savings banks, local bodies, building and investment societies, and various trading companies are also controlled.

229. By maintaining the rates of interest charged by the State Advances Corporation at relatively low levels the Government has also exerted a restraining influence over the general level of interest rates on mortgages.

Control of Credit

230. These controls over interest rates have been accompanied by several measures designed to influence the demand for, or supply of, credit. The various controls imposed on trading-bank credit have been discussed earlier in this Section of the report. In addition, there has been control over issues of capital by companies since 1940. In 1952, because of heavy pressure on the credit market, a Capital Issues Committee was set up to administer the regulations, still in force in much the same form as during the war, except that issues of capital of less than £10,000 were exempted from control. After adopting a fairly strict policy in 1952, the Committee gradually increased the proportion of applications approved, so that only 16 per cent of applications were declined or deferred in 1954. However, in the first nine months of 1955 applications declined or deferred rose to 43 per cent of the total applications made.

231. The Government has controlled borrowing by local bodies since 1926, when the Local Government Loans Board was set up. In general, the Board does not appear, until fairly recently, to have reviewed loan proposals in relation to the complete investment programme, public and private, of the country. In 1955, however, the Minister of Finance directed the Board to have regard to the essentiality of the projects concerned, when considering applications to raise loans.

232. Finally, a measure of control over hire-purchase transactions was introduced in the 1955 Budget. Provision was made for minimum deposits and maximum periods for payment of the balance owing under hire-purchase agreements and credit-sales agreements.

233. After the examination of economic objectives and the historical review of the economy and of the monetary, banking, and credit systems in New Zealand covered in Sections Two, Three, and Four of this report, we now consider the special problems associated with inflation in New Zealand.

Section Five

INFLATION IN NEW ZEALAND

Introduction

234. The main inflationary forces at work in New Zealand during the last twenty-one years and the methods of combating inflation are examined in this section. By 1938 New Zealand had substantially emerged from the depression and had even begun to feel some inflationary pressure, as evidenced by her balance of payments crisis in 1938–39. This situation was commented upon in the 1939 Budget in which it was pointed out that *"the only permanent solution of the unemployed problem"* was *"for men to find work in productive industry"*. In the meantime, Government action in beginning works and subsidising an expansion of local body work had produced quick results in *"a rapid increase in consumer purchasing power"*. But, as the Financial Statement pointed out, *"in the absence of an equally rapid expansion in production"* this increase in consumer purchasing power had *"led to an increase in imports and a drain upon the sterling resources of the Dominion"*.

235. Within a matter of months the second world war was to add its own inflationary problems with production of consumer goods and services quite insufficient to match the purchasing power available for spending. As explained in *The New Zealand Economy, 1939 to 1951*, *"during the war, productive resources both in New Zealand and overseas were diverted to war purposes. Shortages of shipping further reduced imports for civilian consumption and there was some physical destruction of goods destined for New Zealand. On the other hand money incomes increased on account of the addition to the labour supply of more women and elderly people, long overtime hours, upgrading of workers, and high wage and salary rates. The need for Government spending for war purposes was immediate and urgent; production for civilian consumption was far below what people could buy with their higher money incomes. A variety of controls was therefore imposed to prevent the expanded demand from having its full effect in forcing up prices"*.

236. With the end of the war, conditions altered again. The pent-up wartime demand for goods and the need for capital works which had been delayed by the war began to make themselves felt. The gradual removal of controls, when it began, allowed these pressures to cause higher prices. The Korean War and the associated boom in raw material prices, especially wool prices, brought substantial increases in incomes and prices in New Zealand. Because of the special circumstances arising from the war, attention naturally focuses itself chiefly on the ten years since 1945.

The Nature of Inflation

237. Inflation is an expansionary condition of the economy in which prices, incomes, public and private expenditure, and bank credit tend to influence one another in an upward direction. The inflationary process

may begin as a result of either external or internal factors. An essential part of the inflationary process is excessive demand for goods and services at current prices.

238. The basic problem which inflation presents is to keep within reasonable bounds the total demand for goods and services, both locally produced and imported. Inflation usually reveals itself through rising prices, through a greater demand for imports than current earnings of overseas exchange will meet, and through more employment vacancies than can be filled.

239. Because a very large part of our national income is directly and indirectly dependent on prices realised in overseas markets, and because imports form such a substantial proportion of our available goods and services, overseas factors exercise an important and at times even a dominant inflationary or deflationary effect on the New Zealand economy.

Apparent Attractions of Moderate Inflation

240. Despite the very serious damage done by inflation, which we discuss below, it cannot be denied that moderate inflation has certain attractive features. A sellers' market means that goods and services are easy to sell at rising prices. On paper, business profits rise faster than costs. The money value of fixed assets such as land, buildings, and industrial equipment tends to rise, and thus to provide further security for borrowing by way of bank overdraft or otherwise.

241. There is the general feeling of prosperity given by higher wages, salaries, and other incomes. People lose the fear of unemployment and Governments are relieved of responsibility for seeing that unemployment does not arise. "Balancing" both Government and private budgets is made easy by buoyant revenues.

242. All debtors benefit from inflation because the real burden of debts (including the public debt and private mortgages and other forms of private debt) is reduced. Interest and repayment charges are paid in money which pound for pound is worth less in terms of real goods and services than the amount originally borrowed.

Damage Done by Inflation

243. These apparent advantages of moderate inflation are heavily outweighed by the damage done to the economy by the continued existence of inflationary conditions.

244. Inflation brings a serious distortion in the distribution of incomes. Those whose incomes are relatively fixed in terms of money are, in effect, subject to an insidious but nevertheless real form of taxation and a loss of real income.

245. The expansion of money incomes encourages personal spending and stimulates business expansion beyond the point permitted by available physical resources and the labour force. Such conditions lead to upward pressure on the prices of consumer goods and to strong competition for labour. The result is a cumulative tendency for costs, prices, and wages to rise. Particularly in New Zealand's circumstances, the pressure on internal prices is accompanied by an increased demand for imports.

246. The real value of savings, and the incentive to save, are both reduced as the value of money falls. Discouragement of saving is all the more serious when it is associated with a strong demand for private and public capital investment. When this happens there is an inadequate performance of the economic function of saving, which is to withdraw from the stream of purchasing power available for spending on consumer goods and services an amount equivalent to the purchasing power distributed through capital expenditure. This aspect of inflation is referred to later in this section of the report. **We are satisfied that failure to achieve this balance between private and public savings on the one hand and capital investment on the other hand lies at the root of our inflationary problem.**

247. Under inflationary conditions the ability of export industries to compete in overseas markets is impaired, and so is the ability of local industries to meet overseas competition. In New Zealand, inflation is bound to cause balance of payments difficulties, including difficulty in maintaining reserves of overseas exchange.

248. Earlier we referred to the reduction in the real burden of debts brought about by inflation. This feature of inflation has another side, in that long-term contracts in terms of money are falsified. This is a most serious aspect, which of itself is sufficient to demand the avoidance of inflation as far as is humanly possible.

Changes in the Purchasing Power of the New Zealand Pound Compared with the United Kingdom and Australia

249. The following table shows the changes in purchasing power of the New Zealand pound, the United Kingdom pound, and the Australian pound since the period 1926–30, which is commonly selected as a statistical base because of the relatively stable economic conditions in those years:

Purchasing Power Compared With 20s. in 1926–30

Calendar Year	New Zealand Pound	United Kingdom Pound	Australian Pound
	s. d.	s. d.	s. d.
1930	20 5	21 2	20 8
1935	23 11	23 0	24 2
1940	19 4	17 8	21 0
1945	17 1	16 1	17 10
1950	14 2	14 1	12 11
Quarter ended—			
1955—December ..	10 7	10 9	8 3

250. While a fall in purchasing power of the New Zealand pound from 20s. in 1926–30 to 10s. 7d. in 1955 appears very considerable, it should not be overlooked that the New Zealand pound has lost practically no more in purchasing power than the money of her main customer, the United Kingdom. In view of the very great influence of external trade on the New Zealand economy, the purchasing power of the New Zealand pound in comparison with that of the United Kingdom and Australia must be regarded as reasonably satisfactory.

251. Another indication of the extent to which prices have risen since the depression in New Zealand is to be found in the increase in the gross national income between 1934–35 and 1954–55. Measured in money terms the gross national income is seven times as great as it was twenty years ago; but, corrected for price changes (i.e., roughly adjusted to the lower buying power of today's pound) it is only three times as great.

The Main Causes of Inflation

252. The main causes of inflation operating in New Zealand during the last twenty years emerge from the historical review contained in Section Three of this report, as:

(a) Rising overseas prices for New Zealand exports and imports.
(b) High private and Government capital expenditure.
(c) Government expenditure on war and other military requirements.
(d) Inadequacy of voluntary savings to match increased capital investment.
(e) Expansion of the money supply through increases in Reserve Bank and trading-bank advances.
(f) Wage and salary increases.
(g) The comparatively rapid population increase in the post-war years.
(h) Increased Government expenditure on social services and the philosophy and policies commonly associated with the Welfare State.

Overseas Prices

253. The general trend of overseas prices since 1934 has been upwards. The following table shows the increases at five-yearly intervals to 1950, and thereafter each year:

(Base: 1954 = 100)

Calendar Year	Index of Import Prices	Index of Export Prices
1935	35	25
1940	43	36
1945	62	44
1950	84	92
1951	98	108
1952	107	87
1953	101	97
1954	100	100
Quarter ended—		
1955—June	100	100

254. Higher prices overseas mean, of course, higher prices within New Zealand for goods bought overseas, and higher costs for goods and services in New Zealand which are dependent on imported equipment or materials. (Rising prices for imports have brought a higher turnover in money to traders and, therefore, if the percentage of profit on transactions remains the same, have yielded higher profits.) Through their effect on the consumers' price index, these higher import prices also afford grounds for claims for higher wages through general wage orders, new awards and agreements, and in private wage negotiations.

255. In 1934–35 total payments for imports were £33 million or approximately 25 per cent of the gross national income. In 1954–55 payments for imports were £253 million or 27 per cent of the gross national income. Where imports represent a very high proportion of total goods and services available, changes in import prices must exercise a powerful influence on the New Zealand price level.

256. As the above table shows, over the last twenty years New Zealand's export prices have risen more rapidly than import prices. Notwithstanding this considerable improvement in our terms of trade with the rest of the world, we have at several times since 1935, and especially during the last two years, spent on imports and other external payments substantially more than our greatly expanded external income, with a consequent reduction in our reserves of overseas exchange. Such a development is a definite indication of the presence of excessive internal demand.

257. Except for the operation from time to time of factors such as the guaranteed price in the dairy industry, the farm industry stabilisation accounts, the wool retention scheme, or the lowering of the exchange rate, increases in export prices are directly reflected in incomes in New Zealand. During the war the stabilisation accounts exercised a powerful restraining force on farm incomes, and the wool retention scheme —begun in 1950—countered some of the effects of the wool boom. In general, however, and apart from the effect of the stabilisation schemes, the influence of higher export prices on the New Zealand economy has been inflationary. An expansion of farm incomes is certain to be followed by a diffusion of higher incomes throughout the whole economy. It is true that higher export incomes provide the overseas funds to pay for more imports, but there is usually a time lag before the arrival of a higher volume of imports. Through the indirect expansion of other incomes and stimulation of economic activity generally, total expansion of incomes following an increase in farm incomes is apt to lead to a greater demand for imports than can be satisfied from the enhanced overseas earnings. This was the experience after the wool boom, and in the last twenty years a similar sequence of events has occurred several times.

258. During the war period particularly, and again as an immediate result of the wool boom, New Zealand experienced substantial surpluses of export and other overseas receipts over imports and other overseas payments. During the war these surpluses arose because, while New Zealand exports were well maintained and even increased, imports of goods for civilian consumption were greatly restricted. The shortage of imports arose mainly because, in the United Kingdom and other countries, industrial capacity had been diverted to war purposes. In these circumstances, the purchasing power distributed in New Zealand through export incomes was greater than the purchasing power absorbed by the goods and services imported.

Private and Government Investment Programmes

259. Especially in the post-war period the high and increasing levels of private and, to a lesser extent, Government capital investment programmes have exercised a powerful inflationary influence. The proportion of the gross national income devoted to private capital investment

(excluding increases in trading stocks) has risen from 7 per cent in 1937–38 and in 1938–39 to 14 per cent in 1954–55. For the year 1954–55 the ratio of Government (including local authority) investment to gross national income was 9 per cent compared with 8 per cent in 1937–38 and 10 per cent in 1938–39.

260. In our historical survey we have referred to the great growth of activity in the building industry. The very substantial proportion of capital investment made up of expenditure on building is shown by the following table:

Year Ended March	Dwellings	Other Building	Total Building	Total Gross Capital Investment (Excluding Changes in Stocks)	Percentage of Building to Total Gross Capital Investment
	£ million	£ million	£ million	£ million	
1952 ..	28	31	59	148	40
1953 ..	28	33	61	174	35
1954 ..	32	39	71	184	39
1955 ..	40	51	91	211	43

261. The attempting of a greater volume of work than can be carried out economically with the available resources of manpower, material, and equipment, has been manifest in the building industry throughout the post-war period. As a result there has been a constant upward pressure on prices and wages in the industry, and this has also exercised a strong inflationary influence on other sectors of the economy.

262. The effects of capital expenditure on the economy were not understood by some of the witnesses appearing before us. The special importance of capital expenditures as a cause of inflation arises from the fact that capital works employ men, use materials and equipment and involve the expenditure of overseas exchange. In this way they diminish the pool of labour and other resources available for local production and the exchange available to pay for consumer goods and services from overseas. While capital works are in progress they distribute purchasing power in the form of wages, salaries, profits, interest, and other incomes, but not until the projects are well advanced or completed do they produce consumer goods and services. It is when the total volume of investment in relation to the gross national income is expanding or is maintained for a period at a relatively high level, as it has been over the last four years, that strong inflationary pressures are generated.

263. To cite a well-known example, the Roxburgh Hydro-electric Scheme is expected to cost in total about £23 million, a very substantial part of which will represent wages and other similar payments. But, until the generators are in operation and the project is supplying electric power to the South Island network, the scheme will provide no consumer goods and services to match the incomes being distributed. When the scheme is in operation, there will be a substantial addition to electric-power supply in the South Island. Similarly, a large capital work may require heavy expenditure of overseas funds. In the meantime, the export incomes distributed to farmers and others cannot be matched by

imports of consumer goods without drawing on reserves of overseas exchange. The Murupara Pulp and Paper Scheme is another example of capital expenditure involving heavy diversion of manpower, materials, and overseas exchange during the course of construction. Later, an important contribution in the form of increased production for export and local consumption is expected to result.

264. From these examples it is clear that, while capital works are in course of construction, incomes are distributed without a corresponding supply of consumer goods and services. Although we have quoted the Roxburgh Hydro-electric Scheme, which is a notable example from the public sector, it should not be overlooked that, in comparison with the immediate pre-war years, it is in the private sector that capital investment has proportionately shown much greater and more rapid growth.

265. The effect on the economy of increased investment, especially during the last few years, has been an expansion of incomes relative to the supply of consumer goods and services, leading to a situation where everything that can be produced or imported can be sold readily. Vacancies for employment, at increasing rates of remuneration, exist for far more workers than are available, and there has been a greater demand for imports than could be paid for from current export earnings. As we point out later, a higher capital investment gives rise to the need for increased voluntary savings or higher taxation to remove surplus purchasing power and thus reduce the current demand for locally produced and imported consumer goods and services. Capital investment may be expected to continue at a high level and the need for increased savings and higher taxation is, therefore, also likely to continue.

Increased Government Expenditure

266. During the war, expenditure by the Government for war purposes had much the same effect on the economy as a capital works programme, except that war expenditure does not usually improve the productive capacity of the country. In principle the process is similar, in that resources of manpower, materials, industrial equipment, and overseas exchange are diverted to war purposes. At the same time as personal incomes are expanded by Government expenditure on war, the production and importation of goods and services for civilian consumption are contracted, and there is a tendency for demand to exceed supply and for prices to increase.

267. The effects of expanded Government expenditure on social services are dealt with more fully later. As is the case with capital expenditure and war expenditure any inflationary effects can be offset to some extent if the expenditures are financed from taxation. During the war, particularly, it was not found practicable for the whole of Government current expenditure to be financed from taxation, and the result was a very large deficit on current account in the Government's transactions. Such a deficit, which reached a peak of £69 million in 1943–44, means that money is being paid out by the Government, and people are receiving incomes which are not matched by production of consumer goods and services. This process is, of course, highly inflationary and it was one of the main causes of wartime inflationary pressures in New Zealand. As we have pointed out in our historical review, in comparison

with other countries engaged in warfare, New Zealand was relatively successful in avoiding this cause of inflation and in minimising its effects on the price level during the war period.

Expansion of the Money Supply Through Reserve Bank and Trading-bank Credit

268. We have already mentioned in our historical review how an expansion of Reserve Bank credit by the Government was partly responsible for an inflationary situation in 1938 and 1939. Use of Reserve Bank credit is another example of the distribution of purchasing power by the Government through its expenditure, without any increase in the supply of goods and services becoming available, and without any surrender of purchasing power such as occurs when expenditure is financed from taxation or by borrowing from the public. When the labour force is fully employed, financing of Government expenditure from Reserve Bank credit is highly inflationary.

269. Apart from direct inflationary effects, expenditure by the Government from Reserve Bank credit may have indirect effects. When the Government spends money provided by the Reserve Bank, the recipients of consequential payments lodge the Government cheques to the credit of their accounts at the trading banks. The trading banks clear these cheques through the Reserve Bank and, as a result, their balances at the Reserve Bank are increased. Unless the reserve ratio is promptly and appropriately adjusted, the increase in these balances may become the basis for an expansion of trading-bank advances considerably greater than the original spending by the Government from Reserve Bank credit.

270. Taking the last twenty years as a whole, we do not consider that the use of Reserve Bank credit has been a major direct cause of inflation, but on several occasions in the post-war period greater restraint in its use by the Government would have been very beneficial, especially having regard to the effects of the use of Reserve Bank credit in expanding the lending capacity of the trading banks.

271. Trading-bank advances and discounts have risen from £44·6 million at March 1935 to £189·3 million at March 1955. Nevertheless, we do not regard the increase of bank advances as having been one of the chief initiating causes of inflation throughout the greater part of the period which we are considering.

272. As a general rule, a rise in the level of trading-bank advances takes place as a consequence of other inflationary factors, in particular as a result of higher export and import prices and the rises in incomes and costs which come in their wake. Such a rise in advances contributes in its turn to the inflationary process by enabling the existing higher demand for capital and consumer goods and services to be made effective. In some instances, bank credit has been used to finance capital expenditure directly.

273. Higher trading-bank credit was an important factor in the excessive spending which followed the wool boom of 1950–51, and which culminated in the introduction of exchange allocation in 1952. Similarly, a large increase in trading-bank advances was a major contributory factor to the excessive spending and balance of payments deficits which took place throughout 1954 and 1955.

274. It is clear that restriction of the level of trading-bank advances is one of the most effective restraints which can be exercised in an inflationary situation.

275. Nevertheless, as we have already stated in respect of trading-bank advances, we do not regard expansion of the money supply as one of the main initiating causes of inflation over the last twenty years. In many instances we consider that expansions in the money supply have been the result of other developments such as expanding export incomes, rising import prices, wage increases, and so on.

276. An increase in the volume of money is important, however, because it means that individuals, firms and public authorities have more spending power available to them. They can therefore afford to buy more goods and services at current prices (if the country has the resources to produce or import them), or they can then pay higher prices, wages, rents, or rates of interest than those now ruling. But, by itself, an increase in the volume of money does not fully account for the development of an inflationary trend. As we have seen, a change in the volume of money may itself be an effect of changes in prices, production, imports, or employment. Moreover, in any consideration of the impact of money on the economic system, the speed with which money is spent is at least as important as the volume of money in existence.

Velocity of Circulation of Money

277. That the speed with which money is spent may vary considerably is indicated by the following table, which shows changes in the velocity of circulation or turnover of trading-bank deposits for the years 1936 to 1955:

Index of Velocity of Circulation of Trading-bank Deposits: Average of Monthly Index for March Years

(Base: Year ended March 1939 = 100)

Year ended March:		Year ended March:	
1936	100·8	1946	52·6
1937	104·3	1947	60·9
1938	102·7	1948	58·7
1939	100·0	1949	57·7
1940	88·6	1950	64·8
1941	76·9	1951	69·7
1942	69·5	1952	69·3
1943	58·3	1953	65·8
1944	54·4	1954	70·7
1945	49·8	1955	69·7

278. The speed at which bank deposits were turned over declined during the war, the velocity of circulation in 1945 being about 50 per cent below the 1939 figure. This was the result of a large increase in the volume of bank deposits, due mainly to surpluses in the balance of payments and to Government borrowing from the banking system, accompanied by limited opportunities for spending money either on consumer or capital goods. There has naturally been some increase in the velocity of circulation since the war, but, even in 1955, it was still about 30 per cent less than it was in the years immediately preceding the war.

279. Thus the decisions of those who have money as to how rapidly they will spend it are at least as important to the economy as the volume of money in existence.

Wage and Salary Increases

280. We consider that wage increases have contributed to the inflationary process both directly and indirectly during the last twenty years, but in general they have been the result of other and more fundamental inflationary forces such as buoyant export incomes and rising import prices. We refer in Section Three of this report to the tendency in the post-war years for the margin of actual wages paid over award rates to progressively widen, and to the recent great acceleration of the process. This development is, of course, a very definite indication of inflationary pressures because it means that increased wages are being sought and conceded in the confident expectation that the increased payments can be added to prices, together with an appropriate profit margin. Since wages are a very important constituent of costs, it is manifest that, while such conditions continue, it is impossible to expect stability in prices of locally produced consumer goods and services.

281. When a general order increasing wages is made under conditions of over-full employment, the amounts paid in industry to maintain margins well above award rates are much more significant than the direct and necessary legal effects of the wage order. These amounts paid to maintain margins over award rates are, of course, added to prices together with a margin of profit.

Comparatively Rapid Population Increase

282. In our historical survey we pointed out the relatively rapid rate of population increase in the post-war period resulting from natural increase and, at times, from immigration. A rapid population increase gives rise to an accelerated demand for capital expenditure on houses, schools, hospitals, transport facilities, industrial buildings and equipment, and other similar purposes, and this tends to add to inflationary pressures.

Social Services and the "Welfare State"

283. The inflationary influence of increased Government expenditure on social services and the influence of the Welfare State are discussed in the next section of this report.

Measures to Combat Inflation

284. When factors such as those mentioned above are combining and inter-acting to generate inflationary pressures the basic problem of economic policy is to keep the total demand for resources within reasonable bounds. A number of factors which help to keep or bring the level of demand closer to the supply of goods and services becoming available are now discussed.

Higher Production

285. The best remedy for inflation is a higher level of production of consumer goods and services, provided it can be achieved without a disproportionate expansion of income such as occurs when there is a

general increase in overtime at high penal rates of pay. As a supplement to local production, higher imports of consumer goods can make a contribution towards stability. However, in the absence of overseas borrowing, a higher level of imports is likely to exhaust reserves of overseas currency, and the use of import surpluses as a deflationary device is limited by the extent to which reserves or borrowings can safely be used for the purpose.

Savings

286. We have pointed out that higher public or private capital expenditure results in the payment of large sums in salaries, wages, and other incomes, without in the meantime providing consumer goods and services on which these incomes may be spent. This is a highly inflationary process unless it can be offset by reduced spending on the part of the public, thereby reducing demand for the current supply of goods and services. When capital expenditure is increased, inflationary pressures will be generated unless the flow of voluntary savings keeps pace, or the Government withdraws more purchasing power from the public.

287. The inflationary effects of the growing capital expenditure and other factors would have been much less pronounced if it had been possible in the post-war years to maintain the proportion of small savings, or other private saving, to the gross national income, at a level nearer to the wartime level, or even to the 1935 level.

Primary Industry Reserve Accounts

288. These accounts were a special device used during the war and post-war years to ensure that the buoyant export incomes did not exert the full pressure of demand on the depleted supplies of consumer goods and services. The annual accumulations in these accounts were similar in their economic effect to an excess of deposits over withdrawals in the Post Office Savings Bank. In the main the primary industry reserves were invested in Government securities and the proceeds were used to finance Government capital expenditure. In the absence of these accumulations in the industry accounts, the inflationary effects arising from increased Government expenditure on war and capital development would have been much greater.

Wool Retention Scheme

289. The Commission commends this scheme as both timely and appropriate to the circumstances of the boom in wool prices of 1950–51. Under the scheme, the wool growers and the Government both agreed to forego temporarily their respective shares of some £32 million of the very high prices received for wool. The effect of spreading the return to the grower over a period of five years enabled many farmers to carry out an orderly programme of development which, if it had all been attempted in 1951, would have been beyond the labour and other resources available. There was, of course, a benefit to the farmer in that lower tax rates applied in later years when the funds were released and many would also benefit because their relatively lower incomes in the years following 1951 would place them in lower taxation brackets than in 1951.

290. Under the wool retention scheme, in contrast with the primary industry reserve accounts, the amounts retained were not invested in Government loans, but were held in special retention accounts at the trading banks. The scheme, however, did not include any provision to prevent expansions of trading-bank advances based on the accretions which occurred to the balances of the trading banks at the Reserve Bank. We think this aspect should receive attention in any future scheme of this nature.

Restraint on Trading-bank Lending

291. This subject is dealt with extensively elsewhere in the report. The over-generous granting and use of bank credit contribute to an inflationary situation by making the process of financing higher wage payments and holding stocks of a higher money value relatively easy. If finance for these and other similar purposes is scarce, an expansion of private investment like that which has occurred in recent years is much more difficult to carry out. Restraint on bank credit alone cannot be expected to right an inflationary situation, but applied early enough and firmly enough it can act as a powerful reinforcement of fiscal and other policies designed to achieve that end.

Taxation and Government Borrowing

292. Higher taxation is one recognised means of reducing the volume of purchasing power in the hands of the public. Provided the increased taxation is not used for increased Government expenditure but leads to a Government overall surplus, there are circumstances in which this method can be most effective. A surplus so achieved would be appropriately applied to reduction of the Government's indebtedness to the Reserve Bank. It is important, however, that any policy of budgeting for a surplus through higher taxation should be supported by strict control of bank advances and by appropriate interest-rate policy, otherwise increases in taxation may be reflected, at least in part, in higher prices. In other words the inflationary process could be stimulated and not curbed.

293. A Government surplus achieved by reducing expenditure is, of course, likely to be more effective in curbing inflation because in that case there will be a reduction of purchasing power in the hands of the public and no added impetus to inflation from higher taxes.

294. Notwithstanding the reservation we have made that in an inflationary situation higher taxes may be reflected in higher prices, we are firmly of the opinion that budgeting for a substantial surplus, through higher taxation if necessary, is an essential part of any comprehensive policy of curbing inflation. We believe that in inflationary circumstances the Government should finance from taxation as high a proportion as possible of its total expenditure, including capital expenditure. From the point of view of countering inflation we would suggest the following order of preference for sources of finance for Government expenditure (including works and other capital expenditure):

(a) Taxation.
(b) Borrowing in New Zealand.
(c) Borrowing overseas.

295. Financing capital works from taxation is more likely to reduce current expenditure on consumption of consumer goods and services than is borrowing from the public in New Zealand. Nevertheless, we consider that, in existing circumstances, the Government is fully justified in borrowing on the market in New Zealand to the fullest extent practicable, even if as we suggested previously, any overall cash surplus is devoted to reduction of Government indebtedness to the Reserve Bank. This we regard as highly desirable in inflationary circumstances. Competition by the Government for the money available on the market is one means of putting a brake on too rapid expansion in other sectors of the economy and especially in the private sector.

296. Borrowing overseas is justifiable when the level of capital development is so high that it is necessary to augment the resources of overseas exchange becoming available. In this way, overseas borrowing can make a useful contribution by enabling the level of consumer imports to be maintained. However, Government overseas borrowing should not be made a substitute for a withdrawal of purchasing power through taxation and borrowing in New Zealand, when the condition of the economy indicates the need for such a withdrawal.

297. We have not included the financing of Government works from accumulated cash balances or from Reserve Bank or trading-bank credit in the above order of preference because they are directly inflationary in character and they should be avoided unless it is desired to apply a stimulus to the economy. In other words, these methods of finance are more appropriate to depression conditions.

298. In the foregoing paragraphs we have laid special emphasis on the importance of taxation as an anti-inflationary measure. We think that much of the popular objection to such measures stems from a misunderstanding of basic economic processes and of the economic function of taxation. In the modern State it should be recognised that a basic function of taxation should be to control the amount of purchasing power in the hands of the public and to reduce it when purchasing power is in excess of the desirable level. We believe that in inflationary circumstances the principal means of dealing with excess purchasing power should be higher taxation, supplemented by:

(a) A close check on public expenditure.
(b) A tight bank advances policy.
(c) Higher interest rates.
(d) Continued control on the level of private investment through existing controls.
(e) Appropriate adjustments of any arrangement for granting special depreciation allowances. Such allowances tend to accelerate capital expenditure and their withdrawal would remove an incentive to such expenditure.

Exchange Rate Policy

299. Only one general alteration in the New Zealand exchange rate has taken place during the last twenty years. This occurred in 1948 when the New Zealand pound was appreciated from £(N.Z.)125 = £(U.K.)100 to parity with the United Kingdom pound. This adjustment had important disinflationary effects because it curbed effects of increases in export prices and also prevented much of the rapid increase in import prices from being reflected in New Zealand prices.

300. A general alteration in the exchange rate results in an adjustment of farm incomes and of import prices. It so happened that the particular circumstances of 1948, when substantial additions were accruing to stabilisation funds for meat and dairy produce and when both import and export prices in terms of overseas currency were rising rapidly, enabled the exchange adjustment to be accomplished with the maximum beneficial effect and with a minimum of disturbance to the economy.

301. Major alterations in the exchange rate are a drastic and far-reaching method of adjusting the economy to external circumstances, through a redistribution of incomes in New Zealand. Although the immediate effects of an exchange adjustment are apparent, the final incidence of the alteration upon the different sections of the community is most difficult to measure. For example, much of any gain to the farmers from an exchange depreciation will be offset by rising import costs in terms of New Zealand currency and even by consequent increased costs in New Zealand. Similarly, the immediate loss of export incomes following an appreciation in the exchange rate will be compensated for, in part at least, by lower or less steeply rising import costs and also by lower or less steeply rising internal costs.

302. Although exchange adjustments do have important immediate effects in redistributing incomes in New Zealand, such adjustments do not affect the real national income, which comprises the goods and services available during the year to the community. The real national income can be raised only by an increase in production in New Zealand, or by an improvement in the terms of our overseas trade which enables us to import more in exchange for a given quantity of exports.

303. Because of the very far-reaching and disturbing effects on incomes and prices in New Zealand we think it better that major adjustments of this nature should be reserved for very special circumstances, such as those which occurred in 1933 and in 1948.

Interest Rates

304. The need to make greater use of interest-rate policy to reinforce other monetary and fiscal measures is discussed fully later in this report.

Direct and Indirect Controls

305. One method of dealing with inflationary pressures during the last twenty years has been to control directly the effects of inflationary pressures on prices, wages, profits, imports, and so on. The New Zealand experience has been that a comprehensive system of direct controls is very effective under wartime conditions, when operation of the controls is reinforced by patriotic motives and by special wartime fiscal measures. In peacetime any really comprehensive system of direct controls would be unlikely to receive wide public acceptance.

306. In a peacetime economy, tendencies towards inflation are best countered by a comprehensive combination of fiscal and monetary policies. Neither fiscal nor monetary policies are likely to succeed unless they both form part of a carefully concerted overall economic policy. But general economic policies, as with wartime control measures, are dependent to a considerable degree for their effectiveness on public understanding of the need for them. This understanding can only be achieved if the Government is prepared to provide adequate, clear, and objective information.

307. Application of moderate measures at an early stage may avoid the need for drastic measures later. The need for such early action is not always obvious and, if public understanding is to be achieved, the fullest public explanation of policy measures is necessary. It is relatively easy for the public to understand and appreciate measures designed to avoid a slump. Anti-inflationary measures are less likely to be understood or to be welcomed because they usually involve reducing someone's income or preventing someone from carrying out projects which to that individual appear advantageous but which, from the point of view of the community, should be postponed or even abandoned in the interests of economic stability and of making the best immediate use of available manpower, materials, and other resources.

308. Under modern conditions the Government must assume an increasing degree of responsibility for the general management of the economy. To do this successfully requires an objective outlook on the part of the Government and on the part of the public. We fully realise the difficulty in reaching and maintaining such a viewpoint when the interval between general elections and the period between appeals to the electorate are as brief as three years. It is not within our province to make recommendations about parliamentary elections, but we consider that, if the parliamentary term were longer, there would be sufficient time for the effects of longer-term monetary and other economic policies to become apparent.

309. Whatever the parliamentary term, we are satisfied that, if the modern economic system is to operate satisfactorily, the Government of the day must be prepared to take measures to some extent detrimental to short-term individual and political interests, but which are for the benefit of the country. It is only by such measures that the modern Welfare State can be managed satisfactorily and a reasonable measure of stability achieved.

Summary

310. The following is a summary of the more important matters dealt with in this Section of our report:

(a) Inflation is an expansionary condition of the economy in which prices, incomes, public and private expenditure, and bank credit all tend to influence one another in an upward direction.

(b) The apparent attractions of continued moderate inflation are heavily outweighed by the damage it does to the economy.

(c) Compared with a value of 20s. in the base years 1926–30, the retail purchasing power of the New Zealand pound was 10s. 7d. in the last quarter of 1955. Similar computations for the United Kingdom pound and the Australian pound show a 1955 purchasing power of 10s. 9d. and 8s. 3d. respectively.

(d) The main causes of inflation operating in New Zealand during the years 1935 to 1955 have been:

(i) Rising overseas prices for New Zealand exports and imports.

(ii) High private and Government capital expenditure.

(iii) Government expenditure on war and other military requirements.

(iv) Inadequacy of voluntary savings to match capital investment.

(v) Expansion of the money supply through increases in Reserve Bank and trading-bank advances.

(vi) Wage and salary increases.

(vii) The comparatively rapid population increase in the post-war years.

(viii) Increased Government expenditure on social services and the philosophy and policies commonly associated with the Welfare State.

(e) Apart from the drastic measures adopted during the war the more important means of combating inflation are:

(i) Higher production.

(ii) Increased savings.

(iii) Restraint on trading-bank lending.

(iv) Higher taxation and borrowing in New Zealand and in some circumstances borrowing overseas.

(v) Higher interest rates.

(vi) In special circumstances, arrangements like the primary industry reserve accounts and the wool retention scheme.

(vii) In special circumstances, an appropriate adjustment of the exchange rate.

(f) In a peacetime economy, tendencies towards inflation are best countered by a comprehensive combination of fiscal, monetary, and other economic policies, which for their effective operation are dependent to a considerable degree on public understanding of the need for them.

311. In the next section some of the effects of the Welfare State on the economy are examined.

Section Six

THE WELFARE STATE AND ITS EFFECTS ON THE ECONOMY

Introduction

312. When falling export prices brought the world depression to New Zealand in the 1930's, Governments for fifty years had gradually been assuming on behalf of the community a degree of responsibility for the welfare of the individual. The immediate result of the depression was to extend this responsibility to provision for the relief of unemployment. The experiences of the depression gave a fresh impetus to social reform, and the advent of a new Government in 1935 was quickly followed by Government acceptance of a much wider responsibility.

313. This acceptance of wider responsibility for individual welfare is the basis of the philosophy of the Welfare State. The widespread influence of some of the reforms introduced in New Zealand is indicated by this International Labour Office comment to the Geneva Conference of 1949 in a document entitled "Systems of Social Security": *"It* (N.Z.'s Social Security Act of 1938) *more than any other law has determined the practical meaning of social security and it has deeply influenced the course of legislation in other countries".*

314. The purpose of the Social Security Act, as set out in its preamble, is *"to safeguard the people of New Zealand from disabilities arising from age, sickness, widowhood, orphanhood, unemployment, or other exceptional conditions";* to provide medical and hospital treatment to all in need of it; and to provide *"such other benefits as may be necessary to maintain and promote the health and general welfare of the community".*

Redistribution of the National Income

315. The simple alleviation of distress, or prevention of undue hardship, by expenditure from State funds, which was the earlier conception, is no longer the sole aim. The Welfare State achieves some of its purposes through a calculated redistribution of the national income.

316. This redistribution is not confined to payments to the sick, the aged, and the needy, or to assistance to those who may be unemployed. For example, subsidies are used to keep down some prices which affect the cost of living, and the family allowance assists those with young families. In both these instances there is no means test; therefore the whole community shares the assistance, irrespective of income. In other instances, such as the age benefit, a means test is applied.

317. Government assistance towards the cost of housing is another method of redistributing the national income. The 1937 Financial Statement contains this comment: *"A more just distribution of the national income is linked up with the provision of adequate housing facilities".*

318. Not all this redistribution is accomplished through the Social Security Fund. Family allowances are paid through the Fund, but subsidies are not. Nor is Government-assisted housing or State housing financed through it. And the Social Security Fund itself is augmented each year from the Consolidated Fund.

319. Indeed, because the contributions are not invested and accumulated for the future payment of benefits, the Social Security Fund is not a "fund" in the actuarial sense of that term. Rather, it is an account recording taxation collected and payments distributed according to a recognised but changing pattern of benefits.

Greater Scope of Government Action

320. The enlargement of Government responsibility under the Welfare State has been accompanied by widened scope of Government action. The Government controls the Reserve Bank, which is charged with the duty of using credit policy to promote and maintain economic and social welfare, stability of internal prices, and production. It is charged too with the duty of safeguarding the country's reserves of overseas funds.

321. The Government has, of course, also concerned itself with hours and conditions of work and minimum rates of pay since the last century. Here again, there has been a gradual enlargement of objective and action to include a wide improvement in conditions and increased leisure for all.

322. All these responsibilities involve the Government in a much more deliberate and comprehensive management of the national economy than was contemplated, or possible, under the more limited powers of democratic governments of the past. It is difficult to decide exactly where the Welfare State (as such) begins or ends and it is, therefore, also difficult to isolate its effects on the economy and to distinguish them from effects arising from other causes.

Economic Consequences of the Welfare State

323. However, it is possible to identify broadly certain economic consequences which flow from the measures generally recognised as being inherent in the Welfare State. It is with such measures in their relation to the monetary, banking, and credit systems of this country that the Commission must deal.

324. The Associated Banks in New Zealand, in a written reply to a question from a member of the Commission, offered this comment: *"Although social services and social security programmes are desirable in themselves, it must be realised that they involve social cost in other directions."* Mr Whyte, Chairman of the Associated Banks, under examination agreed that, *"One of the factors which today discourages saving is what we would call the Welfare State".*

325. The Reserve Bank, in a document supplied at the request of the Commission listing the causes of inflation in order of importance, gave as No. 5: *"The Welfare State philosophy which, though good in itself, tends to produce:*

(a) *Heavy Government expenditure;*

(b) *Heavy taxation;*

(c) *Excessive protection to secondary industries;*

(d) *A weakening of incentives;*

(e) *Free spending on consumer goods;*

(f) *A feeling that "nobody must be hurt" by economic forces or political decisions."*

326. Mr P. L. Porter, Chairman of the Capital Issues Committee, in the course of a statement on inflation said: *"The conclusion I came to was that it was really the application of the Welfare State idea of running our affairs that is causing the pressure. The method of dealing with social problems by handing out money was very laudable in purpose but it doesn't seem to work out too well in practice."* He also said: *"The restriction of bank advances, restriction of capital issues – all those sorts of things – are dealing with symptoms"*.

327. Measures for redistributing the national income may do more than merely reduce the purchasing power of one section of the community and correspondingly increase the purchasing power of another section. By increasing the demand for consumer goods and services these measures may create a buoyant market with a consequent stimulation of industry and commerce. Buoyant demand in the market may in turn encourage greater production, but under conditions of over-full employment it is more likely to lead to higher costs, profits, and prices without increased output.

328. But even although measures to redistribute the national income may cause some inflationary pressure, it is through such measures that people are made more secure than they would otherwise be against unemployment, the financial burdens of prolonged illness, and hardship in old age; and are helped through other difficulties that might confront them, such as the adequate education of their children. Reduced hours of work ensure more leisure and should tend to produce better work in the shorter hours. The forty-hour week is part of a long continuing process of improvement in working conditions, and the increased leisure thus acquired is, of course, an element in the standard of living.

329. A higher leaving age for school children, and the continuance of the family benefit from sixteen to eighteen years for children remaining at school, give a better opportunity for education to those who will in time provide the labour force of the country. Those staying longer at school should be better equipped for their work and for their duties as citizens.

330. Assistance for home building or home purchase helps to better the housing of the community and removes a large measure of avoidable hardship.

331. These things are not achieved without cost, direct and indirect, and it has become a responsibility of Government to take account of such cost and to consider both the direct and indirect effects of Welfare State measures upon the community.

The Cost of Social Services as a Proportion of Gross National Income

332. The increasing total payments from the Social Security Fund are imposing a lessening proportionate burden on the expanding national income, as the following table shows:

Year Ended March	Social Security Payments(1)	Gross National Income	Percentage of Gross National Income
	£ million	£ million	
1947	36·8	424	8·68
1948	40·4	480	8·42
1949	43·0	488	8·81
1950	46·4	552	8·41
1951	49·4	696	7·10
1952	54·2	722	7·51
1953	58·8	754	7·80
1954	62·4	834	7·48
1955	67·2	927	7·25

(1) Source: The Budget, 1952 and 1955.

333. Even when all social services are taken into account, including those paid for from the Social Security Fund, the monetary cost is still not proportionately an increasing burden:

Year Ended March	Gross Expenditure on Social Services(1)	Percentage of Gross National Income
	£ million	
1947	55·0	12·97
1948	61·3	12·77
1949	67·5	13·83
1950	74·8	13·55
1951	81·5	11·71
1952	91·6	12·69
1953	102·0	13·53
1954	109·8	13·17
1955	117·1	12·63

(1) Source: The Budget, 1952 and 1955.

334. However, the proportionate burden has lessened slightly in the last few years only because the gross national income has risen faster than the expenditure on social services. If there should be any fall in the gross national income, or even if it should become stationary, the picture would be entirely different. In New Zealand, which is so heavily dependent on overseas markets, this is a factor of real significance.

Indirect Effects of Welfare State Measures

335. Everybody contributes through taxation, directly or indirectly, to the cost of the Welfare State. However, broadly speaking, the redistribution of income involves taking money in taxation from those with substantial incomes and transferring it through money payments or free services to those on lower incomes or using it by subsidy to keep down the cost of certain commodities.

336. In other words, money is taken especially from those who have considerable capacity to save (including business concerns) and who would be likely to save and invest money. Much of the money is transferred to those who have less individual capacity to save and are more likely to spend it, or who, if they do save, are more likely to use the savings for subsequent spending on consumer goods and services rather than for long-term investment.

337. While the individual saving capacity of those in the lower income groups is limited, they form so large a part of the population that, as groups, their contribution to the total saving of the community can be very important. Their total spending is of equal moment.

338. The sense of security derived from the State guarantee against unemployment and hardship in old age or through prolonged illness also leads to freer spending. The result of this freer spending is to increase the demand on goods and services (including imported goods) and to add to the upward pressure on prices.

339. In the above circumstances, the Government obtains larger revenues from taxation on increased earnings and there is a tendency to increase State spending. There is consequently keen competition between the State and private individuals or business concerns for labour and materials, particularly in the building industry. This competition again increases inflationary pressures.

340. When housing is undertaken by the State, or given State help through large supplies of credit on easy terms, this adds to the demand on the building industry including the demand for skilled and unskilled labour, and thus tends to increase costs and make it easier to secure higher profits.

341. Shorter hours of work in industry generally, a feature of the Welfare State, must result in lower production and higher prices unless they are offset by greater effort or by improved methods of production, including more efficient equipment. Other social reforms, such as earlier retirement and a higher leaving age for school children, tend to reduce the effective labour force.

342. The cumulative effect of all these aspects of the Welfare State is to contribute to a higher level of demand for consumer goods and services, both locally produced and imported. This higher level of demand results in greater business turnovers and higher profits, also in increased capital expenditure to meet the needs of expanding businesses. In these ways, competition for labour is intensified and, in minimum wage negotiations, resistance to high wage demands is lessened. The Welfare State measures we have discussed therefore contribute to inflationary pressures both directly and indirectly.

The Revision of Welfare State Measures

343. Provisions for the redistribution of the national income need adjustment from time to time to meet changing circumstances, and they have been so adjusted. In 1947, for example, some subsidies were removed and others were reduced. The same thing was done again in 1950. In 1953 the prices of certain commodities were allowed to rise instead of being held by increased subsidies. Similarly, monetary benefits under the Social Security Act have been varied in response to changed circumstances. As an example, a cost-of-living bonus of 5 per cent was granted in June 1950 in consideration of the removal of some subsidies and the reduction of others.

344. The foregoing instances serve to show the close relationship between different measures. This relationship was further exemplified, in the first general wage order made after the reduction of subsidies in 1950, when the Court of Arbitration took cognisance of the effect of the reduction on costs of living.

345. The part played by Government in management of the economy also varies according to circumstances and needs. There have, for instance, been significant changes in the disposal of dairy produce, and in the provisions designed to assure the producer *"of a sufficient net return from his business to enable him to maintain himself and his family in a reasonable state of comfort"* one of the express purposes of the Primary Products Marketing Act 1936.

346. In the marketing of produce of all sorts and in the safeguarding of the primary producer, the Government nowadays plays different parts according to the circumstances of the particular industry. In some cases the Government acts jointly with the appropriate industry in marketing primary products.

347. As Michael P. Fogarty explains in his book *Economic Control*, *"The hall-mark of the Welfare State is, in fact not that the State does everything but that it thinks about everything. Its business . . . is to direct, watch, stimulate, and restrain, and only incidentally to operate"*.

The Conflict Between Objectives

348. As we have pointed out in Section Two of this report, there is inevitably, in a managed economy, a conflict between the different objectives of Government, and it is necessary to examine the extent to which a policy will advance one objective of Government against the extent to which it may hinder achievement of another objective.

349. Such conflict makes it harder for the Government to keep the total demand of the community within the capacity of its total physical resources, which is necessary to a sound economy and to the prevention of inflation. The Government, however, has all the requisite powers to accomplish its task. As the Governor of the Reserve Bank indicated under examination, there is nothing in the Welfare State conception which necessarily involves New Zealand in over-full employment or inflation to the present extent.

The Welfare State and Productivity

350. Without making any allowance for sickness or absenteeism, but taking account of holidays and rest intervals during the day, actual productive hours of work at ordinary rates of pay probably do not exceed $35\frac{3}{4}$ per week.

351. There has been a considerable reduction in the proportion of males actively engaged after sixty-five years of age, as shown by these census figures:

1936: 40 per cent.
1945: 30·7 per cent.
1951: 26·5 per cent.

(The proportion of females actively engaged after sixty-five years has always been negligible.)

352. The steady rise in the age benefit, which is dependent on a means test, would seem to be reflected in the steadily reducing proportion of males working after sixty-five years of age. A recent survey shows, on the other hand, that "nearly half of retired Government superannuitants", who are not subject to a means test, are actively engaged. There must be a number of men over sixty-five who would work if there were no means test.

353. Overall productivity has increased considerably since 1936, but part of this increase has been achieved by working considerable overtime at penal rates of pay, which has added to costs. There has been no attempt at the extensive use of shift work. The table contained in paragraph 93 of this report shows that, since 1949, the index of productivity per head of total population has been static, despite extensions to factories, installation of new machinery, and recent notable expansion of agricultural and pastoral activities.

Conclusion

354. There is no doubt that, during the last few years, the considerable inflationary pressures which have been generated in the New Zealand economy have been accentuated and aggravated by measures based on the acceptance by the State of wider responsibility for individual welfare, which is the fundamental principle of the Welfare State.

355. The indirect effect of some of these measures has been to stimulate private expenditure on consumer goods and services and to increase the demand for capital expenditure, both Government and private. At the same time the incentives to private saving have been to some extent weakened by State provision of benefits designed to protect the individual in adversity.

356. On the other hand (as we point out later when examining the relationship between monetary and budgetary policies), measures which the Government must use to control and eliminate inflationary pressures usually involve some diminution of the purchasing power of individuals. On the surface this appears to conflict with the aim of the Welfare State, which is to promote the welfare of individuals. If the Welfare State is to avoid chronic conditions of inflation, which would do much

to harm both the individual and the economy, it must be understood and accepted that the State which pays benefits may also find it necessary to apply remedies involving curtailment of the purchasing power of individuals through taxation and in other ways.

357. Management of the economy within the resources available would still be a problem without the Welfare State. In such circumstances the responsibility of the Government would be less – but so also would be its capacity for effective action, especially under the threat of a recession.

358. In the next section of this report we assess the present monetary, banking, and credit systems of New Zealand before examining the major proposals for reform.

Section Seven

ASSESSMENT OF THE PRESENT MONETARY, BANKING, AND CREDIT SYSTEMS

359. No complex modern economic system could function without the generally acceptable medium of exchange, measure of relative values, and store of purchasing power for the future, which money provides. Nor could a modern economic system based primarily on the institution of private ownership and enterprise survive without a large volume of credit. Money, banks, and credit, in one form or another, are vital to the continued operation of the economy of a modern community.

360. In assessing the present monetary, banking, and credit systems, it is necessary not to overestimate what could be achieved even by a perfect and farsighted monetary and credit policy. The monetary, banking, and credit systems are only some of the many factors which determine the material standard of living which a country can achieve. More important are:

(a) The proportion of the population able and willing to work.

(b) The quality of the labour force, which includes all those engaged in production; their knowledge of advanced techniques; their ability to devise better methods of production and distribution (which implies a high standard of education and the devotion of a proportion of our energies to research); and their willingness to apply their minds and hands to production and distribution (which involves good relations between management and workers, incentives to work and willingness to make and accept innovations).

(c) The quantity and quality of the natural resources available in the country.

(d) The buildings, equipment, roads, schools, pastures, stock, and so on, that is, the social and material capital built up in the past.

(e) The ability and willingness of the people to maintain, improve, and add to that capital.

(f) The terms on which the country exchanges goods and services with other countries.

361. There is at every point of time a limit to the amount which any country can produce or can obtain by overseas trade for distribution among its citizens. This limit cannot be escaped by any manipulation of the monetary, banking, and credit systems, but only by increasing the proportion of workers, improving the quality of the labour force, making better use of natural resources, increasing the quantity and quality of the country's capital, or by an improvement in the terms on which goods and services are exchanged with other countries.

362. Even a perfect monetary system could not prevent some instability or insecurity in a world where new or improved products, services, and techniques are constantly being devised, and where individuals and firms are allowed a large degree of freedom to choose how

they are going to dispose of their money. The implications of this freedom of choice do not seem to be fully appreciated by many people. When these implications are examined, what is surprising is not that the economic system suffers from fluctuations from time to time, but that the fluctuations are not more severe.

363. Those with money have a wide range of choice in deciding what to do with it. The money incomes of private individuals, business, or Government may be used to buy any of a large variety of consumer goods, either imported or locally produced; to buy a section or a home; to pay for services rendered by other persons; to purchase property, equipment, raw materials, and other goods, either imported or locally produced, for use in production or for sale. Some part of the money incomes must be used to pay taxes or rates; some to repay debts; and some may be saved.

364. If there is a decision to save, the money may be hoarded or left on current account with a bank; placed on deposit to earn interest with a savings or trading bank, or other financial institution; used to pay a premium on an insurance policy; lent to an individual, a firm, a local body, or to the Government; or used to buy existing securities. Moreover, in certain circumstances, it is possible to spend in excess of one's income; the individual, the firm, the local body, or the Government may use past savings, or the proceeds of debts repaid to them; may sell some of their material assets or securities; may borrow money either in New Zealand or overseas; or may obtain goods on credit from their suppliers.

365. With this wide range of possibilities it is not surprising that there should be ups and downs of economic activity, not only in particular sections of the economy, but also in the economy as a whole. There is nothing to prevent the members of the community, if they so desire, from spending less than before from their incomes, from borrowing, or from past savings, on domestic goods and services, thus reducing the sums paid out to producers and lowering the total money incomes accruing to them. Again, if they wish, people may spend more on imported goods and less on local goods, in which case local producers again receive less income. On the other hand, it is possible for spending on goods and services in New Zealand to increase through a reduction of savings or through greater borrowing or use of past savings; or because people begin to spend on local goods in preference to imports. In these cases, total money incomes in New Zealand will rise. The real benefit of such a rise in money incomes depends on how far domestic production and imports can be increased to match the increased spending. As we point out elsewhere, restriction of spending and money incomes may be desirable when there is already excessive competition for goods and services.

366. A further complication in New Zealand's case is that the freedom of choice of people overseas may affect our real or money incomes. If they decide to increase their spending on New Zealand's exports, money incomes in New Zealand will rise; if they decide to reduce their spending on New Zealand's exports, incomes in New Zealand will fall. Again, if there is an increase in the prices of overseas goods which New Zealand imports, we cannot avoid paying the higher price; but if there is a decrease, New Zealand benefits.

367. Thus, quite apart from the type of monetary, banking, and credit systems adopted, New Zealand's economy is inevitably subject to disturbance from the effects of new inventions, changes in the patterns of spending and saving of the people, and economic fluctuations overseas.

368. The most that can be expected from the monetary, banking, and credit systems is that they should certainly not aggravate these natural instabilities; and that they should be capable of being used to assist in the economic adjustments which are necessary to enable society to reap the benefits, while countering any drawbacks, of technical and economic changes.

369. The main criticisms of the present monetary, banking, and credit systems made before the Commission were:

(a) That they had held down the standard of living of the country, because they did not provide sufficient purchasing power for people to buy the goods and services which could be produced.

(b) That they had failed to provide the community with money which remained stable in purchasing power.

370. For reasons given elsewhere in this report, we do not agree with the first criticism of the systems. Production in New Zealand has not been retarded in recent years by any shortage of money or spending. Indeed, we believe that productivity might have been increased if spending had been more effectively restrained, in that greater competition would have provided more incentive to improve methods of production and cut costs, and would have reduced the heavy turnover of labour.

371. The second criticism is, of course, valid. For reasons given in Section Five of this report, where the drawbacks of inflation are discussed, no one can view with complacency the fall in the value of money which has occurred in the last fifteen years or so, even though the majority of the people have managed to increase their incomes more than sufficiently to offset the rise in the cost of living, as measured by the consumers' price index. But the fact that we have not enjoyed stability of prices under the present systems does not necessarily mean that they should be drastically revised. For:

(i) In the circumstances, a great degree of instability of prices may have been inevitable under any system.

(ii) The degree of instability may have been due not so much to the systems as to the way in which they have been administered.

(iii) Alternative systems which might have prevented such a degree of instability of prices might have frustrated other objectives to which the Government must have regard.

The problem is to find improvements which could be made in the existing systems or their operation, or to find alternative systems, which would provide greater stability of prices without frustrating healthy economic development, full employment, and other desirable ends.

372. None of the major proposals for reform of the existing systems put to the Commission seem to us to provide an acceptable solution to this problem of instability of prices. Our reasons for this conclusion are set out in detail in the next sections of this report.

373. In our view, no radical reform of the existing systems is necessary, although we consider that their administration could be considerably improved.

374. It must be recognised that the fall in the value of the New Zealand pound during the bulk of the period considered in this report has been in conformity with a world-wide trend. Since 1935, our export prices have risen by about 300 per cent and our import prices by about 186 per cent. We do not believe that there was any practicable means of preventing this increase in overseas prices from generating a considerable increase in prices, incomes, and the volume of money in New Zealand. (See Section Five of this report.)

375. Nevertheless, we believe that the authorities have permitted spending to expand unduly from time to time, with the result that there has been excessive competition for the limited supply of labour and resources available, a greater rise in costs and prices than was justified by external factors alone, and recurrent balance of payments difficulties despite large current earnings of overseas exchange and improved terms of trade.

376. A major factor contributing to the unduly high domestic spending was a large increase in the volume of money. In turn, one of the factors leading to this increase in the volume of money was an expansion of bank advances. This was not a particularly significant factor up till 1949; but advances were expanded excessively during the period from 1949 to 1952 and again in the period 1954–55.

377. The question arises why the undue expansion of advances during these two periods was not prevented by the monetary authorities:

(a) Are there inherent weaknesses in the methods of control available to the monetary authorities?
(b) Have the methods available not been used?
(c) Have they been used with insufficient speed and resolution?
(d) Have the policies of the monetary authorities been frustrated by factors outside their control?

378. Variations of the statutory minimum reserve ratios and the interest rate on advances to the trading banks, the major methods of control available to the monetary authorities, have special limitations arising from New Zealand's banking and economic system. We outline later in the report some of these limitations. **But we are convinced that the failure of monetary policy to prevent an undue expansion of advances in recent years has not been due primarily to weaknesses inherent in the reserve ratio system. The main reasons for failure have been:**

(a) Tardiness in making use of the reserve ratios while direct controls were being relaxed a few years after the war.
(b) Reliance by the authorities:
(i) On voluntary co-operation from competitive trading banks which was not fully forthcoming; and
(ii) On the theory that leaving the banks with only a narrow margin of free cash would induce them to restrict lending.
(c) Insufficient speed and resolution in effectively applying the reserve ratio controls to changing conditions.
(d) Lack of co-ordination between policies designed to control bank advances on the one hand, and fiscal, capital issues, interest rate, and housing-finance policies on the other.

379. In reviewing past events, we have the considerable advantage of hindsight. The authorities are required to make decisions with no certainty as to what will happen in the months ahead, and sometimes with insufficient information on current trends. The difficulties in the way of reaching proper decisions under such circumstances are obvious. The Reserve Bank has been in operation for only twenty-one years. When it raised the reserve ratios in 1952, it was using this weapon for the first time, so that it had no experience of how it would work in New Zealand. It is understandable that, in these circumstances, it should feel obliged to follow a relatively cautious policy. These factors are in our minds as we make the following analysis; but as our task is to formulate constructive suggestions for the future, we cannot avoid drawing attention to measures which appear to us, looking back, to have been inadequate.

1949 to 1952: Reliance on Voluntary Co-operation

380. We recognise that a great deal of the expansion of bank advances between 1949 and 1952 was inherent in the circumstances. There were sharp increases in export and import prices after the outbreak of war in Korea, followed by increases in wages, the complication of the waterfront dispute, and the sudden arrival in 1951-52 of large quantities of imports which traders had expected to receive spread over a period in the future. Nevertheless, the expansion of advances which took place was excessive. We are convinced that greater restraint in the granting of overdraft limits between 1949 and 1951 would have materially restricted the expansion of gross private investment, which rose from £71 million in 1949–50 to £123 million in 1950–51 and to £132 million in 1951–52, and was thus a potent factor in aggravating the existing inflationary situation. It would also have prevented some of the strong demand for imports from becoming effective and thus, perhaps, have avoided the reintroduction in 1952 of control of imports in the form of a system of exchange allocation.

381. The fact that advances expanded unduly in this period would seem to us to have been largely due to the failure of the monetary authorities to make use of the reserve ratio system. The danger of a substantial increase in advances was inherent in the relaxation or removal of direct controls which had previously restrained demand for local and imported goods and services; in the increasing availability of imported goods; and in the high cash reserves held by the trading banks, reserves which were increased considerably between 1948 and 1950 by Government borrowing from the Reserve Bank and between 1949 and 1951 by balance of payment surpluses.

382. The Reserve Bank does not appear to have recognised the need for imposing restraint until towards the end of 1950, for in May 1950 it relaxed its selective advance control policy to some extent. However, in October 1950, and again in May 1951, the Reserve Bank asked the trading banks to adopt a cautious attitude to all requests by customers for increased accommodation. At this stage, in our opinion, the trading banks did not give to the Reserve Bank the co-operation which the circumstances warranted in restraining the expansion of advances. Towards the end of 1951 a directive was issued to the banks under the selective advance control policy, seeking to restrict advances for trading

purposes and for imports, and to have the banks examine overdraft accounts in cases where customers were obviously leaning too heavily on bank finance. It was not until December 1951 that the banks were advised that it was intended to raise the statutory reserve ratios, and the first increase was not made until August 1952. In the meantime, advances had risen from an average of £82 million in the calendar year 1949 to £113 million in January 1951, to £159 million in January 1952, and to £187 million in April 1952. By the last date, the ratio of the banks' liquid assets to their deposits had fallen to a figure which made it desirable, in their own interests, to restrict credit; and a system of exchange allocations had been introduced to protect the country's overseas exchange reserves.

383. Questions were directed to the Governor of the Reserve Bank and to the Secretary of the Treasury during our hearings with the object of ascertaining what factors had stood in the way of an earlier increase in the reserve ratios. The following are extracts from the replies made to these questions:

Question:

Why then was the reserve ratio policy not introduced until August 1952?

Mr Fussell:

I suppose one could trace many types of reasons but I think the underlying one would be that we were operating actually direct controls, and although we started thinking of ratios as direct controls began in post-war years to be diminished, the time to make the transition did not seem to have arrived, but when we felt it was coming along we took it up with the Government to inform them months beforehand – we had to get the Minister's concurrence – and then informed the banks months beforehand, because it was important that a system should not have to adapt itself too suddenly to a new set of conditions and a new type of technique but from the moment we mentioned the new ratio, it had in fact been in force, because they knew from that moment they would have to restrain themselves. At the same time direct control of manpower and materials had receded into the past – all pointed to the transition from direct control to indirect control, but to attempt to do it or even to run it in conjunction with the Import Allocation System would, I think, have been unwise and double-banking, and during the period of the Import Allocation System, or for the latter part, we were introducing it, but the Import Allocation System had to come in regardless of what was being done with indirect control.

Question:

Could you remember when you first suggested to the Government the reserve ratio system should be introduced?

Mr Fussell:

I think it is mentioned in here. If I had to say offhand I would say it is in October or November 1951.

Question:

It had been considered though before that time?

Mr Fussell:

It had been considered but we had not taken it up with the Government.

Question:

Why was the reserve ratio policy not exercised until 1952?

Mr Ashwin:

Well, for the most part prior to that it had not been necessary at all; it had been under direct control; price control, import control, building control; you had the whole thing controlled, under direct control, and there was no need to use the more indirect and certainly more flexible controls through the monetary system.

And again, I think we started about 1949–50 to dismantle them, and the question may be we were a bit slow on going to work on the thing. After all there is no right to assume that because the banks have a bit of leeway in their cash resources that they are going to rush into trouble. They are, after all, responsible people. Again they were a bit slow off the mark. The wool boom came in 1951, and if the wool prices stayed where they were we would have had all that extra sterling and extra buying ability, the advances would have been quite in order.

384. The following quotation from the Government's Economic Survey for 1951 sets out two other factors which appear to have been regarded at that time as obstacles to an increase in the ratios. Such an increase, it said, *"would be difficult to apply at the present time because trading-bank deposits at the Reserve Bank are many times larger than the required minimum, and also because these deposits vary greatly from time to time and between one trading bank and another"*.

385. We do not regard the existence of trading-bank balances at the Reserve Bank many times larger than the required minimum as an obstacle to an alteration of the ratios; indeed, it makes an alteration imperative when the existing situation is already inflationary. The variations of reserve balances from time to time and between one bank and another present difficulties which will always exist in the application of the reserve ratio system. However, as we point out later, these are not insuperable and they are certainly not of sufficient magnitude to justify a failure to impose any increase in the ratio at all. It would appear to the Commission that the monetary authorities were slow to appreciate the need of restraining bank advances, probably because no positive monetary policy had been in operation for many years, while fairly extensive direct controls had been in force. When the need for restraint was recognised, reliance was placed on the policy of selective advance control. This policy had not previously been directed towards reducing total advances, but towards preventing the expansion of credit for speculation and for other purposes inconsistent with the war effort, and after the war to prevent, as far as possible, the use of credit for "non-essential" purposes. The policy was strengthened in 1951 by requests and finally a directive to the banks to tighten up their lending policies.

386. The experience of the period showed that it was unwise to rely on this form of restraint in a situation where competitive trading banks, holding substantial excess cash reserves, were confronted with a very strong demand for advances from credit-worthy borrowers for purposes which were not (at least until the end of 1951) inconsistent with the principles of the selective control policy.

1952 to 1954: Tardiness in Raising Ratios in Light of Changing Conditions

387. The first changes in the minimum reserve ratios were made when the banks were themselves endeavouring to restrict credit and when there was a temporary easing in the demand for advances as stocks were run down from the high level they had reached early in 1952. At the same time, substantial surpluses were achieved in the balance of payments, which led to a large increase in the volume of money and to large additions to the cash reserves of the banks. The minimum reserve ratios were raised by two steps from 10 per cent of demand deposits and 5 per

cent of time deposits in August 1952 to 20 per cent and 10 per cent respectively in May 1953. But the actual balances held by the banks kept well ahead of the amounts which they were required to keep at the Reserve Bank. In 1953 the cash held by the banks averaged 39 per cent of their deposits. Towards the end of 1953 the overdraft limits granted by the banks were again increasing, although up till the end of the year there had been no significant expansion of advances.

388. By the end of 1953, it was evident that restrictive monetary and fiscal policies had become necessary in the best interests of the country, and that a rise in bank advances could only aggravate the existing situation:

(a) Between January 1953 and January 1954 the volume of money increased by over £40 million. This rise in the money supply led to a substantial increase in the purchasing power available to the community.

(b) There was a large number of recorded employment vacancies.

(c) Domestic prices were rising despite a falling trend of import prices, and

(d) The exchange allocation control was being gradually relaxed.

389. Yet, despite the large amounts of free cash in the hands of the banks, the minimum reserve ratios were not raised again until the end of May 1954. By this time total bank credit granted was £16 million greater than in January 1954. **In our opinion, a firmer policy should have been adopted in the latter part of 1953, e.g., by reducing the margin of free cash available to the banks to a very low level and indicating that the reserve ratios and the interest rate for borrowing from the Reserve Bank would be raised speedily and considerably if advances increased to any significant extent.** Mr Whyte agreed, under examination, that if the ratios had been substantially raised at that time *"the effect on trading-bank cash . . . would have been such as to have lowered the level of advances"*.

May 1954 to March 1955: Reliance on Narrowing the Margin of Free Cash

390. Between May 1954 and March 1955 the Reserve Bank appears to have adopted a policy of leaving the banks as a whole with a relatively small margin of bankers' cash above their statutory minimum requirements and of raising the interest rate to make borrowing by the trading banks more costly. On the average, between June and November, the actual balances held by the banks as a whole were about £9½ million above the statutory minimum. Nevertheless, the Bank of New Zealand was borrowing consistently from the Reserve Bank throughout this period. Its need to borrow arose from two factors:

(i) Because it handles the Government's business outside of Wellington, it requires to keep very large holdings of notes in comparison with the other banks. The Reserve Bank has estimated that the Bank of New Zealand requires to hold additional notes to service Government business to an amount of £5·5 million in December and £3 million for the rest of the year. For this reason, it has been agreed to allow the Bank accommodation up to these amounts free of interest, if required to maintain its statutory minimum balances.

(ii) It held fairly substantial assets overseas but did not sell these, as did some other banks, in order to reduce indebtedness to the Reserve Bank. (See Section Two of Appendix C.)

Since £3 million of the amount borrowed by the Bank of New Zealand was interest free, this could really be regarded as an addition to the free cash available to the banking system. Between December 1954 and March 1955, the free cash held by the other banks was substantially reduced – on average to a level of about £3 million among the four of them – and the Bank of New Zealand remained in debt to the Reserve Bank. The interest rate for borrowing from the Reserve Bank was raised from 1½ per cent (at which level it had remained since 1941) to 3½ per cent in April 1954 and to 4 per cent in November 1954.

391. However, despite the tighter policy adopted from May 1954 onwards, advances continued to rise from £148 million in May to £170 million in October 1954, and then, after a period of relative stability until February 1955, there was a sharp rise to £189 million in March 1955. This sharp rise in March was due primarily to advances to customers for payment of taxation and to higher advances than usual in this period to marketing authorities owing to a change in the procedure for marketing primary produce. But the available evidence indicates that the narrowing of the margin of free cash and the raising of the Reserve Bank's lending rate in the second quarter of 1954 did not have any restraining effect on lending by the trading banks. A fair indication of the total credit granted by the banks to private customers may be obtained by adding together their advances and unexercised overdraft authorities. This total rose from £260 million in May 1954 to £280 million in October 1954 and to £288 million in March 1955.

392. There is no doubt that the expansion of bank advances made a considerable contribution to the renewal of inflationary pressures and to the consequent marked upsurge of private imports during this period. Mr Whyte agreed that external factors were not exerting an inflationary influence at the time, that the expansion of trading-bank credit was the major cause of the expansion of the money supply which took place, and that it had been a factor in making effective the desire of the community to increase their spending. (Between the years ended March 1954 and March 1955 gross private investment – including stocks – rose from £84 million to £159 million, personal expenditure on consumer goods and services rose from £530 million to £610 million, and private imports increased from £175 million to £232 million.)

393. **The experience of this period indicates that, when the banks are holding cash reserves well above what they would regard as a prudent minimum, it is insufficient merely to reduce the free cash of the trading banks to low levels and raise the interest rate for borrowing from the Reserve Bank as a means of preventing any significant expansion of trading-bank advances.** The assumption underlying this policy is that the banks regard the necessity of borrowing from the Reserve Bank as most undesirable and if they see the possibility of such a situation arising they will take rapid steps to restrict their lending. Mr Fussell and Mr Whyte both stated in evidence that trading banks disliked strongly having to borrow from the Reserve Bank. But after May 1954 it should have been evident to the banks that, if the prevailing level of the reserve ratios were maintained, and if advances were increased, they would become quite heavily indebted to the Reserve Bank, especially in March 1955. Yet they granted a substantial amount of additional credit throughout the rest of 1954.(1)

394. In fact, the banks were assisted to avoid any substantial borrowing from the Reserve Bank up till the end of March 1955 by a temporary lowering of the reserve ratios in September 1954, designed to compensate for the drain of cash from the trading banks to the Government as a result of the £10 million National Development Loan and by a further reduction in March 1955 at the income-tax period. On the latter occasion, the Treasury also deposited up to £16 million temporarily with the banks at a low rate of interest in order to prevent their being penalised by a loss of cash *"for reasons unrelated to their own lending policies"*. We are not convinced that the difficulties of the banks on these occasions were entirely *"unrelated to their own lending policies"*.

March to December 1955: Putting the Banks "In the Red"

395. By March 1955, the ratio between the cash held by the banks and their customers' deposits had reached a level which, in view of the continuing deficit in the balance of payments, made it necessary for the banks themselves, for reasons of prudence, to restrict their lending. The following extract from the transcript of evidence makes this clear:

Question:

If there was no Reserve Bank restriction at the present time, would the banks be following substantially the same attitude, or taking substantially the same attitude, in overdraft lending?

Mr Whyte:

They would have to in self-protection if for no other reason, but they would certainly do so in the interests of the country.

396. The authorities have also pursued a firmer policy since March. Between March and October the reserve ratios were raised gradually again by four steps to 24 per cent of demand deposits and 7½ per cent of time deposits and the rate of interest charged to the trading banks for accommodation was raised by three steps to 7 per cent. As a result, the average of the weekly figures of indebtedness of the banks as a whole to

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(1) Again, even after the Reserve Bank's interest rate for lending to the trading banks had been raised to 7 per cent in October 1955 – still not necessarily a penal rate to the banking system as a whole – the Bank of New Zealand has preferred, as a matter of policy, to borrow from the Reserve Bank, at times, quite substantial amounts, while maintaining a high level of overseas assets, some of which could have been sold to the Reserve Bank to reduce its indebtedness. In drawing attention to this fact, we are not criticising the Bank of New Zealand's policy in this respect, but merely pointing out that trading banks do not necessarily find indebtedness to the Reserve Bank, even at high rates of interest, so undesirable as to induce them to avoid such indebtedness by changing their policies.

the Reserve Bank or Treasury(1) between 1 April and 31 December was just over £10 million. The figure for December was nearly £14 million. Judging by a statement by the Governor of the Reserve Bank when the ratios were raised in October, the policy of the Reserve Bank in the latter part of the year was to keep the banks as a whole "in the red" to the extent of about £12 million.

397. In addition, there have been abnormally large sales of sterling by some of the trading banks to the Reserve Bank – a total of £20·5 million in 1955. The majority of these sales no doubt arose from a desire by the banks to reduce their debt to the Reserve Bank to a minimum. Though they thus escaped payment of interest to the Reserve Bank, they had to forego the interest which might otherwise have been earned on short-term investments overseas. It is impossible to assess exactly how far the banks have been penalised indirectly in this way by the reserve ratio policy, but they have undoubtedly been affected to some extent. Some banks have also been borrowing overseas during the period, but the amounts borrowed by the banks as a whole do not seem abnormally high in comparison with previous years.

398. In assessing the importance of borrowing by the trading banks from the Reserve Bank, the fact that, for reasons given above, the Bank of New Zealand is able to borrow certain amounts free of interest, should be borne in mind. Yet the figures of total indebtedness of the trading banks (including the Bank of New Zealand) to the Reserve Bank have been used, without qualification, to demonstrate to the public the severity of the reserve ratio policy.

399. In fact, although the average of the weekly figures of borrowing by the trading banks from the Reserve Bank and the Treasury between June 1954 and February 1955 was over £7 million, nearly all of this amount was borrowed by the Bank of New Zealand. Therefore, the average indebtedness on which interest was payable was less than £4 million. Some banks were also granted interest-free accommodation by the Reserve Bank at the time of the National Development Loan in 1954. The Bank of New Zealand was also responsible for over

(1) Some of the moneys deposited by the Treasury with the trading banks in March 1955 were left with the banks until early in June 1955. Also in December 1955 the Bank of New Zealand borrowed £3 million from the Treasury on fixed deposit at $2\frac{1}{2}$ per cent per annum. In response to inquiries, the Commission was informed that "the arrangement was concurred in by the Treasury on representation from the Bank of New Zealand that its bank-note holdings for the Christmas season requirements in respect of Government business, temporarily and greatly exceeded the normal allowance made by the Reserve Bank by way of interest-free loan. The deposit was made for one month only and was regarded as a temporary adjustment not materially affecting the general control of bank lending". It was considered preferable for the Bank of New Zealand to meet this unusually large seasonal expansion of note requirements on Government account by obtaining a short-term deposit of £3 million from the Treasury, rather than by borrowing temporarily in London, where it had adequate securities available. An understanding had been reached between the bank and the Treasury some time ago that the bank would be assisted by the Treasury in the event of funds being needed to fulfil the statutory reserve ratio requirements. The assistance was to be related to overdraft accommodation (involving considerable direct outlay of overseas funds) granted by the bank to certain Government and semi-Government organisations at the request of the Government. Treasury also deposited with the bank sums varying from £2 million to £3 million between August 1954 and May 1955, in accordance with this understanding.

55 per cent of the borrowing from the Reserve Bank and the Treasury in the last nine months of 1955 and 80 per cent in the last six months of 1955. Therefore, the amounts borrowed must be similarly deflated if a proper indication is to be obtained of the severity of the policy. We can see no valid reason why the existence of the arrangement between the Reserve Bank and the Bank of New Zealand should not have been brought to the notice of the general public and, in view of this, we must express our concern at the use, without qualification, of statistics of indebtedness which could only mislead the public as to the true extent to which the privately owned banks were being penalised by the reserve ratio policy.

How Penal Has Reserve Bank Policy Been?

400. Although the amounts borrowed may seem large, the actual interest paid by the banks has been small in relation to the additional income made by the banks on their higher advances. Total interest paid by all the banks to the Reserve Bank between 1 June 1954 and 31 December 1955 was £180,395. Of this amount, 60 per cent was paid by the Bank of New Zealand. £138,543 of this interest was paid after 1 April 1955, reflecting the firmer policy adopted by the Reserve Bank since that date. In addition, interest amounting to £81,669 had accrued, but was not due for payment, by 31 December 1955. But the average level of advances in 1955 was approximately £25 million higher than in 1954 and £45 million higher than in 1953. Assuming a rate of interest on advances of $4\frac{1}{2}$ per cent the banks' annual gross earnings on advances in 1955 would therefore be about £1·1 million greater than in 1954 and £2 million greater than in 1953. **Even allowing for any consequential increases in administration expenses, and loss of income due to sales of sterling, the banks' additional earnings obviously greatly exceeded the interest payments made to the Reserve Bank.**

401. The policy of keeping the banks as a whole "in the red" to the extent of about £12 million, combined with the Bank of New Zealand's policy of keeping relatively large holdings of overseas exchange in spite of its having to borrow continuously quite large amounts from the Reserve Bank, also had the rather anomalous effect of preventing the intended measure of restraint on lending from operating with full force on the other trading banks. Thus the policy of the State-controlled bank operated, in the circumstances, to shield the private banks.

402. A further drawback of a policy of keeping the banks approximately £12 million "in the red" is that the financial penalty on the banks is increased, not reduced, if they succeed in reducing advances, at least until they have actually reached the figure deemed desirable by the Reserve Bank. In addition, the Commission gained the impression that the Reserve Bank had given the banks no clear objective at which to aim in restricting credit. **It would seem desirable to the Commission that the banks should be given a clear, if necessarily tentative, indication of the Reserve Bank's objectives, and a rather more direct incentive to co-operate with its policy.**

403. Advances fell from £189 million in March 1955 to £176 million in December 1955, a figure £10 million higher than the level of advances in the previous December. The total of advances and unexercised overdraft authorities fell from £288 million in March to £272 million in December, which was £7 million less than the previous December.

There is evidence, therefore, that an attempt was made by the banks in this period to reduce the total of their advances to some extent and it is important not to minimise their achievement in restraining their lending in the face of strong pressure for accommodation. How far the reduction since March 1955 has conformed with the wishes of the monetary authorities is difficult to assess in the absence of any clear statement of the objective of their policy. Since the banks as a whole have in recent months been put more heavily in debt at higher rates of interest, one would assume that the authorities have not regarded the reduction achieved as satisfactory. Again, since it would appear to have been in the interests of the banks themselves to reduce their advances, it is impossible to assess whether the firmer policy of the authorities has been to any real extent responsible for bringing about the degree of reduction that has occurred.

The Need for a Co-ordinated Policy to Combat Inflation

404. Because the spending of the community was not sufficiently reduced by other anti-inflationary policies, a still more rapid reduction in the level of advances would have been advisable in 1955. The continuing high level of private imports and of employment vacancies and many other indications showed that the anti-inflationary policies adopted had not been sufficiently effective up till the time of writing. Inadequate support from other policies has been an important element in the lack of success in controlling advances over the past six years. Inflation cannot be effectively fought on one front alone. The adoption of appropriate policies in such fields as public finance (including housing finance), interest rates, and capital issues would have considerably eased the pressure on the banks for additional credit; pressure which it is difficult for competitive banking institutions to resist, especially when their own liquid reserves are at a high level.

405. Quite apart from making the control of advances more effective, it is most desirable that, when reduction of spending is necessary to control inflationary pressure, it should be effected through a series of co-ordinated measures, covering a wide field of spending, rather than through additional restrictions in one field of activity alone. In the past two years, undue reliance has been placed on control of spending by the restriction of bank advances, with insufficient attention to supporting this control by other means. Should an expansion of spending prove desirable at some future period, it can be achieved most effectively by a variety of measures which ensure that the increase is spread over the community as a whole.

Inadequate Attention to Stimulating Voluntary Savings

406. The best method of effecting a necessary reduction of spending is to induce people to reduce their spending voluntarily. To do this requires an aggressive effort by the Government and by financial institutions to "sell" the advantages of saving, and to make available adequate and attractive facilities for the accumulation of savings. We do not feel that sufficient attention has been given to this problem and we make suggestions later in the report as to measures which might be adopted to increase voluntary savings.

407. However, after a period of rising prices like that through which we have passed, many people will no doubt be sceptical of the advantages of saving, unless it is made clear that the Government is determined to take other action to maintain reasonable stability in the value of money.

408. The Government has not made adequate use in recent years of certain measures which could have helped to restrain spending and thus curb inflation.

Unduly Rigid Interest-rate Policies

409. Interest-rate policy has been too rigid. Although it would be a mistake to expect any marked reduction of spending from a rise in interest rates alone, we are convinced that they have an important part to play in a co-ordinated programme to restrain inflation. A rise would make saving somewhat more attractive and, more important, might encourage those who are forced to borrow to reduce their stocks, to re-examine their building and construction programmes, and to exercise greater caution in buying goods on credit.

Non-banking Credit, Especially for Housing

410. Insufficient attention has been paid to the inflationary effects of some types of non-banking credit. Government policy in the provision of finance for housing, in particular, has not taken sufficient account of the labour and resources available in this field. Although the policy adopted has undoubtedly helped to increase the number of houses constructed annually, it has done so at a heavy price. The effect of a large expansion of credit in a particular field is similar to the effect of a large expansion of spending in the economy as a whole. If labour and resources cannot be expanded in step with the expansion of credit, part of the extra spending made possible by the credit must be dissipated in higher building costs or in higher prices for existing houses. Average costs of dwellings have risen in the past eight or nine years considerably more than most other costs and prices, as shown by Table 55 in Appendix H. And the effect is not limited to housing, for competition by builders for labour and resources raises incomes and costs and leads to pressures for higher incomes in other industries. Moreover, undue expansion of credit in a particular direction may have effects not only on costs and prices in that field, but also on the balance of payments, e.g., an undue expansion of credit for the purchase of motor cars could cause a considerable expansion of imports. For these reasons the Government must pay attention not only to the total volume of money and credit, but also to the extent of credit granted in particular sectors of the economy.

411. The housing programme has also tended to frustrate the Government's anti-inflationary policies, either by reducing the overall budget surplus achieved, or at times by necessitating recourse by the Government or by the State Advances Corporation to the banking system for finance. A recent example is the sale of £12 million of State Advances Corporation stock to the trading banks. Similarly, it is probable that the expansion of private credit, especially of hire purchase and of other forms of consumer credit, has been financed partly by the extension of bank overdrafts, with similar effects. The banks, under the selective advances control policy, are enjoined not to give credit for this purpose,

but is is quite impossible for them in many cases to check on the actual use of funds advanced for other purposes. This is a further reason for paying attention to credit granted by institutions outside the trading-bank system.

Budgetary Policies

412. Although the desirability of using budgetary policy to restrain inflationary pressure has been recognised in successive Economic Surveys, the Government has not in fact made sufficient use of its power to restrain private expenditure in an inflationary period by collecting more from the public, by taxation and borrowing, than it pays out. Governments have, throughout the post-war period, been too ready to grant taxation concessions which economically were in all the circumstances inadvisable. From a short-term point of view, especially to the individuals receiving the concessions, it might appear that the tax reductions were beneficial; but, as pointed out elsewhere in this report, if labour and resources are already fully employed, goods and services available for purchase cannot be rapidly increased.

413. If in these circumstances spending is permitted to expand too rapidly, aided by the tax concessions of the Government, it must lead, in a reasonably free economy, to rising costs and prices and/or to the dissipation of overseas exchange reserves. If costs and prices rise, the temporary benefit of the concessions granted is offset, and perhaps more than offset, by the depreciation of the purchasing power of money, involving a much more haphazard and inequitable form of levy than the taxation normally imposed by the Government. If the excess spending is diverted to imports, the point must eventually be reached where reserves have fallen so far that further reduction cannot be contemplated.

414. Thus, if it failed to curb domestic spending by appropriate budgetary policies, the Government could find itself faced with the unpalatable necessity of introducing vexatious controls over imports and exchange. And even this step would not solve the root problem of inflation, which would then express itself in rising prices or, if suppressed by controls over domestic transactions, in continued shortages of goods and services. The relevance of these remarks to the current situation is examined in a later section of this report.

Conclusion

415. We do not believe that any radical reform of the existing monetary, banking, and credit systems is necessary or desirable. Certainly, none of the major alternatives put to the Commission provides an acceptable basis for reform.

416. In view of New Zealand's continued dependence on overseas trade, some instability of prices and incomes in New Zealand must be expected if instability occurs in our major markets and sources of supply, as has been the case for the bulk of the period under review.

417. In the post-war period, Governments have permitted, and through tax reductions have even encouraged, unduly high domestic spending. This has led to avoidable shortages of goods and services, a diversion of labour and resources from more essential to less essential industries, an unnecessarily steep increase in costs and prices, and recurrent balance of payments difficulties despite continuously high export receipts.

418. The control of bank advances has not been sufficiently effective, primarily because of:

(a) Tardiness in introducing controls through the reserve ratio system:

(b) Reliance on voluntary co-operation by the banks, which was not fully forthcoming:

(c) Tardiness in raising reserve ratio requirements in the light of changing conditions at the end of 1953:

(d) Misjudgment as to the deterrent effect on lending by the banks of narrowing the margin of free cash available to them:

(e) Failure to impose an interest rate for trading-bank borrowing from the Reserve Bank, that made it unprofitable for the banks to expand their advances unduly:

(f) Inconsistency between policies designed to control bank advances and other Government policies.

419. Greater attention should have been paid to stimulating voluntary savings, and greater use should have been made of higher interest rates and a more restrictive budgetary and housing-finance policy as part of a co-ordinated policy to restrain spending.

420. No monetary, banking, and credit systems could create an economic Utopia or fully counter fluctuations which occur for reasons other than the operation of those systems. But we believe that, given wise, timely, and resolute action by the Government and its monetary authorities to counter inflationary and deflationary tendencies, the existing monetary, banking, and credit systems will continue to contribute to the healthy expansion of economic activity in New Zealand, while maintaining the maximum possible degree of freedom for its citizens.

421. Following this assessment of the present monetary, banking, and credit systems, we turn to an examination of major proposals for reform.

Section Eight

REPRESENTATIONS MADE FOR REFORM

I. General Comments

422. In the Preface to this report we point out that, apart from the thirteen witnesses who appeared at the public hearings in response to the direct invitation of the Commission, a further fifty-nine witnesses volunteered personal submissions or presented the views of organisations desiring to make submissions. The Commission also received and considered eighty-nine written submissions on which no appearance was sought. Details of these appearances and submissions are contained in Appendices A and B to this report.

423. Throughout the public hearings, and during the consideration of the written statements, we were greatly impressed by the obvious amount of time and trouble involved in the preparation of submissions. Many of these were very detailed and carefully documented.

424. Substantial portions of some submissions were taken up by historical or analytical surveys of the New Zealand monetary, banking, and credit systems. In the earlier parts of this report, and in Appendices C and H, we set out the facts and figures which appear to us to provide the necessary background against which suggestions for reform must be considered.

425. Suggestions for reform of the present systems were many and varied as might be expected from the wide scope of the terms of reference. The proposals which appear to us to justify special consideration are discussed in the remaining sections of this report. In some instances the persons or organisations mainly responsible for the proposals are mentioned, but in most instances there is no direct reference of this sort. In some cases, many individual submissions were made on the same subject.

426. In this section of the report, before considering special aspects of the monetary, banking, and credit systems, we deal with the following:

(a) State monopoly of the creation of credit.
(b) Social Credit submissions.
(c) The submission of Mr H. J. Kelliher and The Mirror Publishing Co. Ltd.
(d) Proposals for a commodity-backed currency.

II. Should the State Have the Sole Right to Create or Destroy Money?

Introduction

427. A number of witnesses contended that the State should have the sole right to "create" or "destroy" money and that the trading banks should not be permitted to do so. This contention was fundamental

to the proposals of Mr H. J. Kelliher and The Mirror Publishing Co. Ltd., and it received some support from the New Zealand Social Credit Association and from a number of other witnesses.

The Origin of Creation of Money by Banks

428. The process called "creation of credit" or "creation of money" is no new development. Its origin in England in the seventeenth century as a development of the activities of the goldsmiths is described in the following passage from *The Theory of Credit* by Macleod (first published in 1891), Vol. II, Part II, at page 520.

When a customer paid in money to his account: and when they discounted a merchant's bill: they simply gave them a Credit in their books: which in the technical language of banking is termed a Deposit. Moreover, in order to diminish the demand for actual payment as much as possible, they agreed with their customers to make these Credits or Deposits as transferable as money itself: and to pay any person to whom their customers had transferred their Credits, in the same way as to themselves.

These Credits, or Deposits, were transferred by means of paper documents, which were of two forms—

1. Either the Goldsmith gave his customer a written promise to pay to himself, or to his order, or to bearer on demand, such a sum as he asked for: these notes were in simple writing: and were called Goldsmiths' Notes.
2. The customer might write a Note to the Goldsmith, directing him to pay a certain sum to any person, or to his order, or to bearer, on demand: these Notes were at first termed Cash Notes; but in modern language they are termed Cheques.

These two forms of documents were thus as transferable as Money itself, and produced all the effects of Money. And by experience, the goldsmiths soon found that they could keep afloat an amount of Credit considerably exceeding the amount of cash they kept to meet the demands upon them; and this increased quantity of Credit was in all its practical effects exactly equivalent to an increase of Money of equal amount.

People found it much more convenient to lend their money to the goldsmiths, where they could have it whenever they pleased along with high interest, than to lend it out on real or personal security. The goldsmiths soon received the rents of all the gentlemen's estates, which were transmitted to town. Five or six stood pre-eminent among their brethren, and Clarendon says that they were men known to be so rich and of such good reputation, that all the money in the kingdom would be entrusted in their hands. These goldsmiths, then, first came to be called Bankers.

429. At page 870 of the same work, Macleod defines "banking" in the following terms:

The business of banking does not consist, as is so commonly supposed, and as stated in books and documents which might be supposed to be of authority, in borrowing money from one set of persons and lending it to another set: but in creating and issuing Circulating Rights of Action, Credits or Debts, on a given basis of bullion, several times exceeding the basis; according to the different degrees of perfection on which the system is organised. These Circulating Credits have exactly the same effects, in every respect, as an equal quantity of money.

430. The views of Macleod are supported by the following extract from *An Outline of Money* by Geoffrey Crowther, (1948), page 26:

And finally, the goldsmith, now fully developed into banker, makes the discovery that he can safely issue deposit-receipts in excess of his gold stock. It is immaterial whether he does this by printing off more receipts and lending them to people in need of accommodation (or indeed using them to pay his own household bills), or whether he does it by allowing his customers larger "deposits" (on which they can draw by cheque) than the value of the gold they have deposited. In either case the crucial step has been taken. The principle of "creation" of money has been discovered. At first, the goldsmith was doubtless cautious in his "creation". Then later, with growing confidence, he went too far. But gradually he accumulated experience about the proper proportion of actual gold to keep in reserve . . .

But the unique function of the banker, and the one that makes him important for this book, is . . . the provision of a convenient mechanism by which people can make payments to each other without having to walk around to each other's houses with bags of coin. And in providing this mechanism he also provides, or "creates", the money itself. He has discovered the secret, for which the medieval alchemists strove, of manufacturing money. So at least it seems, though we must now examine more closely this apparently miraculous business of "creation".

431. The above extracts indicate that historically the creation of credit has been inseparable from the business of banking. They disprove a statement by Mr Kelliher that, *"Nowhere in the literature is it authoritatively stated that the function of banking is to create money"*. Appendix D, Part II, to this report contains a number of further extracts which indicate that the explanation of the creation of credit by banks has been a common feature of textbooks on economics for many years.

The Legality of Creation of Money or Credit by Trading Banks

432. Mr Kelliher went so far as to contend that, in conducting their operations as they do, the trading banks in New Zealand were breaking the law because creation of money by the trading banks was a breach of the Crown's prerogative, and because the creation of money or credit was not properly part of the functions of a trading bank. Because of the inadequacy of the legal argument both for and against these contentions, the Commission requested the Minister of Finance to seek the independent advice of the Solicitor-General, whose opinion on the issue is attached to the report as Appendix D, Part I. In essence, this opinion affirms that:

(a) The Royal Prerogative in respect to money matters *"relates primarily, if not exclusively, to the regulation of the coinage"* and has *"no application whatever to the creation and issue of 'credit'"*.

(b) On the authority of the Privy Council in the case of the *Attorney-General for Alberta* v. *the Attorney-General for Canada* (1947), *"it is not beyond the business covered by the word 'banking' to make loans which involve an expansion of credit . . ."*

(c) There is no doubt *"that the 'creation of credit' is a legitimate function of a trading bank which has been duly authorised to carry on the business of banking in New Zealand, and that in performing this function such a bank is in no way invading or usurping the prerogative of the Crown or infringing any other principle or rule of law"*.

433. After considering all the material before it, the Commission rejects the contention that the operations of the New Zealand trading banks under the existing banking system are illegal.

Creation of Money and the Public Interest

434. Apart from the historical and legal aspects outlined above, the next question to be considered is whether it is in the public interest that the power to create or destroy money or credit should be withdrawn from the trading banks and reserved to the State or to institutions owned by the State.

435. The burden of the contentions of those who sought to deprive the trading banks of the power to create and destroy money was that the trading banks for their own profit sometimes expand the money supply

to an undesirable extent and so cause inflation, and in other circumstances, such as in times of economic depression, cause an undesirable reduction in the money supply by reducing advances.

436. In the view of the Commission the Government possesses adequate powers to prevent any undesirable expansion of trading-bank credit. It can do this through the Reserve Bank under the reserve ratio system and, if it is so desired, it could take special steps through the Bank of New Zealand which it owns. The Governor of the Reserve Bank said in evidence that the Reserve Bank could prevent the trading banks from making any further expansion of advances if at any time it was considered desirable to do so.

437. The Commission does not regard the existing reserve ratio system as a perfect instrument for controlling trading-bank advances, and later in this report we make suggestions for improvements in the system. We have no doubt, however, that it can be used to restrain lending by the trading banks provided the Government and the Reserve Bank are sufficiently resolute in their determination to restrict such lending.

438. There is, of course, the possibility of bringing about necessary expansion of the money supply entirely by financing Government expenditure from Reserve Bank credit, and by at the same time preventing trading banks from expanding their lending through a rigid application of the reserve ratio. We consider that the needs of industry and commerce for additional credit can be more conveniently and efficiently met by expansions of trading bank credit than by expansions of Reserve Bank credit. The trading banks are in close touch with the multitude of industrial, commercial, farming, and other businesses and they are in a position to give attention to the needs of individual businesses.

439. The Commission is convinced that there is no real danger of the trading banks attempting to bring about an undue restriction of trading-bank credit for their own purposes during a recession. It is in the financial interests of the trading banks to see that their advances do not fall unnecessarily since interest on advances is the main source of the banks' income. In any event, the Government, having complete ownership and control of the Bank of New Zealand, is in a position to ensure that sufficient trading-bank credit is made available, providing credit-worthy customers exist and are willing to borrow.

440. The trading banks in New Zealand are able to create and destroy money through their lending transactions (subject to certain definite limitations discussed elsewhere) basically because a very substantial proportion of commercial and industrial business in New Zealand is transacted by trading-bank customers through current accounts at the trading banks, known as demand deposits, and because these deposits, transferred by cheque, constitute a customary and generally acceptable form of payment. Because so large a part of business is done through the trading banks by this means, any expansion of advances by a New Zealand trading bank is likely to result in some increase in the total of demand deposits held by bank customers and therefore in the creation of money. Similarly, a reduction of trading bank advances tends to reduce the total of demand deposits and therefore to destroy money. The trading banks can create additional money only if they have balances at the Reserve Bank (including any amounts borrowed from the bank)

more than sufficient to meet their reserve ratio requirements. Otherwise they can expand lending to some customers only as other customers repay their loans.

441. The essential ingredients in creation of money by the trading banks are:

(a) Their ability to make additional advances on overdraft.

(b) The fact that they handle the bulk of commercial and industrial business of the country through the cheque system.

(c) The fact that a large proportion of their advances is not withdrawn in cash but is deposited within the trading-bank system.

442. To ensure that the trading banks do not create or destroy money it would be necessary to prevent them from increasing or decreasing the existing level of advances, because either an increase or a decrease in total trading-bank advances will in part at least be reflected in an increase or decrease in the total of customers' demand deposits. As mentioned previously, it is practicable to place an upper limit on trading-bank lending through the reserve ratio system, but below whatever limit the Reserve Bank imposes it appears to the Commission impossible to prevent increases and decreases in trading-bank lending from affecting the level of customers' demand deposits and thus creating and destroying money.

Nationalisation of Trading Banks Not Advocated

443. One means of preventing privately-owned trading banks from creating and destroying money would be to nationalise them. However, neither Mr Kelliher nor the New Zealand Social Credit Association favoured this course, although Mr Kelliher presented it as a likely consequence if his own scheme were not adopted.

444. After reviewing all the evidence submitted, the Commission is satisfied that the private trading banks operating in New Zealand are providing an efficient service to the community at reasonable cost. And the Government, through its ownership and control of the Bank of New Zealand, is in a position to control the cost of banking services to the public should it be found necessary to do so. In these circumstances, there appears to the Commission to be nothing inherently wrong in part of the process known as the "creation or destruction of money" being undertaken by private institutions.

Conclusion

445. The essence of the matter is that insufficient or excessive credit creation can have important repercussions on the whole economy and, for that reason, control should be exercised by the Government through the Reserve Bank and, if necessary, through the Bank of New Zealand. Such control can be exercised under existing legislation. Furthermore, the Government has itself adequate powers to create money through the Reserve Bank or through its ownership of the Bank of New Zealand.

446. To concentrate the whole of the trading-bank activities or the whole business of credit creation in a Government monopoly of banking would, in the opinion of the Commission, lead to an undue and unnecessary aggregation of power in the hands of the Government. It would remove a highly desirable element of competition and it could not be expected to provide as good a banking service as the commercial community now enjoys.

III. Social Credit Submissions

Introduction

447. The Commission received oral or written submissions from forty-eight persons or organisations who claimed to be supporters of Social Credit or who made suggestions which were closely akin to the principles of Social Credit.

448. Much time was given to the submissions of the New Zealand Social Credit Association, which were approved by the New Zealand Social Credit Political League. They were presented by Miss M. H. M. King and Mr R. G. Young, Vice-Presidents of the Social Credit Political League, of which Mr Young was in addition acting-leader at the time in Mr W. B. Owen's absence overseas. Both Miss King and Mr Young were also members of the New Zealand Social Credit Association, although without executive office. Almost eleven days of our hearings were devoted to the reading of brief statements by these witnesses, lengthy cross-examination on the statements, and the opening and final addresses of the Association's counsel, Mr F. C. Jordan. Mr Jordan claimed that together the Association and the League represented most of New Zealand's social crediters (to adopt his own term). However, a number of other witnesses who claimed to be social crediters made their own submissions which differed in matters of substance from those of the Association. The evidence of the Association's witnesses under examination was also in many respects inconsistent with the Association's prepared submissions, in some instances to the point of withdrawal.

Differences Between the Social Credit Association's Submissions and the Election Policy of the Social Credit Political League

449. The Association's submissions differed in important aspects from the policy which the Political League submitted to the electors in 1954, and Mr Jordan objected strongly to any questioning of the Association's witnesses on this policy, or on Social Credit political literature. He explained that the political policy had aroused the *"strongest resentment"* among some Association members, and that as a result it had been reconsidered and *"rectified"* in certain matters. From Mr Jordan's explanation it became clear that the case prepared for submission to the Commission did not conform with what many people have come to accept as Social Credit theory and policy.

Consideration of Social Credit Literature

450. Mr Jordan also at first objected to the examination of witnesses on any Social Credit publications other than the Association's submissions, but finally withdrew this objection. During the hearings the Association's witnesses under examination and Mr Jordan in his remarks rejected or substantially modified a number of important propositions contained in Social Credit publications. For example, Mr Jordan described the A + B theorem as of only "academic interest", and Mr Young admitted important flaws in the A + B theorem and in the examples of its application given in *How Social Credit Works,* compiled by Mr W. B. Owen, leader of the Social Credit Political League. Yet the core of the Social Credit theory that there is a chronic gap between purchasing power and prices, as conceived by its founder Major Douglas, and as expounded in the past by the Social Credit movement, has been the A + B theorem.

451. The Commission has not felt it desirable to trace and discuss in the main body of its report all the inconsistencies with which it was confronted. It has decided to consider here the principles and proposals which seemed to be commonly accepted by most of the social crediters who appeared before it. For a fuller account of the Social Credit Association's proposals, for an indication of the significant withdrawals and departures during the hearing from the original submissions of the Association, and for a better understanding of the differences between the various versions of Social Credit, a study of Appendix E to this report is necessary.

Social Credit Analysis of Existing System

452. The social crediters regarded the present system as inherently defective. They drew attention to the fact that public and private debt, taxation, and the cost of living have all been increasing. They claimed that there was no real security for the individual or the nation.

453. The basic reason for these defects they gave as a *"chronic gap"* between the amount of purchasing power in the hands of the people who want to buy goods and services and the prices which sellers must charge to earn a fair return on the goods and services which they can produce; that is, a chronic shortage of purchasing power.

454. A chief cause of the gap, they claimed, is that the banking system has a monopoly of the creation and destruction of money, so that all money comes into existence as a result of interest-bearing loans to producers from the banks. They argued that, since no money is created to pay the interest charges on these loans, the members of the community can meet them only by impoverishing one another or by going more deeply into debt to the banks.

[NOTE—For convenience the term "gap" is used in the rest of this report, although, as pointed out elsewhere, we are convinced that no gap in the sense postulated by the social crediters has existed in recent years.]

455. This position, they said, is aggravated by the fact that persons and business firms save part of their incomes.

456. For these reasons, in their opinion, at certain times there are depressions while at others, as in New Zealand since 1936, the community bridges the gap by such means as the extension of the time-payment system and the growth of public and local body debt, or by struggling to find export markets overseas. Miss King claimed that the growth of public and local body debt between 1933 and 1953 *"measures the extent to which depression is kept at bay by the State or local bodies undertaking capital projects financed on debt money"*.

Social Credit Proposals for Reform

457. To remedy this situation, the Association proposed that a National Credit Authority should be set up first to ascertain, through a national survey, the extent of the gap, and, secondly, to direct the amount of extra purchasing power which should be issued *"debt free"* to balance production and consumption. The extra purchasing power could be issued in many ways, but the Association proposed that it should be used by the Government to: (1) reduce taxation; (2) increase social security benefits; (3) subsidise retailers who would reduce their

selling prices to agreed figures; and (4) pay for public works of a non-commercial nature. Other Social Credit witnesses did not appear to think that a survey was necessary, and indicated that the Government could henceforth finance all its expenditure with debt-free money, thus avoiding the need to tax or borrow from the people.

Examination of Social Credit Analysis

458. The Social Credit view of the defects of the existing system lacks perspective. For example, it is true that the absolute amount of the public debt has increased considerably since the 1930's, but a balanced assessment must take account of such factors as the changes which have taken place in the national income and in the relative proportions of the debt held overseas and in New Zealand since that time. When that is done, it is evident that New Zealand's debt today is a very much lighter burden than it was twenty years ago. In 1932–33, to take the years chosen by the Association, the total public debt was more than double that year's gross national income; in 1954–55, it was only four-fifths of the gross national income. In March 1933, the Government's overseas debt was £174 million; in March 1955, it was £100 million. In 1932–33, overseas interest payments used up £18 in every £100 of overseas earnings; in 1954–55, interest payments used only £1 2s. in every £100.

459. The growth of private indebtedness, which the social crediters regard as another defect of the existing system, is largely a transfer of purchasing power from one group of people to another. And, of course, both public and private debt largely represent savings which have been lent to the Government, to local bodies, to business concerns, and to individuals, and have been put back into circulation by the borrowers. What somebody owes somebody else owns. New Zealand's recent prosperity and expansion have increased the opportunity to save and the need and the willingness to borrow. Increased public and private debt is very largely a reflection of rapid social and industrial development financed from savings.

460. Similarly, taxation should be related to the national income and to the purposes for which the taxes have been used. Taxation has increased since 1938–39, even as a proportion of the national income. But the ratio of taxation to the national income has increased mainly because a larger part of the money collected through taxation is now used to redistribute income through social security and other monetary payments, and to finance capital works for which money was previously borrowed. The vital fact is that the Government itself is using a slightly smaller share of the nation's real resources than it did before the war. And, as Social Credit witnesses so often pointed out, it is real resources, not monetary values, that matter.

461. Again, there has been a rise in the cost of living in recent years, and those people on relatively fixed incomes have suffered as a result. But the average citizen has a substantially larger real income and consequently a higher standard of living than before the war. In addition, the security of the individual has been improved by the extension of social security benefits, by the accumulation of substantial reserve funds for the primary industries, and by the virtual disappearance of unemployment in New Zealand.

462. In short, the Social Credit witnesses gave a completely distorted description of the state of the New Zealand economy, emphasising those facts which gave colour to their arguments, but ignoring many other facts essential for a balanced appreciation.

463. The Social Credit claim that all new money comes into existence as an interest-bearing debt to the trading banks is contrary to fact. Only about half (£139 million) of the increase in the volume of money (£271 million) between June 1935 and June 1955 was due to trading-bank advances. About £20 million came from Government borrowing from the banking system (mainly from the Reserve Bank) and another £77 million came from overseas transactions. The balance of the increase is accounted for by a number of other factors which individually are relatively unimportant.

464. Reserve Bank lending, as we show later, does not involve borrowing in the ordinary sense, and the increase in the volume of money from overseas transactions does not usually involve borrowing in any sense. When New Zealanders obtain overseas funds, mainly from the sale of exports, they sell this foreign exchange to the banks in return for the equivalent in New Zealand money. On the other hand, New Zealanders who have to make payments overseas, chiefly importers, buy the necessary foreign exchange from the banks with New Zealand money. When overseas receipts exceed overseas payments, as they did in the main between 1939 and 1954, the banks buy more foreign exchange than they sell, and the volume of money in New Zealand is correspondingly increased – without debt or interest.

465. In any event, payment of interest to the banks does not cause a shortage of purchasing power, as the Social Credit argument runs. Nor does a shortage of purchasing power necessarily arise from business and private saving, another Social Credit contention. If bank interest, reserves set aside by business concerns to provide for depreciation and contingencies, and savings of private individuals all represented purchasing power withdrawn from circulation, as the social crediters contend, the national income would fall and the purchasing power of the community with it. But this money is not hoarded; it is normally spent into circulation; and the assumption that it is hoarded is a grave, basic fallacy in the Social Credit proposition.

466. The banks do not destroy or hoard their interest receipts. They use them to pay wages and salaries to their staff and dividends to their shareholders, and to make purchases from other firms which in turn use their income in a similar way. Business concerns normally use within the business the funds which they set aside as reserves, or sometimes use these funds to buy shares and securities. Private individuals commonly place their savings with some financial institution such as the savings banks, which by this means are enabled to increase lending. or they also acquire shares or securities.

467. In all instances the money is either spent directly or is made available for borrowing by others to spend. The Association's witnesses finally conceded this point, and, incidentally, recognised that the lending and borrowing of private savings is a basic necessity if a system of private ownership and private enterprise is to be preserved, an objective which they considered desirable.

468. However, the Social Credit witnesses carried the argument one step further. They claimed that the investment of savings meant the reappearance of the same money in a fresh set of transactions which included new costs but that no new money was made available to meet these costs as reflected in prices. This is an instance of another basic Social Credit fallacy – the fallacy that new money must be created to finance every new transaction.

469. Most of the Social Credit witnesses did not seem to appreciate that money circulates, that one bank note or bank deposit may be transferred several times during a year, thus financing several transactions and becoming part of the incomes and expenditures of several people. Some of these witnesses implied that each unit of money was cancelled as soon as if it had been spent and that fresh supplies of money were needed to finance each new transaction.

470. A relatively small amount of money is enough to finance a very large volume of business. There is no need – and indeed it would be disastrous – to create new money for every transaction which takes place in the economy. Yet that is what the Association's argument on this aspect of the monetary system amounts to. This argument is totally destroyed by a comparison of all transactions settled by cheque with the volume of bank money available. For the year 1954, the value of cheque transactions (excluding Government transactions) was £4,430 million, but the average value of deposits and unexercised overdraft authorities in that year was only £344 million.

471. We agree that if people hoard their savings instead of investing them, or if financial institutions fail to find borrowers for the savings placed with them, the community's spending is likely to fall, and the national income also. But no deficiency of purchasing power need arise if the saving of some individuals or business concerns out of their incomes is matched by the spending of other individuals or business concerns in excess of their incomes, either by the use of past savings or of borrowed money. And, of course, there may also be times when purchasing power is increased through the spending of some members of the community, from borrowed money or from money saved in the past, exceeding the current savings of other members of the community.

472. This is one of the fundamental and generally accepted explanations of the ebb and flow of economic life in the past. But it provides no foundation whatever for a theory that there is a permanent shortage of purchasing power.

473. Growth of public and private debt provides no evidence of a general shortage of purchasing power. For instance, examination of the holdings of the Government's internal debt shows that most of the increase which has taken place since the 1930's can be attributed to the investment of savings by the public, either directly or through savings banks, insurance companies, and so on. In other words, some people have found it unnecessary or undesirable to spend part of their incomes and have transferred the money temporarily to the Government in return for an agreed annual interest payment. In addition, substantial reserve funds have been accumulated by the primary industries – another form of saving – and invested in Government securities. Similarly, private indebtedness largely represents a transfer of income from one set of persons to another.

474. The Social Credit suggestion that our need to export primary produce is due to a deficiency of purchasing power in New Zealand is absurd. The local market could not absorb all our wool, meat, and dairy produce, and without imports, which can be bought only with foreign exchange earned by exports, we could provide very little of the material and equipment essential to our farming, manufacturing, and service industries. Indeed, without imports, the New Zealand economy, as we know it, would cease to function. To give only one example, without petrol and oil all forms of transport dependent on these fuels – motor cars, motor lorries, passenger buses, farm tractors, and aeroplanes – would be brought to a standstill, the transport system would collapse, and mechanical farming would come to an end.

Examination of Social Credit Proposals for Reform

475. Under examination after they had heard a good deal of the evidence put before the Commission, the Association's witnesses themselves seemed at least to have revised their estimates of the extent of the gap and even to have begun to doubt its existence in recent years. It does not require a national survey to prove to the Commission that, since the war, spending has been generally excessive in New Zealand in relation to the goods and services available. Certainly some people have had insufficient income to buy the goods and services which many people regard as providing the basis for a reasonable standard of living, and some have suffered from the continually depreciating value of their savings or their relatively fixed incomes. But evidence that some people have not enough purchasing power is not evidence that the community as a whole has not enough purchasing power. All the evidence, in fact, points to the existence of too much purchasing power. There has been no undue accumulation of stocks; there has been a very large number of employment vacancies; and prices have risen constantly. These conditions would not have prevailed if there had been insufficient purchasing power in the hands of the people as a whole.

476. The Association's counsel made it quite clear that *"there is no necessity for the creation of any money to balance available goods and services with purchasing power . . . if the gap does not exist"*. Since there is obviously no gap we cannot recommend any issue of debt-free money at the present time.

477. It is recognised that more money will be required as our production and population grow. If it seems expedient, the Government can use its control of the trading banks through the Reserve Bank to prevent the provision of this extra money by way of bank overdraft, which the Association claimed increases the debt burden of the community. And, if circumstances seem to demand that more money should be put into circulation debt free, as the Social Credit Association urged, this also can be done by financing Government expenditure through the Reserve Bank. Today, when the Government borrows money from the Reserve Bank it can set its own terms as to interest and repayment; it need not repay the loans if it is felt desirable that the money should remain in circulation; and the Government even now pays the interest to itself (as the owner of the Reserve Bank, the profits from which are paid into the Consolidated Fund). That is not borrowing in the ordinary (and to the Social Credit Association, objectionable) sense.

478. Since the Government, therefore, already possesses all the powers the Social Credit Association wishes it to have, the only question is whether the issue of debt-free money is desirable or advisable.

479. The Commission is most strongly opposed to meeting the need for extra money in the future through the Government issue of debt-free money.

480. In normal times, when additional credit is necessary to finance increased production, it is more appropriately provided through the trading banks. They are in direct and frequent touch with farmers, traders, and business houses of all sorts, and are in the best position to judge the needs and estimate the resources of their customers. The conditions of trading-bank advances – repayment when called upon and the payment of interest – are in themselves some brake on excessive demand for credit.

481. Even in these circumstances, too much may be advanced and too much purchasing power may be made available. Through its ownership of the Reserve Bank and its power to direct Reserve Bank action, the Government can, however, limit trading-bank advances. In addition, as the owner of the Bank of New Zealand, which handles two-fifths of the trading-bank business of the country, the Government is in a position to form its own opinion of, and to influence, trading-bank policy. These important aspects of the monetary, banking, and credit systems are fully discussed elsewhere in this report. Here it is enough to point out the measure of Government control of credit within the existing system.

482. It might appear that costs and prices would be lower if all the extra money required were issued debt free to the Government rather than through trading-bank loans to industry. This idea is largely illusory. As population and production grow, firms will need more working capital; if they cannot get it from the banks, they will have to increase their capital, borrow at interest elsewhere, or increase their prices. Likewise, the expenses of the trading banks will increase as the number of depositors and the volume of deposits rise; if they cannot increase their advances and investments, which are the main sources of their income, they would probably have to raise their charges for keeping accounts.

483. The community's need for more purchasing power in ordinary circumstances is vitally different from the need in a depression. A direct increase in the incomes of consumers is urgently necessary in depression conditions to enable what is produced to be sold and to maintain full employment. At such a time a Government might properly issue money through the Reserve Bank, and no doubt would. But even then it would be unwise to use debt-free money.

484. If the Government adopts a policy of issuing debt-free money to pay for its capital works, it enters into very one-sided competition with the private sector of the economy for the labour and resources available, and the community gets a completely false picture of the real cost of such works. In our view, there is a grave danger that this false picture would lead to pressure upon the State to take over from private firms services which, in terms of real resources used, it could run no more efficiently, but which, by reason of its favoured financial position, it could supply more cheaply in money terms, at least in the short run.

485. Similar considerations apply in the case of the use of debt-free money for the payment of benefits or subsidies. If these must be financed by taxation, there is a potent check on extravagance, in the form of critical scrutiny by the taxpayers who are relieved of part of their income to enable the payments to be made. If it is conceded that benefits and subsidies may be financed by an issue of debt-free money, this check is removed, and the pressure on the Government for extra benefits must increase.

486. Thus, serious objections to reliance upon debt-free money to expand the money supply as population and production grow are:

(a) It would give a false picture of the real cost of Government operations;

(b) There would be pressure for the State to take over functions which it could perform no better than private firms;

(c) It would be very difficult to keep the issue of debt-free money within the bounds of prudence; and

(d) If an excessive issue were made, costs and prices would be driven up very steeply and rapidly.

487. Among the uses suggested for debt-free money by the New Zealand Social Credit Association were:

Tax reductions:
Increased social security payments:
Price subsidies.

488. This proposal reveals an immediate problem. If in one year taxation were reduced and the reduction off-set by the issue of debt-free money, in the following year taxation would either have to be restored to the old level or more debt-free money issued to meet the deficiency. Similarly, an increase in social security payments would either have to be financed by more debt-free money in the second year or the payments would have to be cut back to their old level. The same would apply to prices; either more debt-free money would have to be issued to keep them down by subsidy or they would have to be allowed to rise again. The same process would have to be repeated year after year.

489. If £80 million to £90 million of debt-free money were issued in the first year of a Social Credit Government, as Miss King and Mr Young at one time appeared to believe practicable, by the end of the year the volume of money would have risen by about one-third.

490. Unless the debt-free money could be cancelled out of existence the result of repeated issues of debt-free money of this magnitude would be most serious chronic inflation. Although they recognised *"the utmost importance of cancellation"* – Mr Young said that it was fundamental to the Social Credit case – the Social Credit witnesses were unable to show how the money could be cancelled. The Commission can only conclude that it would never be cancelled.

491. Inherent in the Social Credit proposals is the belief that an increase in the volume of money will bring increased production of goods and services. Money is, of course, only power of demand over goods and services; the issue of money will of itself produce nothing. At a time like the present, when the resources of the community are already fully employed, production can be increased only by acquiring

more land, labour, or capital, or by making more effective use of the existing supplies. The social crediters were unable to show us that the issue of more money would in these circumstances produce anything but higher prices.

492. Perhaps the belief that the issue of large quantities of new money would be beneficial rests mainly on a confusion between what is good for the individual and what is good for the community as a whole at a time when resources are fully employed. We know that if, as individuals, we won a lottery or received a substantial increase in pay we could buy more of what we want. But, if an issue of debt-free money for tax reductions or increased benefits gave us all the equivalent of a lottery prize or a pay increase, no one would be better off at a time when resources were fully employed. The extra money would of itself produce no more goods and services.

493. It is not surprising that a doctrine like Social Credit should have flourished during a depression, a time when the resources of the community were very far from fully employed. When large numbers of people are unemployed, when wages and prices are falling, and when stocks of goods stay unsold on shop shelves, to put more purchasing power into the hands of the people certainly improves matters. But, when business and industry are consistently many thousands of workers short of their needs, when there are recurrent shortages of goods and services, and when prices are continually rising, there is no advantage but on the other hand real and grave danger in the issue of large quantities of new money.

494. The extra money would not remain unspent; nor would it be cancelled out of existence as soon as it was spent as some witnesses appeared to believe. We would merely have more money chasing a relatively constant supply of goods and services. Inevitably prices would be driven up by extra competition for the goods and services available. If the tax concessions and increased benefits financed by the new money were continued in subsequent years – involving more and more issues of debt-free money – New Zealand would be engulfed in rapid inflation which would bring in its train economic, political, and social problems of a magnitude which it is to be hoped New Zealand will never be required to face.

495. It was made quite clear to us that, in the words of Mr Young, *"there is nowhere in the world where the financial technique of Social Credit is in operation"*. Social Credit theory has, therefore, not been put to the test of practical application.

496. In our view, the Social Credit analysis of the existing position in New Zealand was falsely based, in that it:

(a) Grossly exaggerated the importance of increases in public and private debt and in taxation.

(b) Assumed, contrary to fact, that all money comes into existence as an interest-bearing debt to the banks.

(c) Wrongly assumed that bank interest and business and private savings are hoarded and withdrawn from circulation.

(d) Ignored the fact that money circulates, a relatively small amount of money being enough to finance a very large amount of business.

(e) Accepted the false premise that, because some people have not enough money to meet all their needs, the whole community must be short of money.

497. The Social Credit witnesses failed to produce any evidence of a chronic gap between purchasing power and prices although, as they admitted, the existence of such a gap is the whole basis of Social Credit. Under examination, Mr Young agreed to this proposition: *"No gap, no Social Credit"*. A similar admission came from Miss King.

498. During the hearing the Social Credit Association witnesses and the Association's counsel made very substantial withdrawals from evidence originally submitted in proof of the gap. Mr Jordan admitted, for example, that *"increases in debts, public and private, are neither a measure of the gap, nor conclusive proof of it"*. He finally went so far as to say that the Association did not *"postulate a chronic shortage of purchasing power"*.

499. Under examination, Mr Young at first placed considerable reliance on certain estimates of the gap published in New Zealand Social Credit literature. Later he admitted that these computations were full of serious errors. Indeed, he even admitted that the computation of a gap of £193·5 million, on the basis of which an issue of debt-free money of some £80 million to £90 million was promised in 1954 by the Social Credit Political League, involved comparisons of 1951–52 production with a total of salaries and wages for 1950–51 and company and other incomes for 1949–50. It is obvious that such a computation is worthless either as proof of a gap, or as a measure of its magnitude.

500. The Association's witnesses and counsel also retreated from the original contention that the banking system's claim to own the credit it dealt in was "a usurpation of the most important and powerful social asset the community possesses". Mr Jordan committed himself to this statement in the final address: *"We do not allege . . . that the banks have usurped the State's prerogative to create money. We allege that they did and had until the passing of the Reserve Bank Act . . . but we can see that nominally at least now the control of money is in the hands of the Government"*.

501. The only positive Social Credit Association proposal for immediate application that was sustained throughout the hearings was that a National Credit Authority should be set up and a national survey made to ascertain, *inter alia,* whether or not a gap existed.

Findings

502. After close examination of the Social Credit submissions and evidence the Commission finds that:

(a) The Social Credit Association witnesses and counsel were seriously at variance, not only with other social crediters who appeared before us, but also among themselves. They made significant withdrawals in matters of substance; even the A + B theorem was virtually discarded (see paragraph 450).

(b) The Association's witnesses presented a distorted picture of the present state of the New Zealand economy and their analysis of New Zealand's existing monetary system was falsely based and seriously erroneous.

(c) They failed completely to substantiate their original submission that there was a chronic gap between purchasing power and prices (that is, a chronic shortage of purchasing power), which is a fundamental proposition of Social Credit. They withdrew during the hearing from their chief arguments in support of this proposition.

(d) The only positive Social Credit proposal for immediate application sustained throughout the hearings by the Association was that a National Credit Authority should be set up and a national survey made to ascertain, *inter alia,* whether or not a gap existed.

(e) Nevertheless, their whole submission rested on the assumptions that the survey would undoubtedly disclose a gap and that an increase in the volume of money was of itself certain to bring increased production of goods and services.

(f) On the basis of these totally wrong assumptions, they envisaged the application to the existing inflationary situation of remedies devised for a situation of depression, like that of the 1930's on which their theory appears to be founded. They did not allow for the radical change in circumstances since then, and they drew many of their examples of alleged deficiencies in the present economic system from the conditions of twenty-five years ago.

(g) There is abundant proof that New Zealand's present problem is not a shortage of purchasing power, as in the 1930's, but an excess of purchasing power. Nothing in the Social Credit proposal was designed to meet such a situation. When, as now, the resources of the community are already over-stretched, further issues of money will produce nothing except further pressure on the existing supply of goods and services – and consequent higher prices and dissipation of overseas exchange reserves.

(h) If made in the present circumstances, the large issues of debt-free money contemplated by the Association and recommended by other Social Credit witnesses would produce most serious and chronic inflation and gravely disrupt New Zealand's economy.

(i) The admitted ultimate objectives of Social Credit, the abolition of debt and interest and the substitution of a national dividend for the wage and salary system, would necessarily involve the abolition of private ownership of property.

IV. Submission of Mr H. J. Kelliher and the Mirror Publishing Co. Ltd.

Introduction

503. Mr H. J. Kelliher and The Mirror Publishing Co. Ltd. presented six volumes of submissions to the Commission. Many of the matters raised were of a technical nature, including questions of economics, accountancy, and banking. These technical matters have been dealt with in Appendix F. Mr Kelliher did not himself enter the witness box, but evidence was given on his behalf and on behalf of The

Mirror Publishing Co. Ltd. by Mr W. S. Otto. Dr O. C. Mazengarb, Q.C., appeared as counsel for Mr Kelliher and The Mirror Publishing Co. Ltd. The hearing of evidence, examination of the witness, and addresses by counsel occupied nearly twelve days. Wherever we ascribe matter to Mr Kelliher in the report, we are referring to the preliminary documents placed before the Commission, to the prepared submissions, and to the remarks of Mr Kelliher's counsel. Where Mr Otto is mentioned, we refer to his statements under examination, to his written replies to questions put to him during the hearings, and to documents presented in amplification of his evidence.

504. In his submissions, Mr Kelliher diagnosed the chief cause of the inflation in New Zealand as the creation of new money by the banking system in the expansion of its lending and investing operations. He also put forward the view that deflation is caused by the reverse policy of reducing lending and investment. He submitted what he described as *"a new concept in banking technique which will enable the banks to lend and invest without creating or destroying the nation's money supply"* which he called *"Loanable Funds"*. To supplement his main proposal, the Loanable Funds Scheme, he also submitted a number of ancillary proposals, such as schemes for insulation of the New Zealand economy from the effects of overseas price changes, for control of capital investment in New Zealand, for regulation of wage increases, and for a number of other purposes.

Brief Explanation of the Process of Creation and Destruction of Money

505. Preparatory to a discussion of Mr Kelliher's proposals for reform of the banking system, the next few paragraphs explain briefly the terms "money supply", "volume of money", and "creation" and "destruction" of money which are more fully discussed in Section Four of this report and in Section One of Appendix C.

506. The term "money supply" and "volume of money" are synonymous. As defined by the Reserve Bank, they represent the amount of money at any time in the form of coin and bank notes in circulation, and free (or demand) deposits available at the banks to the public or to the Government for spending. It is an essential element of the "money supply" that it represents money which the public (or the Government) has an unqualified right to spend at will. For example, a free deposit is an asset immediately available for spending by the customer who owns it. A fixed deposit is also an asset of the customer who owns it but it has been lodged with the bank for a definite period and is therefore not available for spending until the end of that period. For this reason fixed deposits are excluded from the official definition of the money supply adopted by the Reserve Bank.

507. A bank overdraft is a liability of the customer to whom it has been granted. He is liable to repay any amounts he has drawn, when he is called upon to do so by the bank. Amounts drawn by customers against overdraft accounts play an important part in determining the total amounts held as demand deposits by bank customers. When a customer exercises his right to draw cheques on his overdraft account, such cheques will usually be paid to other people who then lodge the cheques to the credit of their own bank accounts. As the number of

customers' accounts in credit is greatly in excess of the number of overdraft accounts, it may be expected that, in the normal course of business, many cheques drawn on overdraft accounts will be lodged to the credit of accounts which are in credit (i.e., free deposit accounts).

508. By this process an expansion of bank advances on overdraft will usually lead to some increase in the total of free deposits, which form the greater part of the money supply. Similarly, when bank advances are reduced, there may be a reduction in free deposits and therefore in the money supply. These increases and decreases in the money supply are sometimes called "creation" and "destruction" of credit or "creation" and "destruction" of money. The other causes from which similar increases and decreases in the money supply may arise are described in paragraphs 157 to 163 of this report and in Section One of Appendix C.

Claims by Mr Kelliher for the Loanable Funds Scheme

509. Mr Kelliher claimed that his main proposal for banking reform, the Loanable Funds Scheme, would have these principal advantages:

(a) Trading-bank lending and investment transactions would not increase or decrease the money supply. He said: *"What I advocate is a new concept in banking technique, which will enable the banks to lend and invest without creating or destroying the nation's money supply"*. In this way Mr Kelliher claimed that the Loanable Funds Scheme would cure what he described as the *"cardinal defect"* in the existing banking system.

(b) Inflation could be cured without restricting bank lending. In his own words, *"Monetary inflation has been the principal culprit and major cause of price inflation. How then is the situation to be rectified without restricting bank lending for private and business purposes? I have endeavoured to supply the answer"*. Elsewhere Mr Kelliher stated that he advocates a *"more elastic and vastly improved banking technique whereby the trading banks would be enabled to lend from the existing stockpile of money to the limit of credit-worthy borrowing"*.

(c) The trading banks would be prevented from *"destroying the nation's money supply"* in a recession.

(d) The scheme would *"revitalise free enterprise and enable all controls to be dispensed with"*.

(e) The trading banks would *"borrow to lend"* according to the principle *"to which all Savings Banks and other financial institutions must conform"*.

510. The Loanable Funds Scheme would begin on the basis of the level of trading-bank advances existing at the time. Thereafter, in the main, the trading banks would be limited in their authority to make advances by their ability to attract additional fixed deposits or *"savings"* deposits as Mr Kelliher calls them, together with any reduction in the former total of advances. (Full details of the transactions which increase and decrease the ability of the banks to lend under the Loanable Funds Scheme are set out in paragraphs 23 and 24 of Appendix F.)

Demonstration of Creation of Money Under the Existing System

511. As part of his explanation of the Loanable Funds Scheme, Mr Kelliher gave a demonstration of the manner in which the money supply is increased or decreased as a result of trading-bank lending and other transactions. This demonstration was technically correct, and was in line with the brief description of the mechanism of bank lending given above and with the explanation previously supplied to the Commission by the Reserve Bank when the hearings opened.

512. Mr Kelliher placed much emphasis on a statement made by Mr Whyte, Chairman of the Associated Banks, under examination, that in the course of their lending and investment operations the trading banks *"create money"*. Similar statements had been made previously to the Commission by representatives of the Reserve Bank, the Treasury, and the trading banks. As we have pointed out in paragraphs 428 to 431, such statements have appeared in economic text books for the greater part of the present century and, indeed, even before 1900. In the Commission's view Mr Kelliher placed undue emphasis on this characteristic of banking which has existed at least since the times of the goldsmiths and which has been recognised and written about for many years. (See Part II of Appendix D.) Mr Kelliher has attempted unsuccessfully to remove this characteristic by means of the Loanable Funds Scheme.

Special Accounts Introduced by Mr Kelliher: "Bank Demand Deposits Account" and "Loanable Funds Account"

513. The Loanable Funds banking technique introduces two new items to the accounts of a trading bank called *"Bank Demand Deposits"* and *"Loanable Funds"*. Mr Kelliher in his submissions explained that the *"Bank Demand Deposits Account"* was *"the repository for New Zealand money acquired by the various methods already referred to"*, as, for instance, the amount transferred by customers from free deposits to fixed deposits, reductions in the total of advances to customers, etc. The *"Loanable Funds Account"* he said was *"the amount of New Zealand money available for lending and investment"*. The former account was treated as a liability and the latter as an asset. Both accounts would always be equal in amount, as one was the counterpart of the other.

514. Under the Loanable Funds banking technique, when a bank increased its loans to customers, the Bank Demand Deposits Account would be debited with the amount of the increase and a corresponding credit would be made in the Loanable Funds Account, thus decreasing the credit balance in Bank Demand Deposits Account and decreasing the debit balance in the Loanable Funds Account. On the other hand, when a bank obtained a transfer by its customers of some of their free deposits to fixed deposits or repayments of previous loans, the Bank Demand Deposits Account would be credited with the total of these transactions and a corresponding debit would be made in the Loanable Funds Account. This entry would increase the credit balance in the Bank Demand Deposits Account, and increase also the debit balance in the Loanable Funds Account.

515. Mr Kelliher made a further and, in our opinion, quite improper use of the Bank Demand Deposits Account by including its balance from time to time in the specimen computations of the money supply he used in his attempt to prove that under his proposals expansion or contraction

of bank lending and investment would not cause any change in the money supply. In doing this he violated the definition of the money supply which he had previously accepted. It is only by this means that he is able to produce an apparent constancy of the money supply under the Loanable Funds Scheme.

516. The Bank Demand Deposits Account would merely show the extent to which a bank may at any time increase its loans or investments. It represents no more than a computation of the additional amount which the banks could lend at any time, but in fact have not lent. Clearly, therefore, the inclusion of Bank Demand Deposits in the measurement of the money supply must produce a result which is fallacious and wholly misleading. We have seen how Bank Demand Deposits Account is expanded by increases in fixed deposits and by repayments of existing advances and is reduced by the actual loans or investments which the bank makes. Under the Loanable Funds proposals, if customers of a bank transferred certain moneys from free deposits to fixed deposits, the Bank Demand Deposits Account would be increased by the amount of the transfer. As the free deposits have been reduced, the amount of money available to the public for immediate spending has been reduced correspondingly, because the fixed deposits are not available for spending. Consequently, there has been a reduction in the money supply. Under the Kelliher Scheme this reduction is countered by the inclusion of Bank Demand Deposits in the money supply.

517. On the other hand, when a bank makes a loan it will usually result in an increase in the money supply. Under the Loanable Funds proposal, the Bank Demand Deposits Account is reduced by the amount of the loan, so that the inclusion of that account again creates an illusion of maintaining a constancy in the money supply when in fact an increase has occurred.

518. *"Bank Demand Deposits"* is a very misleading name for the account which Mr Kelliher sets up, conveying as it does the false impression that the account is similar in nature to the "demand deposits" owned by trading-bank customers and available for spending by them, which comprise the greater part of the money supply.

519. The Bank Demand Deposits Account does not represent deposits payable by the bank to anyone. No one can "demand" repayment of these sums in the same way that bank customers can demand repayment of their deposits. Neither is this account in any sense a liability of the bank or part of the proprietor's interest in the business. It is a memorandum record of the extent to which a bank would be entitled to increase its lending and investment under the Loanable Funds Scheme. Its counterpart on the assets side of the balance sheet, the Loanable Funds Account, is in no sense an asset of the bank. It is merely a double-entry counterpart of the other fictitious item Bank Demand Deposits and is introduced merely to balance the books.

520. If the Bank Demand Deposits Account had been given a name correctly describing its nature, such as "Unused Bank Lending Limit", the error of principle involved in including it in the money supply would have been apparent on the face of the examples submitted by Mr Kelliher. The name *"Bank Demand Deposits"* conceals this error of principle but does not remove it.

521. After examination of Mr Kelliher's main proposal, the Loanable Funds Scheme, the Commission finds that under it the process of increasing bank advances leads to an expansion of the free deposits available for spending by bank customers. The Commission also finds Mr Kelliher's contention that his proposals would result in a stable money supply to be demonstrably false even on the face of the examples submitted in support of his claim.

522. These examples preserve an arithmetical constancy in the money supply, but under examination this apparent constancy is shown to be entirely spurious. As explained above, a constant total has been preserved only by the introduction into Mr Kelliher's computation of the money supply of a fictitious item specially created for the purpose. This fictitious item is not part of the recognised definition of the money supply which Mr Kelliher himself cited previously with approval. It does not represent money available for spending by bank customers. Indeed, as pointed out in paragraph 516, it merely represents the maximum permissible limit, for the time being, to increases in bank lending.

The Meaning of the Term "Money Supply"

523. When he demonstrated that trading-bank transactions under the existing system may increase or decrease the money supply, Mr Kelliher adopted the Reserve Bank's definition of the latter term, but when he purported to show that such increases and decreases in the money supply did not occur under the Loanable Funds Scheme he gave the term "money supply" a different and, in our view, fallacious meaning. Under examination Mr Otto admitted that such a change in definition had been made. When exactly the same reasoning and definition by which he had proved that the trading banks at present create and destroy money was applied to the Loanable Funds examples which Mr Kelliher himself had supplied, it was found that the same increases and decreases in the money supply (or creation or destruction of money) still occurred. This also was admitted by Mr Otto. It is thus clear that the argument by which Mr Kelliher sought to establish that his scheme would prevent trading-bank transactions from increasing or decreasing the money supply is fallacious. The main virtue claimed for the Loanable Funds Scheme is therefore destroyed by the admission of Mr Kelliher's own witness. The *"cardinal defect"* which he alleges in the existing system is thus shown to continue in his own examples of the working of the Loanable Funds Scheme, just as it did in his examples of the existing system. (See Appendix F, paragraphs 39 and 40, for details of the admission referred to above.)

524. Mr Kelliher's contention that inflation could be cured under the Loanable Funds Scheme *"without restricting bank lending for private and business purposes"* is, in our view, without foundation. We have already pointed out that, when bank advances are expanded under the Loanable Funds Scheme, the same increase would occur in the free deposits of customers as might be expected under the existing system. We find nothing in the Loanable Funds Scheme to convince us that such an increase would not have the same inflationary effects as a similar expansion of advances would have under the existing system.

Increases in Fixed Deposits as Main Limit on Trading-bank Lending

525. Under the Loanable Funds Scheme, the limit to which trading banks could extend their advances would be determined mainly by the additional amounts which they could obtain on fixed deposits. The only manner in which advances could be greatly expanded would be through a substantial accession of fixed deposits. Under the scheme the banks would not be restricted in the interest rates they could pay for fixed deposits. We doubt whether the trading banks could induce any worth-while transfer of free to fixed deposits without offering relatively very high interest rates.

526. To the extent that the banks could attract into fixed deposits amounts from time to time standing to the credit of customers' free deposits, they could make increased advances. Where free deposits are lying idle, their attraction into fixed deposits would not of itself justify an expansion of trading-bank advances. Under the Loanable Funds Scheme, as under the existing system, increased advances might be expected to result in increased free deposits, some of which in turn would be placed on fixed deposit if the interest rates offered by the banks were sufficient to attract them. Such a process, which involves the creation of free deposits and therefore of money, would be technically quite possible under the Loanable Funds Scheme. If, as seems unlikely, the trading banks were able to attract a sufficient sum in fixed deposits to enable an expansion of trading-bank lending *"to the limit of credit-worthy borrowing"*, the result would be, in the prevailing circumstances, highly inflationary. A fundamental flaw in Mr Kelliher's argument is that under his scheme a mere change in the terms on which a trading bank borrows money from its customers (i.e., from free deposits, repayable on demand, to fixed deposits, repayable after three, six, or twelve months) is made the justification for expanding trading-bank advances.

527. According to the evidence, unduly high rates of interest would be necessary to enable the trading banks to attract sufficient fixed deposits to permit a worth-while expansion of advances. Payment of unduly high rates of interest would constitute a serious threat to the continued existence of the recognised savings institutions. To the extent that transfers of fixed deposits were achieved, they would permit a pound for pound expansion of trading-bank advances. In our view it would be quite wrong in principle to permit such an expansion of advances especially if, as proposed under the Loanable Funds Scheme, the existing control of trading-bank advances through the reserve ratio system were to be discontinued.

The Money Supply in a Recession

528. As mentioned in paragraph 509 (c), Mr Kelliher claimed that, under the Loanable Funds Scheme, the trading banks would be prevented from *"destroying the nation's money supply"* in a recession. In a time of economic depression business men take action designed to reduce their financial requirements, such as reducing the volume of the stocks they normally carry. This results in a reduction in bank over-drafts and consequently in the money supply. Under the Loanable Funds Scheme a reduction in bank overdrafts would result in an increase of a corresponding amount in the Bank Demand Deposits Account. To suggest that there has been no reduction in the money supply is wrong. The actual reduction in demand deposits of bank

customers is offset in Mr Kelliher's computation by the increase in Bank Demand Deposits. In these circumstances, this increase merely represents authority to lend which the bank is unable to exercise, because either no one wants to borrow, or those who do are not credit worthy.

529. We have pointed out above that in a recession one of the reasons why trading-bank advances decline, with a possible fall in the money supply, is that customers of the banks are no longer willing to borrow to the same extent. Indeed, on past experience, the banks would find their fixed deposits increasing in a recession but would lack sufficient willing and credit-worthy borrowers to enable advances to be maintained. We find nothing in the Loanable Funds Scheme which would prevent bank advances from declining in a recession if bank customers did not wish to borrow or if the trading banks decided to restrict lending.

The Abolition of Controls

530. Mr Kelliher claimed that the Loanable Funds Scheme would *"revitalise free enterprise and enable all controls to be safely dispensed with"*. Among his ancillary proposals, which we discuss at length in Appendix F, there are suggestions which we think would do much to stultify free enterprise and especially capital development rather than to revitalise it. The proposal to restrict the annual capital expenditure of a business to a percentage of its *"shareholders funds"* in our view is a far more rigid and vexatious form of control than the existing Capital Issues control. Mr Kelliher's scheme would apply not only to capital expenditure from moneys raised on the market, but also to any capital expenditure which a business was able to finance from its own resources. A further example is a proposal for compulsory savings under which *"at least 25 per cent should be deducted from the income of every wage earner under twenty-one years of age . . . such savings would be available for drawing only on the attainment of twenty-five years or earlier in the event of marriage or for any other approved purpose"*. **In our opinion Mr Kelliher's scheme would subject the economy to a series of controls more rigid than those which he seeks to remove.**

"Borrowing to Lend"

531. Mr Kelliher cited the present savings-bank system as exemplifying a principle which he called "borrowing to lend", and which he strongly advocated should be applied to the trading banks.

532. It is clear from the submissions that by "borrowing to lend" Mr Kelliher means that, under his scheme, "creation or destruction of money", or increases or decreases in the money supply, would no longer occur through trading-bank lending and investment.

533. Mr Kelliher contended that the Loanable Funds Scheme was *"the most efficient means by which the provision(s) of the nation's money supply may be divorced from the arbitrary lending and investment decisions of hundreds of trading-bank branches throughout the country"*. His proposal was simply *"that the banks should obtain money to lend from the existing stockpile of money, by means readily available to them (which most people think they are doing already), instead of creating new money to lend"*.

534. We have already stated that the Loanable Funds Scheme does not accomplish its primary objective of ensuring that the trading banks will not create and destroy money. The fundamental reason why it fails to achieve this purpose is that it retains the features which enable the existing system to create and destroy money. These features are:

(a) Through the overdraft and cheque systems the trading banks handle the bulk of the commercial transactions of the country and their liabilities, "demand deposits", are used as a customary means of payment and therefore are "money".

(b) Any expansion of bank lending may therefore be expected to result in an increase in the demand deposits of trading-bank customers.

(c) Any contraction of trading-bank lending is likely to lead to a contraction of customers' demand deposits and therefore to a reduction in *"the nation's money supply"*.

535. It is quite clear from the examples of the Loanable Funds Scheme submitted by Mr Kelliher that "arbitrary decisions of hundreds of trading-bank branches throughout the country" would still have the effect of reducing or of increasing the total of customers' deposits, and the *"provision(s) of the nation's money supply"* would therefore *not* be divorced from those decisions.

536. It appears to us that in advocating that trading banks should be required to "borrow to lend" by operating on the same principles as savings banks, Mr Kelliher has overlooked a most important question of principle. Even if the present trading banks were constituted savings banks, provided that they retained the overdraft system and payment by cheque, their deposits at call would then constitute a customary means of payment by bank customers and would therefore qualify for inclusion in the money supply just as demand deposits at the trading banks do now. In those circumstances increased lending by the new "savings banks" would lead to increased "savings-banks" deposits and therefore to the equivalent of increases in the "money supply".

537. These increases would occur whenever savings-bank customers drew cheques on overdraft accounts and paid the cheques to customers who had credit balances in their "savings-bank" accounts, thereby increasing the total of "savings-bank" deposits.

538. The essence of the matter is that where a banking system handles the bulk of the commercial transactions in a country, any expansion of its lending is bound to result in increased deposits somewhere in the banking system. If total demand deposits are increased in this way, there is creation of deposits and therefore creation of money as a result of an increase in advances.

539. The Loanable Funds Scheme does not embody any *"principle to which all savings banks and other financial institutions must conform by prescription of law"*, which would prevent the creation and destruction of money. As we have explained, the creation and destruction of money is inherent in the nature of trading-bank transactions, even under the Loanable Funds Scheme where creation and destruction of money still occurs, but is concealed by the devices we have explained.

540. What the Loanable Funds Scheme does is to place a variable upper limit on trading-bank lending, but it certainly does not enable or require the trading banks to "borrow to lend" in the sense of eliminating

the fundamental features of the present banking system through the operation of which creation and destruction of deposits and money take place.

Legality of Trading-bank Operations

541. Mr Kelliher's contention that the trading banks are operating illegally is dealt with in the previous part of this section of the report and in Part I of Appendix D. As already stated, after a review of all the evidence and argument for and against this contention, the Commission rejects it.

Ancillary Schemes

542. We have dealt in Appendix F and at other places in this report with certain ancillary proposals submitted by Mr Kelliher for use in conjunction with his Loanable Funds Scheme. Our examination of his proposals for the insulation of the New Zealand economy, for the control of capital investment, and for the control of wage increases according to increases in productivity convinces us that they are entirely impracticable for the reasons we give in the appendix. In some instances their operation would be quite inequitable in its effects on different sections of the community.

Comments on Loanable Funds Scheme

543. From the foregoing it should be clear that, in our view, the principal claims made by Mr Kelliher for his Loanable Funds Scheme have not been sustained. We are satisfied that the scheme would not make any fundamental change in the nature of trading-bank transactions. Neither would it alter the inflationary or deflationary effects of an expansion or a contraction of bank lending. All it would accomplish is to impose a somewhat arbitrary upper limit on increases in trading-bank lending, mainly by restricting such increases to the extent to which the banks are able to attract additional fixed deposits.

544. We are satisfied that the mere increase or decrease of fixed deposits is not a satisfactory criterion of the extent to which it may be desirable or necessary to expand or contract trading-bank advances. Judged by the evidence given by Mr Fussell and Mr Whyte, there is considerable reluctance on the part of holders of free deposits at trading banks to invest such deposits for fixed periods, even to earn interest. If this remained so in the future, the scheme could prove far too rigid to enable the trading banks to meet the necessary requirements of trade and industry in an expanding economy. It was apparent that Mr Kelliher envisaged such a possibility, since he included in his submissions a suggestion that in such circumstances the trading banks could be assisted by loans from the Reserve Bank or by other Reserve Bank operations. Assistance in this form would result in the creation of new and additional money.

Conclusion

545. We acknowledge the high sense of public duty which prompted Mr Kelliher to make his submissions and the great industry shown in the detail in which they were compiled. Our conclusions on the submissions are summarised as follows:

(a) In his analysis of the economic system Mr Kelliher greatly exaggerates the effects of increases in the money supply and especially of trading-bank advances as causes of increases in the New Zealand price level.

(b) The claim that trading-bank lending and investment transactions under the Loanable Funds Scheme would not result in increases and decreases in the money supply or in the creation and destruction of money is not sustained. Neither is the related claim that under Mr Kelliher's scheme the trading banks would "*borrow to lend*".

(c) Apart from certain open market operations, which we do not consider would be effective, there is no provision in the Loanable Funds Scheme by which an inflationary situation could be remedied "*without restricting bank lending for private and business purposes*". If trading-bank lending was expanded as Mr Kelliher proposed "*to the limit of credit-worthy borrowing*", the result in present circumstances would be highly inflationary.

(d) Under the Loanable Funds Scheme, contraction of trading-bank credit in a recession would have the same effect on the money available for spending by the public as it would have under the existing system.

(e) The principal criterion for future increases in bank lending (i.e., increases in fixed deposits) is unsound in principle and, in our view, would be likely to prove far too rigid in practice to enable the trading banks to meet the needs of trade and industry in an expanding economy.

(f) The contention that the trading banks are operating illegally in conducting their lending and investment operations as they do is rejected.

(g) The Loanable Funds Scheme would not "*enable all controls to be dispensed with*". Indeed adoption of the ancillary proposals put forward by Mr Kelliher would substitute a number of more rigid controls in place of certain existing controls.

(h) In our view the ancillary schemes submitted by Mr Kelliher in support of his Loanable Funds Scheme contain many impracticable features and would have highly inequitable results, even if they could be operated.

546. In the light of the foregoing conclusions we are completely convinced that the Loanable Funds Scheme should not be adopted. Nor do we recommend adoption of the ancillary schemes for insulation of the New Zealand economy, for control of capital investment, and for regulation of wage increases.

V. Commodity Currency Proposals

547. Mr Colin Clark, M.A., Director of the Institute of Agricultural Economics, Oxford, England, and formerly Economic Adviser to the Government of Queensland, who was visiting New Zealand, was invited to give evidence. He advanced proposals for stabilising the value of the currency by backing it not by gold, but by stocks of commodities. A