scheme similar in basic principles was advanced by Mr A. N. Field, of Nelson. Mr I. W. Weston, of Christchurch, advocated the adoption of a commodity currency scheme on an international basis.

548. Details of the schemes suggested are included in Appendix G to this report, which also contains an analysis of the proposals and some relevant comments from a United Nations publication dealing with the same subject.

549. For the reasons set out in full in paragraphs 23 and 24 of Appendix G we do not recommend the adoption of these proposals.

Section Nine

COMMISSION'S VIEWS ON REFORM AND COMMENTS ON PROPOSALS FOR REFORM

Introduction

550. In the previous section and in Appendices E, F, and G we comment on certain major submissions made to us. In this section we examine further submissions and discuss a variety of proposals for reform of particular aspects of the monetary, banking, and credit systems.

I. Recommendations for Improvements in the System of Controlling Bank Credit

551. If a system of control of bank credit is to be reasonably effective, we believe that it should satisfy the following criteria:

(a) The monetary authorities should make an estimate of the trend of bank credit which is likely to be in the best interests of the country in the months ahead.

(b) The trading banks should be consulted in the preparation of such an estimate and be promptly and fully informed of the decisions eventually made by the authorities as to the desirable trend of bank credit.

(c) The trading banks should be given a direct financial incentive to co-operate with the credit policy decided upon by the authorities.

(d) The system should be as direct and as simple in operation as possible, so that the implications of changes in credit policy may be made clear to the general public.

(e) It should be capable of prompt adjustment to meet changing circumstances.

(f) It should allow for competition for business among the trading banks.

552. As indicated in Section Seven of this report, the authorities responsible for administering the present system of variable minimum reserve requirements, based on the demand and time deposits of the trading banks, have not succeeded in recent years in preventing an undesirably large expansion of trading-bank credit. However, we consider that their lack of success has been primarily due not to inherent defects in the system of control, but rather to defects in the administration of the system. Most of the above criteria could be satisfied through the existing reserve ratio method of control, supplemented by appropriate Government action in other spheres.

553. One of the major faults in administration by the monetary authorities in recent years would seem to have been failure to set any clear and definite objectives of policy.

554. The Governor of the Reserve Bank said in evidence that there was no means of deciding in advance what the volume of money should be at a given date. While acknowledging the difficulties of reaching such a decision we consider that the monetary authorities, if they are to have a policy at all, must make some attempt to estimate what the volume of money should be and, therefore, also to estimate what would be desirable levels of bank credit for different periods of the year ahead.

555. In the sections of this report dealing with statistics, economic research, and forward exchange, we make suggestions which should help to overcome some of the difficulties involved in estimating desirable levels of bank credit (and in fixing appropriate reserve ratios).

556. If the trading banks were consulted in preparing the estimate of the desirable levels of credit for the months ahead, and were fully informed of the credit policy decided upon by the authorities, they would have no justification for substantially expanding advances in the light of unexpected increases in their cash reserves even if the reserve ratios were not immediately raised. In the past, because of the lack of any clearly-formulated objectives, and tardiness by the authorities in raising the ratios to offset increases in bankers' cash, advances have been allowed to rise to totals which, too late, were seen to be too high. Once advances have expanded unduly, as we point out later, it is difficult to reduce them quickly without causing some dislocation of economic activity. Constant review of the level of bank credit and of the money supply would help to obviate the need for sudden changes of policy to check excessive expansion of spending or any undue contraction of spending. Such sudden changes must necessarily cause inconvenience and some hardship.

557. The minimum reserve ratio system cannot be relied upon to provide automatically a direct financial deterrent to the trading banks against deviation from the credit policy of the authorities or a direct financial incentive to co-operate with their policy. However, it could be used deliberately to provide such financial deterrents or incentives.

558. The banks are not automatically penalised if they are forced to borrow from the Reserve Bank to maintain their statutory reserve requirements as a result of an expansion of their advances. This is so even if the minimum reserve ratios are fairly high and the rate of interest charged to the banks by the Reserve Bank is higher than the rate of interest which the banks can obtain on their advances. The simplified example at the end of this section shows that an expansion of advances by the banking system as a whole of £10 million, not desired by the authorities, would be profitable to the banks even if the minimum reserve requirement were 25 per cent of the banks' demand deposits, and the Reserve Bank's lending rate were 6 per cent as against an average rate of interest of 5 per cent earned by the banks on advances. In these circumstances, after allowing for a loss of the banks' reserve balances of £3 million to buy extra overseas exchange for their customers (who can be expected to spend more on imports if advances increase), the banks' indebtedness to the Reserve Bank would increase

by only £4¾ million (at 6 per cent), as against the expansion of advances of £10 million (at 5 per cent). Their gross profit, after payment of interest to the Reserve Bank, would be £215,000 and it is most unlikely that any consequential increase in their administrative expenses would approach this sum. Even if the Reserve Bank charged the banks 7 per cent, they would still not be financially penalised.

559. It should be made clear that this example refers to an expansion of advances by the banking system as a whole with all the banks keeping in step in their lending policies. If, on the other hand, one bank which was just meeting its minimum reserve requirement expanded its lending by £10 million while the lending of the other banks was not increased, it would certainly be penalised. As explained earlier, it would lose large amounts of cash to the other banks, and would be forced to borrow heavily from the Reserve Bank to maintain its required reserve.

560. Thus, the banking system as a whole is not automatically penalised when an unwanted expansion of advances occurs. Further examples could be given to show that even fairly high reserve requirements and lending rates do not automatically provide a sufficient penalty to bring about a reduction of excessive advances.

561. However, the existing system could be used to provide a direct financial deterrent to an unwanted expansion of advances or a direct financial inducement to the banks to reduce advances from a level which was deemed too high. The pre-requisites are that the banks should be fully informed of the credit policy of the authorities and that the authorities should be prepared to act speedily and resolutely to ensure that their policy is implemented. The authorities would require to set target levels of bank credit for certain dates in the months ahead. The banks would then be informed that, for every £1 million by which advances exceeded the target level fixed for a particular date, the ratios would be raised to put the banks into debt at the Reserve Bank to the extent of £1 million. To avoid unduly conservative lending policies by the banks, it might be desirable to fix two rates of interest for borrowing from the Reserve Bank. One would apply to extensions of credit slightly above the desired level and would be fixed at such a figure that the banks made neither profit nor loss by expanding credit to that extent. The other, a penal rate, would be applied after this margin of tolerance had been exceeded.

562. The target levels of credit for later months would need to be revised from time to time in the light of changing circumstances. If, through no fault of the banks, circumstances altered so that the then level of credit was deemed excessive by the monetary authorities, we would envisage consultation with the trading banks on a planned programme of reduction. Having decided on such a programme, the Reserve Bank would serve notice to the trading banks that the ratios would be altered in future so that credit above the levels which it had been decided should be attained on given dates, would be unprofitable to the banks. If an expansion of credit were desired, the ratios and the rate of interest charged would, of course, be lowered.

563. We contemplate frequent changes of the ratios to allow for changes, expected or unexpected, in the level of the bankers' cash, so that the banks would be neither unnecessarily penalised, nor permitted

to hold excessive amounts of free cash. These changes should not be disturbing to the banks, provided that they were fully informed of the target levels of credit set by the authorities. If there were a large increase in bankers' cash (e.g., as a result of a balance of payments surplus), it might be necessary, in the public interest, to raise the reserve requirements to a very high ratio in order to prevent an undesirable expansion of bank credit by several times the increase in bankers' cash.

564. Any system of control would limit the freedom of action of the banks, but experience has shown that the total of advances must be controlled in the public interest to prevent the aggravation of inflationary or deflationary tendencies. Such control, incidentally, would add to the long-term strength and flexibility of the banking system as a whole.

565. It was suggested by the Associated Banks that the power of the Reserve Bank to vary the statutory minimum reserve ratios should be restricted by making amendments to the Reserve Bank Act to empower the Reserve Bank merely to require the trading banks to maintain statutory deposits varying between a minimum of 7 per cent of demand and 3 per cent of time liabilities and a maximum of 25 per cent of demand and $12\frac{1}{2}$ per cent of time liabilities. In making this suggestion the Associated Banks explained that they had in mind, "*that the circumstances which might justify a higher ratio would be sufficiently serious to need full discussion by Parliament*".

566. We see no justification for restricting the power of the monetary authorities to fix such reserve ratios (above the minimum of 7 per cent of demand deposits and 3 per cent of time deposits at present fixed by law) as they may deem necessary in the public interest.

567. We suggest that, dependent on the circumstances existing at the time, some compensation might be given to the banks if it became necessary to raise the reserve ratios to very high levels. Presumably the necessity for such action would usually be due to a considerable expansion of bankers' cash (e.g., as a result of persistent surpluses in the balance of payments) which would be accompanied by an expansion of customers' deposits. If, in such circumstances, the banks' administrative expenses were to rise, and if they were to be prevented in the public interest from expanding their advances, it might then be equitable to allow them to earn some income from at least part of their frozen balances at the Reserve Bank. This could be done either by paying interest on some of these balances or by permitting the banks to take up Treasury bills already held by the Reserve Bank. Neither of these courses would add to the existing supply of money.

568. The existing reserve ratio system is not the only method which could be used to control bank credit. The Reserve Bank suggested to the Commission that the reserve ratio system should be modified as follows:

Instead of the trading banks' minimum balances at the Reserve Bank being related to their demand and time liabilities, it is proposed that—

(a) The whole of bankers' cash in New Zealand be included, i.e. notes and coin in addition to balances at the Reserve Bank;

(b) That minimum cash be related to advances, discounts and securities.

569. The above scheme has two main advantages over the existing system:

(a) The proposal that notes and coin be included in the calculation of the ratio partly overcomes a difficulty which arises from the fact that, because of differences in the type of business which they handle, different banks require to hold different proportions of notes and coin. Consequently, under the existing system, although two banks may each hold the same proportion of their customers' deposits in notes, coin, and balances at the Reserve Bank, one may be forced to borrow from the Reserve Bank at a given ratio because it has to keep large working balances of notes while the other, with most of its liquid assets in the form of balances at the Reserve Bank, need not borrow at all. If the suggestion that notes and coin be included is adopted, we see no reason why the present arrangement under which the Bank of New Zealand can borrow certain amounts free of interest from the Reserve Bank should be retained.

(b) The Reserve Bank proposal relates the minimum cash requirement more directly than at present to the credit which it is desired to control, and thus penalises the banks more directly for an unwanted expansion. Nevertheless, as with the existing system, it does not automatically satisfy the criteria set out at the beginning of this section, and, to be effective, it would have to be operated in conjunction with the suggestions made above, as to setting target levels of credit and providing appropriate inducements and deterrents to the banks.

570. As an alternative to the variation of reserve ratios, the Government could amend the banking legislation to permit the Reserve Bank to charge the banks interest directly on any credit extended in excess of a level previously determined. The total credit which the authorities thought desirable during, say, each quarter, could be allocated among the banks in proportion to the notes, coin, and balances at the Reserve Bank which each held at selected dates. This suggestion departs more radically from accepted central banking practice than the other suggestions made above, but it has the virtue of being relatively simple and direct in operation.

571. In the Commission's view, any of the three courses suggested above could be used as a reasonably effective method of control of bank credit and are recommended for consideration by the monetary authorities, that is:

(a) The present system of reserve ratios, whereby the banks have to maintain balances at the Reserve Bank equal to stipulated proportions of their customers' demand and time deposits.

(b) The Reserve Bank's suggestion that the banks be required to keep notes, coin, and balances at the Reserve Bank equal in total to stipulated proportions of the total of their advances, discounts, and investments.

(c) A system whereby the banks were charged interest directly on the amount by which their advances, discounts, and investments exceeded a figure previously determined as desirable.

In all cases, however, it would be essential to fix target levels of credit, and to provide appropriate penalties and rewards to induce

the banks to co-operate with the policy of the authorities. The Government should also ensure that its budgetary, interest rate, and other policies are as far as possible consistent with its credit-control policy.

Overdraft Interest Rates

572. In another part of this report we recommend that greater use should be made of changes in interest rates as a part of monetary policy than has been the case in recent years. The same recommendation applies to bank overdraft rates.

573. For reasons given in the part of the report we have just referred to, we do not advocate that overdraft rates should be completely freed from control in present circumstances, but we are of opinion that the banks should be free to vary their interest rates within a wider range than the 4 to 5 per cent as at the time of writing. **We therefore recommend that the banks be permitted to fix rates of interest charged on overdrafts within a fairly wide range, on the understanding that the average rate of interest charged will not exceed a figure deemed desirable in the circumstances.**

[Since this section of the report was written, the Government has adopted a policy along the foregoing lines.]

574. In making this suggestion, we would emphasise that it is merely part of a co-ordinated programme to bring inflation under control. Higher overdraft rates have a part to play in such a programme, in that they may reduce spending by deterring some people or firms from borrowing from the banks. The higher fixed deposit rates which we envisage would accompany the higher overdraft rates might also induce some people to refrain from spending. We doubt the possibility of achieving any large reduction of bank advances by changes in the overdraft rate alone, especially when the demand for bank credit is high, because borrowing from the banks is convenient and relatively inexpensive and there are few alternative sources of credit available. Increases in the overdraft rate must therefore be accompanied by a firm advance control policy, embodying a financial encouragement to the banks to reduce advances to a desirable level. Adequate supporting policies in other fields are also necessary to spread the necessary reduction of spending as widely as possible.

575. Our remarks are made against a background of inflationary pressure, but should the occasion arise when some stimulation of spending is necessary, we believe that lower overdraft interest rates can contribute to a co-ordinated programme of expansion.

Selective Advance Control

576. In an inflationary situation, it is desirable that the credit available should, as far as possible, be channelled into those industries which are deemed essential in the national interest. We agree with the contention of Mr Ashwin, Mr Fussell, and Mr Whyte that, in such a situation, the policy of selective advance control should be retained. We suggest that it might be strengthened if some use were made of a financial deterrent to the expansion of less essential industries. **Accordingly, in making our recommendation that the trading banks might fix overdraft rates within a wider range, we have in mind that they might be requested by the**

Government to charge higher rates of interest for loans to borrowers in the least essential categories in accordance with the selective control policy.(1)

577. If and when a period of reasonable stability is reached, consideration should be given to the removal of control of interest rates and of selective advance control.

Control of Purchase of Investments by the Trading Banks

578. If the mechanism for the control of bank credit is effective, we can see no reason why the banks should not be left free to choose the form in which they will hold their interest-earning assets. On the assumption that an efficient system of control is introduced to hold total bank credit (advances, discounts, and investments) at the level deemed to be in the national interest, we therefore recommend that the banks should no longer be prevented from investing in Government securities.

Some Difficulties of Control Through the Reserve Ratio System

579. In addition to the problems mentioned above, there are other practical difficulties involved in the application of a reserve ratio system to which attention must be given.

580. Difficulties arise in fixing a ratio which will impose a suitable degree of restraint on the banks in the existing circumstances because the cash reserves, deposits, and advances of the banks change frequently in response to variations in external trade and as a reaction to the impact of Government finance, both over long periods and seasonally. For example, in March when income-tax payments are made, there is invariably a rise in bank advances and a drain of cash from the banks to the Government, as customers' deposits are drawn upon to meet their tax obligations. It is inevitably difficult to predict the timing and extent of changes in the balance of payments and in the Government's cash position.

581. The suggestions made in this report on forward exchange should assist in forecasting changes in the balance of payments.

582. The difficulties which arise in respect of tax payments in March would be reduced to some extent by the introduction of a system of pay-as-you-earn taxation. The staggering of payments of taxes by companies and farmers over the year would also assist.

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(1) The Government might, for example, arrange with the banks that the average rate of interest charged on overdrafts should not exceed 5 per cent. But the banks might be asked to charge only 4 per cent for advances for purposes deemed of major national importance, e.g., to farmers for purposes likely to increase primary production, or to manufacturing firms which might expand the economic production of goods of a type which must currently be imported. Advances would, of course, be made only for purposes for which bank credit might properly be used. On the other hand, the banks might be asked to charge, say, even as high as 10 per cent for advances for purposes which the government wished to discourage in the circumstances. It should be understood that there are inherent limitations in any policy of selective advance control, in that the banks cannot police the use of the advances which are granted for particular purposes. Nevertheless, higher overdraft rates, judiciously applied, should restrain at least some less essential expenditure.

583. Finally, although it would be unrealistic to expect that existing overdraft authorities should not be used for the payment of taxation, those responsible for monetary policy should give no encouragement to the extension of overdrafts purely for this purpose, especially in inflationary circumstances. Nor should overdrafts be extended to enable people to contribute to Government loans.

Different Types of Banking Business

584. Because they have different types of customers, the trading banks do not have a uniform pattern of business throughout the year. For example, banks which finance a large part of meat exports may experience a marked seasonal upsurge of advances and loss of bankers' cash which is not shared by other banks. This is a problem which would have to be faced under any system of control. But many businesses have to make provision for seasonal variations in their operations, and we see no reason why special concessions should be made on such grounds under a policy of credit control.

Varying Margins of Free Cash

585. At certain times difficulties arise in the application of the reserve ratio system of control because no uniform minimum ratio affects the banks equally. To provide an effective deterrent to expansion of advances by the banks it might be necessary to put some banks considerably into debt with the Reserve Bank while others, which hold a greater margin of free cash, might not need to borrow at all. In our opinion while this was undoubtedly a problem in the early post-war period its importance can be exaggerated in existing circumstances. Difficulties may arise in the short run. If, however, the ratio system were resolutely applied, the difficulties would eventually be overcome as those banks with free cash accepted new business and those borrowing from the Reserve Bank were forced to restrict advances.

586. Any uniform method of control must affect the banks unequally. The main question is whether the control is effective in bringing about a desired level of credit for the banks as a whole, and achieves as equitable a distribution of business as possible among the banks. If the problem of varying margins of free cash is regarded as serious, it might be overcome by fixing a different ratio for each bank. As a general rule, however, we would not favour such a suggestion on the following grounds:

(a) In order to decide what was an equitable ratio to fix for each bank, the Reserve Bank would have to make continuous and detailed investigations into the business of individual banks.

(b) Each variation of the ratios would lead to charges of unfair discrimination from banks subjected to higher ratios than their competitors.

587. Nevertheless, if credit policy were being frustrated by the fact that the policy of a particular bank was out of line with that of its competitors, there might be no alternative but to introduce differential ratios. An amendment of the Reserve Bank legislation would probably be necessary to permit differential treatment.

Frequent Changes of the Ratios

588. If the reserve ratio system of control is to work effectively under New Zealand conditions, frequent changes of the ratios are necessary to keep adequate but not excessive pressure on the banks to maintain or achieve the desired level of credit. The trading banks have complained that frequent changes of the ratios make it difficult for them to plan their operations. This would be so only if the banks had been given no indication by the Reserve Bank of what it regarded as a desirable level of bank credit. Changes in the ratios do not necessarily indicate changes in the severity of the restraint being imposed on the banks.

Lack of Securities as Collateral for Loans from the Reserve Bank

589. There are difficulties in putting the banks very deeply into debt with the Reserve Bank. These difficulties arise primarily as a result of Government policy, in that the banks' holdings of securities which are acceptable to the Reserve Bank as collateral, are small. This difficulty could be met, even under the existing legislation, because the Reserve Bank Act enables the bank to make unsecured loans provided permission is granted by Order in Council. The difficulty would disappear if the banks were penalised directly on credit in excess of a predetermined level, as suggested in paragraph 570 above, and would be lessened if the banks were able to increase their holdings of securities as a result of the adoption of the proposal in paragraph 578.

Unexercised Overdraft Authorities

590. At any period there remains in existence at the disposal of customers of the banks a large volume of unexercised overdraft authorities. During the calendar year 1955, these totalled between £90 million and £120 million. The importance to monetary policy of the existence of these unexercised authorities is that, when credit is tightened, those with unexercised authorities may not immediately be affected and the reduction of advances may well take a considerable time to achieve. In other words, although a policy of credit control may be having a considerable effect in reducing limits, advances may continue to rise.

591. The following table re-constructed from a statement by the Reserve Bank on this question, brings out the importance of unexercised authorities. The table shows advances as a percentage of advances plus unexercised authorities, for each of the banks and for all banks combined, in March over several years.

(Percentages)

March	A	B	C	D	E	All Banks Combined
1939 ..	68·0	75·5	70·8	69·4	65·7	69·9
1950 ..	56·5	63·6	68·2	60·1	64·1	61·7
1952 ..	69·7	76·2	74·9	75·4	81·5	73·7
1953 ..	60·6	63·4	62·8	63·6	61·2	62·1
1954 ..	58·6	59·1	57·0	58·9	59·1	58·4
1955 ..	65·6	69·0	60·4	67·3	64·3	65·1

592. The Reserve Bank commented as follows on this information:

> While it is obvious that *all* unexercised authorities will not be used simultaneously, the table shows that the percentage of limits used has varied between 57 and 81 per cent, with a "normal" range of 59 to 75 per cent. A change of 10 points in this percentage can easily happen – and that means £28 million of advances. The fact that between March 1954 and March 1955 the percentage increased from 58·4 to 65·1 accounts for £17 million of the increase in advances during that year. The banks had no control over that increase. Obviously the unexercised overdraft authorities are very important, and limit the effectiveness of ratio policy.

593. In our view, it is important that, in the public interest, the trading banks should keep a close watch on the volume of unexercised overdraft authorities and from time to time review limits which appear unreasonable and unnecessary according to the circumstances and to the use that has been made of them.

Difficulties in Inducing a Desired Expansion or Contraction of Advances

594. The power of the monetary authorities to restrict trading-bank advances in a period of inflation is much greater than their power to induce an expansion of advances, should business activity fall off. The main reason for this is that trading banks cannot expand their lending if there are not enough credit-worthy customers willing to borrow. During a recession, when business confidence is low, this may well be the case. In such circumstances, the Government must itself take steps to stimulate economic activity and restore confidence.

595. There are also difficulties involved in reducing advances quickly, especially in a period of appreciable inflationary pressure. This is so, not only because of pressure on the banks by large numbers of apparently credit-worthy customers at such a time, and because of the existence of a considerable volume of unexercised overdraft authorities, but also because there is a limit to the speed at which customers can reasonably be expected to repay advances upon which they have come to rely. The Commission gained the impression from the evidence of the Governor of the Reserve Bank that undue weight had been given, in the past two years particularly, to the dangers of "*putting the economy into a skid*". But we agree that undesirable disruption might be caused by an attempt to force traders to sacrifice stocks too quickly or to take any other precipitate action to obtain finance for repayment of bank advances. In any case, the first result might merely be to pass to other firms the pressure exerted by the banks. For example, those affected might merely defer payment of their accounts, thus in many cases forcing their creditors to make greater use of their own overdraft limits. Alternative sources of finance are not readily available and for larger firms the position is complicated at present by the fact that the Capital Issues Committee will not usually permit issues of capital for the purpose of reducing overdrafts. Elsewhere in this report we recommend a change in this policy.

596. Thus, although monetary measures have the advantage that they may be adjusted quickly in the face of changing circumstances, they cannot always be expected to produce the desired results quickly. The authorities should therefore keep a constant watch on the level of bank credit and the money supply, and take prompt action to prevent, as far as possible, expansions and contractions which may lead to difficulty in the future. Any system of control of credit must depend for its success

mainly on good judgment, timely action, and resolute and skilful administration by the authorities, for which, in our opinion, there is no real substitute.

Summary of Opinions and Recommendations

597. **We summarise our views as follows:**

(a) In consultation with the trading banks the monetary authorities should try to assess the levels of bank credit which are likely to be in the best interests of the country in the months ahead, should inform the trading banks promptly and clearly of the credit policy decided upon, and should give them a direct financial incentive to co-operate in this policy.

(b) The policy should be as direct and simple in operation as possible and should be capable of prompt adjustment to meet changing circumstances. It should allow for competition among the banks for business. The public should be fully informed of the current policy and the means being used to carry it out.

(c) Several different methods of control could be used to implement these principles. However, no reserve ratio system will automatically provide the banks with a financial incentive to co-operate with the policy of the authorities, who must be prepared to vary the minimum reserve requirements quickly and resolutely in order to make them effective.

(d) No limit should be placed on the power of the authorities to raise these requirements to whatever level is deemed necessary in the public interest. But, if reserve requirements are fixed at very high levels, it might sometimes be equitable to allow the banks interest on part of the balance which they are required to keep at the Reserve Bank, or to permit them to take up Treasury bills held by the Reserve Bank.

(e) More use should be made of changes in bank overdraft interest rates as an aid to credit policy. The banks should be permitted to fix rates of interest on overdrafts within a fairly wide range, on the understanding that the average rate of interest charged will be at a level deemed desirable by the authorities.

(f) The banks should be requested to use this right to fix overdraft rates within a wider range in such a way as to strengthen the selective advance control policy, which we recommend should be retained while inflationary circumstances prevail.

(g) If an effective system of control of total bank credit (advances, discount, and investments) is adopted, the banks should be allowed to invest in Government securities.

(h) For reasons given above, the operation of the ratio system of control would be improved if:

(i) Notes and coin held by banks were included together with the balances at the Reserve Bank for the purpose of meeting the minimum reserve requirements.

(ii) Fluctuations in bankers' cash were reduced by the introduction of a system of pay-as-you-earn taxation and the staggering of payment of taxes by companies and farmers.

(iii) The trading banks were from time to time to examine existing overdraft limits critically with a view to eliminating those considered unnecessary.

(i) Successful use of monetary policy requires considerable skill and judgment by the authorities. In a country like New Zealand, which is especially subject to disturbances arising from external trade as well as to the disturbances which arise from technical change and changes in the mood of business and consumers, it is essential that policy should be flexible. Adjustments should be made promptly, either to meet changing circumstances, or if the authorities find that they have previously made an incorrect diagnosis. A change of monetary policy is not a sign of weakness, but a sign of increased knowledge and alert appreciation of changing conditions.

NOTE (refer paragraph 558)—The following example shows that the banking system as a whole is not automatically penalised, under the existing method of control, by being forced to borrow from the Reserve Bank as a result of an expansion of advances regarded with disapproval by the authorities, even if the reserve requirements are fairly high and the rate of interest charged by the Reserve Bank for borrowing by the trading banks is higher than that earned by the banks on their advances.

For the purpose of this example, we assume that:

(a) The banks are required to keep a minimum balance at the Reserve Bank equal to 25 per cent of their customers' demand deposits. (The requirement in respect of time deposits is ignored in the interests of simplicity.)
(b) The interest rate charged by the Reserve Bank for borrowing by the banks is 6 per cent.
(c) The banks can earn an average rate of 5 per cent on advances.
(d) Advances are £160 million, a level deemed desirable by the authorities.
(e) Demand deposits are £200 million, so that—
(f) The banks are required to keep a balance at the Reserve Bank of £50 million (25 per cent of £200 million).
(g) The banks can just meet this requirement without borrowing from the Reserve Bank.
(h) If advances expand by £10 million, the demand for overseas exchange by customers to buy imports will rise by £3 million.

Then, if an expansion of advances of £10 million occurs, the banks may lose balances at the Reserve Bank of £3 million to buy overseas exchange for their customers. The remaining £7 million return to the banks as demand deposits.

Thus, as a result of the expansion of advances:

(a) Demand deposits rise to £207 million.
(b) The banks' balances at the Reserve Bank fall to £47 million.
(c) The minimum balance which they must keep at the Reserve Bank rises to £51$\frac{3}{4}$ million (25 per cent of £207 million).
(d) To satisfy this requirement, they must borrow £4$\frac{3}{4}$ million from the Reserve Bank at 6 per cent.
(e) This will cost them £285,000 per annum.
(f) But their increased earnings on the extra £10 million of advances will be £500,000 per annum.

The increased earnings of advances exceed the cost of borrowing from the Reserve Bank by £215,000 per annum. Even if the interest rate charged by the Reserve Bank had been 7 per cent, the increased earnings from advances would have exceeded the cost of borrowing from the Reserve Bank by £167,500 per annum.

It is most unlikely that, in either case, the administrative costs of the trading banks would rise sufficiently to make the net result of the transaction unprofitable.

(N.B.—This example refers not to the operations of an individual bank, but to an expansion of advances by the banking system as a whole, with all the banks keeping in step in their lending policies.)

II. Trading-bank Profits in New Zealand

598. The evidence of a number of witnesses disclosed an uneasiness about the extent of the profits of the trading banks. This was apparently based upon the belief:

(a) That the accounts of the trading banks do not disclose the full extent of their profits because undisclosed reserves are created before the published profits are determined.

(b) The trading banks constitute a quasi-public utility and their profits should therefore be kept within reasonable bounds in the public interest.

599. In the light of this evidence and of the fact that the views expressed appeared to be widely held, we obtained from the trading banks in strict confidence the following information in respect of their New Zealand business as a group for each of the years 1943 to 1954, the latter being the latest year for which the information was available:

(a) The income returned for income-tax purposes.
(b) The taxes paid in respect of such income.
(c) Any non-taxable gains including capital gains.
(d) The total amount of the shareholders' funds employed.

600. After carefully examining the foregoing information we are satisfied that the profits of the trading banks were reasonable during the above period.

601. Nevertheless, because of the apparent uneasiness of a considerable section of the public in regard to bank profits and because of the advisability of inducing the utmost public confidence in the administration of the trading-bank system, we recommend that the Government should take power forthwith to enable it to investigate the profits of the trading banks, if at any time in the future such a course appears to be advisable in the public interest.

602. The Government by virtue of its ownership of the Bank of New Zealand is in a position to inform itself on the general trend of trading-bank profits as evidenced by its experience with its own bank, and so to determine whether a complete investigation of bank profits would appear to be warranted.

III. Charges Made by Trading Banks in New Zealand

603. In New Zealand the trading banks make a charge, termed inland exchange, for the collection of a cheque drawn upon a bank situated in a different centre from the collecting bank. It was represented to the

Commission that the abolition of this charge would represent a considerable saving in expense to the community, particularly as the operations of many businesses are spread over a considerable part of the country. Frequently, elaborate and costly methods are adopted in order to avoid the costs of inland exchange.

604. It should be pointed out that in New Zealand it is the custom of the collecting bank to credit its customer with the proceeds of a cheque when it is lodged for collection, which is sometimes a number of days before the amount is received by the collecting bank. In some countries where inland exchange is not levied we are advised that the custom is not to credit the amount of the cheque to the account of the depositor until the proceeds have been received by the collecting bank. The practice adopted in New Zealand can often result in a considerable saving in interest charges to customers who are operating on overdraft.

605. Another aspect in which banking practice in New Zealand differs from that in some other countries (including the United Kingdom and the United States of America) is the basis of the annual charge for keeping the customer's account. In New Zealand a standard charge of 10s. per half year is made for each account regardless of the amount of work involved in keeping the account. In some other countries the charge is based upon the number of entries involved in keeping the customer's account.

606. To some extent, inland exchange and the charge for keeping accounts are related. Both represent charges made in respect of items passing through customers' accounts.

607. Our investigation of these matters brings us to the following conclusions:

(a) The abolition of inland exchange would mean a considerable saving in time and expense to the community.

(b) A considerable portion of the revenue of the trading banks is derived from inland exchange.

(c) The present basis of charge for keeping a customer's account is arbitrary since it does not take account of the work involved.

608. We recommend that consideration be given to:

(a) Abolishing or reducing the inland exchange charge made for the collection of cheques.

(b) The fixing of the half-yearly charges for keeping customers' accounts in a manner more commensurate with the work involved.

IV. Finance for Dairy Products Marketing Commission, Apple and Pear Marketing Board, and Other Statutory Marketing Organisations

609. Several marketing organisations whose operations are controlled by statute conduct their banking operations through the Reserve Bank. The organisations marketing dairy products, apples and pears, honey, and milk have a statutory obligation to do so. Those marketing eggs and citrus fruits may use either the Reserve Bank or the Bank of New Zealand; but, naturally, they choose the Reserve Bank because the rate

of interest charged by that institution on advances to marketing organisations is at present only 1 per cent, as against the minimum rate of 4 per cent charged by the trading banks. All of these marketing organisations have a State guarantee for any overdraft accommodation which they may require to carry out their functions.

610. On the evidence before us we consider that the account of the Dairy Products Marketing Commission, by virtue of its size, should remain at the Reserve Bank. It is difficult to see how any one trading bank, in current circumstances, could take over the financing of the marketing of dairy produce.

611. In general, however, we think it undesirable that the Reserve Bank should finance commercial transactions of this kind and would recommend that steps be taken to transfer the accounts of the other marketing authorities to the trading banks.

612. In the view of the Commission, there is no reason why statutory marketing organisations, merely by virtue of the fact that their accounts are held at the Reserve Bank, should receive preferential treatment over other marketing organisations with respect to interest charges. **We therefore recommend that the rate of interest payable on an advance granted by the Reserve Bank to a statutory body should be similar to that which it would be required to pay if its finance were obtained from the trading banks.**

V. Interest-rate Policy

613. Considerable evidence was submitted to the Commission on the efficacy of a rise in interest rates as a means of restraining inflationary pressures. There were substantial differences of opinion or emphasis among witnesses, and it was evident that recognised authorities could be found to support any of a wide diversity of views on this question. There was no suggestion that interest rates should not be permitted to fall during a period of recession. We therefore concentrate our attention on the former question.

614. Flexible interest rates have been used in recent years as one instrument of monetary policy in the United States of America, the United Kingdom, and a number of European countries. But their real value is difficult to discover, because many other parallel or conflicting factors were operating on the economic systems of these countries at the times when interest rates were changed.

615. It was generally accepted by witnesses that higher interest rates would make a valuable contribution to curbing inflationary pressure if they led to a significant increase in savings, or to a significant decrease in expenditure. However, views differed as to whether such consequences would necessarily follow.

Interest Rates and Savings

616. The Treasury pointed out that:

(a) A major part of personal savings was contractual (e.g., life-insurance premiums, mortgage repayments, and so on), and that changes in interest rates would have little effect on such savings.

(b) Many people saved for a specific purpose, such as buying a motor car or section, rather than for the purpose of earning interest.
(c) In part, personal savings were residual and were simply the difference between people's income and what they spent.
(d) Generally speaking, a very large increase in interest rates would be necessary to induce people to save more than usual solely in order to add to their future income.

617. The Treasury considered it debatable whether changes in interest rates would lead to an increase in savings by businesses. On the one hand, since a rise in interest rates would lead to a drop in share values, firms would be inclined to maintain dividend payments to prevent a further drop. On the other hand, since borrowing would be more costly, firms might wish to retain in the business a larger proportion of their profits than before.

618. Finally, the Treasury considered if a rise in interest rates induced people to lend money which they had previously held idle, inflation would be aggravated by the extra spending thus made possible.

619. The Reserve Bank accepted most of the above arguments, but drew attention to three other points which it suggested should not be overlooked:

(a) Relatively low interest rates tend to channel available savings into investment in property or shares. (The consequent increased demand tends to drive up prices in these fields and indirectly aggravates inflationary pressure elsewhere.) Higher interest rates should tend to deflate some of the false property values so common during inflation.
(b) A rise in interest rates may have a sobering effect on private expenditure – especially the tendency to "buy now before prices rise" – if it is taken as evidence of official determination to control prices more effectively.
(c) If interest rates rise, assets such as Government securities could be realised before maturity only by incurring a capital loss. Moreover, with small savings, a greater loss of interest income than before would be incurred if the savings were spent. These factors might lead to greater reluctance by the community to realise assets or draw on past savings to increase current spending.

Interest Rates and Private Expenditure

620. The Treasury pointed out that interest costs were only a small proportion of total costs of firms which were able to turn over their stocks of goods quickly. Taking into account the fact that interest payments on overdrafts are deductible for income-tax purposes, a very large increase in interest rates would be necessary before the extra cost became a significant factor in financing stocks or other working capital requirements. In addition, trends in prices and expected profits were likely to be more important than interest rates in influencing plans for expenditure on machinery and equipment, other than that with a long earning life.

621. Higher interest rates would, however, in view of the Treasury, be a greater deterrent in the case of long-term business investment, and *"would be effective in curtailing expenditure on private housing"*,

through an increase in annual loan repayments on mortgages. Still, loan money released by a fall of spending in these fields might merely be diverted to less essential shorter-term projects, with little reduction in overall spending. A reduction in private house building would also almost certainly lead to demand for the building of more State-rental houses for people who could no longer afford to buy or build their own houses.

622. The Reserve Bank acknowledged the force of many of the above arguments, but pointed out that high interests rates were likely to have a marginal effect in discouraging businesses from holding more than reasonably adequate stocks, especially if the rise in rates helped to induce an expectation of more stable business conditions. It might also encourage business men generally to adopt a more conservative viewpoint and to revise their plans for capital expenditure. Control of bank advances would also be more effective if restraint on the banks' lending through the reserve ratio system were accompanied by restraint on the borrower through higher overdraft interest rates. For a housing mortgage of given amount and term, the higher the interest rate the bigger the instalments, as shown in the following table and comment supplied by the Reserve Bank:

Table Mortgages for Housing at Different Interest Rates and Terms: Quarterly Instalments Per £100

Term	Interest Rate: 4½ Per Cent	5 Per Cent	5½ Per Cent	6 Per Cent
	£ s. d.	£ s. d.	£ s. d.	£ s. d.
Twenty years	1 18 0½	1 19 8¼	2 1 4½	2 3 1¼
Twenty-five years ..	1 13 5	1 15 1¾	1 16 11	1 18 9
Thirty years	1 10 5½	1 12 3¼	1 14 1½	1 16 0½
Thirty-five years	1 8 5¼	1 10 4	1 12 3¼	1 14 3¼

Term	Difference Between Rates Per £100 of Mortgages: 4½ to 5 Per Cent	5 to 5½ Per Cent	5½ to 6 Per Cent
	s. d.	s. d.	s. d.
Twenty years	1 7¾	1 8¼	1 8¾
Twenty-five years ..	1 8¾	1 9¼	1 10
Thirty years	1 9¾	1 10	1 11
Thirty-five years	1 10¾	1 11¼	2 0

623. A person having a table mortgage of £2,500 for twenty-five years at 5 per cent would pay a quarterly instalment of £43 18s. 9d., while a person with a similar mortgage, but at a rate of interest of 5½ per cent, would have to pay £46 3s. 1d. At a rate of 6 per cent the quarterly instalment would amount to £48 8s. 7d.

624. The difference between 5 and 6 per cent on a twenty-five year table mortgage on £2,500 would thus be about £18 a year or 7s. a week. However, the Reserve Bank claimed that "*this would be much more than fully offset by the benefits of a fully effective anti-inflationary*

policy – especially in so far as such a policy would safeguard the purchasing power both of savings and of current incomes. Furthermore, higher interest rates could well result in a reduction in house-building costs".

625. On this point, the Managing Director of the State Advances Corporation expressed the opinion that an easing in the rate of building construction appeared to be desirable in order to relieve the heavy pressures being exerted on resources of labour and materials in the building industry.

Interest Rates and Government or Local Body Expenditures

626. Since Government capital works were already heavily pruned down to those essential to economic development, the Treasury considered that higher interest rates would not lead to any curtailment of spending on such works. The Treasury also made the important point that while the additional cost of Government borrowing is relevant, it is not a very important factor in New Zealand in deciding whether interest rates should be controlled or not. Some interest is paid on departmental investments and is retained within the public accounts, and some is returned in the form of additional profits from State trading organisations. Receipts from taxation on the incomes or profits of those to whom interest is paid, offset some of the cost to the State of the extra interest. If the rate of interest on Government borrowing rose by, say, 1 per cent, the net additional cost of new borrowing and conversions each year would be no more than a few hundred thousand pounds. It would be about fifteen years before all existing debt was converted to debt at a higher rate of interest.

627. The Treasury considered that nearly all local body expenditure was essential to cope with the needs of our rapidly growing population. To postpone some expenditure would therefore merely create a problem for the future, and higher interest rates would increase the burden to be carried by ratepayers in the future.

628. The Reserve Bank considered that higher interest rates would contribute to achieving lower costs generally and would in this way reduce the cost of Government and local body works. Essential works would not be impeded, but to the extent that higher rates induced the paring down of works that could reasonably be dispensed with, slowed down, or postponed, the result would be beneficial. An important factor was that many essential projects were being held up now, not from lack of finance, but from lack of labour and materials.

Interest Rates, Prices, and Wages

629. It was argued by the Treasury and by the President of the Federation of Labour that, in the present state of over-full employment and excessive demand, the cost of any rise in interest rates was likely to be passed on in higher wholesale and retail prices and in the price of services. Further, because of the close link between prices and wages, any rise in prices might well lead to a successful application to the Court of Arbitration for a general increase in wages. In conditions of over-full employment, therefore, a rise in interest rates might well tend to push up prices rather than reduce them.

630. The Reserve Bank did not agree that this would necessarily follow and felt that any such tendency would be more than offset by the reductions of prices which would result from a successful anti-inflationary policy, to which higher interest rates could make an important contribution.

Interest Rates and the Balance of Payments

631. The Reserve Bank pointed out that, if higher interest rates contributed to a reduction of spending, imports would also be reduced, thus assisting in correcting the current balance of payments deficit. In addition, higher interest rates would discourage people overseas from borrowing in New Zealand rather than in their own countries – a tendency which the Reserve Bank was satisfied existed to a significant extent, particularly in the field of meat and wool financing, due to lower rates of interest in New Zealand than prevailed overseas. Low interest rates also deterred the inflow of capital from overseas.

632. The Treasury agreed that it was undesirable for interest rates in New Zealand to become too far out of line with interest rates in other countries.

Interest Rates and Bank Profits

633. Some witnesses objected that higher interest rates would merely add to the profits of the banks and other financial institutions.

634. The Reserve Bank pointed out that, with the banks, certain other factors must be considered:

(i) The fact that overdraft rates have been unchanged for 14 years at what is probably the lowest level they have ever been, and that they were reduced to that level at the Government's request as part of a war-time cheap money policy;

(ii) To the extent that overdrafts are brought down, the total interest received by the Banks will not increase in proportion to the higher rate. (This point was mentioned in evidence by the Chairman of the Associated Banks);

(iii) If higher overdraft rates were charged, higher rates would be paid on fixed deposits;

(iv) The banks will this year be paying out significant sums in the form of interest on borrowing from the Reserve Bank and Treasury;

(v) About 70 per cent of any increase in bank profits returns to the Government as income tax or Bank of New Zealand profits.

To a very large extent, therefore, if not entirely, any increased income received by banks in the form of interest will be offset by other factors.

Interest Rates or Direct Controls?

635. In countering the criticism that flexible interest rates did not provide an effective method of selecting the projects which were essential, the Reserve Bank made the following points, among others:

(i) If two lists were made out, one based on the "essentiality" of all private capital expenditure, the other based on profitability; and if, say, 10 per cent of items (by value) were to be cut off the bottom of each list, the deleted items would not be greatly different nor would the welfare of the economy be necessarily injured more by one set of deletions than by the other.

(ii) Someone must decide the order of "essentiality" of all capital projects and have a logical basis for decisions.

(iii) A completely planned capital programme would be difficult to administer efficiently.

(iv) Such complete direct controls would be unacceptable to many people.

(v) Many "essential" projects are being held up now, not from lack of capital but from lack of labour and materials. Any measure which weeds out marginal demand for labour and materials will facilitate, not hinder, the progress of essential jobs.

The Importance of Marginal Effects

636. The Reserve Bank suggested that, although spectacular results in increasing savings or reducing expenditure could not be expected from moderately higher interest rates, this did not diminish their value as one aspect of anti-inflationary policy. It claimed that at existing interest rates there are, and must be, marginal borrowers and lenders, and any change in interest rates, even if small, would shift the margins to include or exclude persons at or near the margin. In the opinion of the Reserve Bank, since the degree of inflation in New Zealand was not intense, the desired results could be achieved by restricting only a relatively small proportion of total projected capital expenditure or bank overdrafts.

Commission's Conclusions on Interest-rate Policy

637. Believing it to be an important matter, we have given careful consideration to the general question of interest rates. We have come to the conclusion that the past policy of cheap money is unfitted to the conditions obtaining in New Zealand today. Such a policy of arbitrarily fixing a pattern of low interest rates was appropriate during recovery from the depression. However, we have had in New Zealand a period of prosperity with considerable inflationary pressure.

638. In our opinion a continuing policy of fixed low interest rates contributes to inflationary pressure. Under today's conditions such a policy tends both to discourage savings and to increase spending by facilitating borrowing.

639. We were impressed by the opinion expressed by the Managing Director of the State Advances Corporation that an easing in the rate of building construction appeared to be desirable in order to relieve the heavy pressures which are being exerted on resources of labour and materials in this field. In order that the relationship between expenditure on dwellings and on other buildings may be appreciated the figures of the value of building permits issued for the years ended 31 March 1950 to 1955 are shown hereunder:

Year	Dwellings	Other Buildings	Total
	£	£	£
1950	28,999,000	13,478,000	42,477,000
1951	32,728,000	16,042,000	48,770,000
1952	36,457,000	22,786,000	59,243,000
1953	37,278,000	23,850,000	61,128,000
1954	41,736,000	27,764,000	69,500,000
1955	52,767,000	40,638,000 (1)	93,405,000 (1)

(1) Includes Tasman Paper and Pulp Company, £4,050,000.

640. The above figures, and other evidence before us, reveal that the volume of housing construction in recent years has been an important inflationary factor. We believe that the provision of finance for housing in increasing amounts and at low rates of interest, by creating excessive demand for labour and materials, has had the effect of driving up building costs and thus of frustrating, to some extent, the intention of the Government to make available an adequate supply of houses at reasonable cost. The statistics of the number of persons per dwelling show an

occupancy in New Zealand of 3·61 persons, in Australia 3·76, and Canada 4. **In our opinion, an easing in the annual expenditure on building construction including dwellings is desirable, both from a short-term point of view and in the interest of the long-term stability of the building industry. We believe that a rise in interest rates would operate as a restraint on the present rate of building construction and that it should be used for this purpose.**

641. A rise in overdraft interest rates would, in our view, contribute to the more effective control of bank credit. However, it is important that the rise in overdraft rates should be regarded purely as part of a co-ordinated programme to reduce bank credit and that, as suggested earlier, the banks should be given appropriate financial encouragement, by varying the penalties under the reserve ratio system, to co-operate with the credit policy of the authorities.

642. In inflationary circumstances it is a mistake for the Government to endeavour to hold down rates of interest by refraining from borrowing to finance its own capital expenditure and meeting its requirements by drawing on accumulated cash balances or by increasing its borrowing from the banking system. Either course is directly inflationary.

643. It has been suggested that the effect of higher interest rates on both saving and borrowing would be only marginal. Even if that is so, marginal effects are important in their effect on economic equilibrium. The joint effect of the two marginal influences we have referred to should help to restore economic equilibrium gradually and without disruption.

644. In our view the ultimate objective should be the complete freeing of interest rates from control so that supply and demand will bring about periodic variations best suited to the conditions from time to time obtaining. We realise, however, that a sudden complete removal of long-standing controls may have serious repercussions while inflationary circumstances persist. In the meantime, therefore, we recommend that progress be made towards the above ultimate objective by forthwith increasing in some degree the whole pattern of interest rates.

[Some steps in this direction have been taken by the Government since this report was written, e.g., by raising the average level of interest rates which the banks are permitted to charge on overdrafts, and by increasing the return offered on the current conversion loan, while at the same time raising the rates which local bodies may offer for loans.]

645. Unless the foregoing policy is adopted and carried out fearlessly, we consider that other remedies will be much less effective. This question of interest rates is a striking example of the imperative necessity for co-ordination of various phases of Government policy.

VI. Control of Borrowing by the Public

A. CAPITAL ISSUES COMMITTEE

646. The evidence before the Commission revealed a strong opinion on the part of some witnesses that the Capital Issues Committee, in the exercise of the discretionary powers entrusted to it, had shown a strong bias towards assisting Government issues of capital at the expense of the

private sector, and that its decisions were influenced by the policy of the Treasury. The constitution of the Committee, comprising as it does a majority of State servants, seems to have contributed to the attitude of some of these witnesses.

647. So long as it is necessary to retain the Capital Issues Committee, we consider that its decisions would be more widely acceptable if the personnel were changed by reducing the number of State servants on the Committee and correspondingly increasing the number of members selected or appointed from the business community.

648. From the details supplied to us of the applications declined and deferred, it appears that the Committee has performed a useful task in helping to restrain the amount of investment in the private sector of the economy at a time when the available physical resources have been subjected to heavy pressure.

649. We make the following recommendations in regard to matters which at present come within the purview of this Committee:

(a) That the limit of issues of capital which may be made without the consent of the Committee (now fixed at £10,000) should be raised appreciably. The present restrictions encourage complicated procedures in order to avoid the need for making application to the Committee.

(b) That the issue of preference shares should be freed from control, with the exception of:

(i) Redeemable preference shares; or

(ii) Cases where the preference dividend is non-cumulative.

(c) That the fixing of the appropriate premium on an issue of shares should be left to the discretion of the directors of the company concerned.

(d) That the Committee should not refuse permission to companies to issue capital on the grounds that the proceeds of the issue are to be used to reduce or repay bank overdrafts. Such a policy tends to increase the difficulties of controlling bank credit. It should be a condition of any consents granted under this recommendation that the proceeds of any such issues should be applied to the reduction or extinction of any bank accommodation previously granted.

B. HIRE-PURCHASE

650. The degree of inflationary pressure which can be attributed to hire-purchase trading depends on its relationship to the overall trading position at any given time.

651. Giving evidence before the Commission, Mr Ashwin said:

> . . . it (hire-purchase) has not been a significant factor in the country so far . . . what you have to watch . . . is violent changes in the level of it. After all, if your economy has adjusted itself to a given level of hire-purchase, the money coming in will balance the higher spending . . . at times of prosperity or a bit of a boom starts, it is apt to swing up and accentuate.

Mr Fussell on the same subject said:

> That (hire-purchase) is not a central banking matter at all, our matter is concerned with finance, and we would not be experts in determining what is best to do about that, and it would have to be decided on the degree of hire-purchase income in relation to national turnover or national income, and also the relativity of it in New Zealand and whether or not it has an inflationary effect. On that

point as to whether it is an inflationary factor, I should say two things – one, that it is an inflationary factor to the extent that it enables people to spend next year's income, or even the year after next's income, now. But, on the other hand, . . . in certain respects where it is for industrial purposes that factor may be offset by the impetus given to production, . . . I would be the last to suggest that because it has some inflationary factors, hire-purchase should be abandoned, because it is the family man's mode, and particularly the family man on a small income, and the young married people's mode of getting access to needful things which they would not be able to finance entirely out of current income. But that is my general view.

Question:

. . . I suggest that people, workers, who have entered into hire-purchase agreements have a powerful incentive to increase their earnings because people will work harder to meet an obligation than to save . . . ?

Mr Fussell:

. . . I agree . . .

652. In New Zealand there are no satisfactory statistics available on any section of hire-purchase trading, and it is therefore impossible for the Commission to make any statement on the question as to whether hire-purchase trading is actually increasing in total or not. (In our recommendations regarding improved statistical information we recommend that statistics of hire-purchase trading be collected.)

653. Another factor which must be taken into consideration in weighing the inflationary effect of hire-purchase is that part of the fall in small savings mentioned elsewhere in this report has been replaced, or probably more than replaced, by mortgage payments and repayments under hire-purchase agreements.

654. In other words, instead of "saving to spend", people have undertaken contractual obligations, which means that the saving comes after the spending. On this point also we suggest elsewhere in this report that more statistics are required.

VII. The Stimulation of Private Savings

655. In Section Five of this report there is a full discussion of the importance of business and private savings to the national economy. Here we discuss only the various methods by which private saving might be stimulated.

656. Except for some Social Credit witnesses, including Miss M. H. M. King (one of the witnesses for the New Zealand Social Credit Association), there was general agreement among those who appeared before the Commission that saving should be encouraged in every possible way.

657. It is obvious that when, as in recent years, our economy is stretched to the limit, unnecessary expenditure of all kinds should be restrained. Saving is a form of self-restraint. A proper public understanding of this, and of the useful purpose it serves (as explained in Section Five), is necessary to the encouragement of saving.

658. The widespread agreement of a number of witnesses with the views expressed in Section Five is evidenced by the following extracts from the record of proceedings of the Commission:

Mr Kelliher:

The decision as to how much of current production is to be consumed and how much is to be put aside as "seed corn" to provide for future needs is determined mainly by the spending habits of the people as a whole . . .

Mr Ashwin:

If you could persuade the people to drop the level of consumption by saving more, you could right . . . (the present undue pressure on the economy) that way . . .

Mr Ashwin:

. . . in the long term interest of the community I would think the difficulty (of inflationary pressure) would be better overcome by greater saving rather than lesser (public or local body) works, because works are needed to maintain the standard of living in future years . . .

Mr Fussell:

For a country like New Zealand, the only sort of savings that this free-minded democracy can tolerate are those which are voluntary.

(However, Mr Kelliher stated that "*. . . if it is assumed that the level of current savings required to finance current investment is inadequate . . . some scheme for compulsory saving could be instituted here*".)

Mr Sutherland (General Manager of the Auckland Savings Bank), quoting the President of the German League of Savings Banks:

Savings are the road to material freedom as long as we remain on guard against the social crime of secret or open inflation.

Interest Rates on Deposits

659. Some witnesses considered that an increase in interest rates on fixed and demand deposits would help to raise the level of savings, but opinions varied widely as to how great an increase would be required.

660. Mr Sutherland stated in his submissions that:

I would agree that a rise of only ¼ per cent would not bring spectacular results, but I do contend that it would guarantee that extra incentive which would produce the steady growth in savings that should take place and has taken place in normal times, and when freedom of action (to raise interest rates) was permissible or when a realistic attitude was adopted in regard to interest rates.

661. Other witnesses, however, were less confident. They did not believe that even a 2 per cent rise in interest rates would necessarily bring about an increase in "small" savings. Mr Kelliher in his submissions suggested that saving should be encouraged "*. . . by allowing a generous return on small savings*". Mr Ashwin on the other hand said "*I think the average man in the street saves his money to buy something*" (i.e., not to get interest).

NOTE—In the United Kingdom if a depositor has £50 in an ordinary savings account, he can open a special investment account on which he is paid 3 per cent instead of 2½ per cent. According to Mr Sutherland this has brought about large increases in amounts lodged.

662. However, in discussing the probable effects of a rise in interest rates, at least two important factors must be taken into account. First, a rise in interest rates could cause a fall in the capital value of some assets (e.g., existing Government or local body stock). Secondly, the psychological effect of any changes has some importance.

663. We would recommend that the trustee savings bank and Post Office rates should be increased as part of the general policy on interest rates set out earlier in this report.

Income-tax Rebate

664. An income-tax rebate on savings on the following lines was suggested:

(a) Deduction of savings-bank interest, with a fixed maximum, from returnable income. This would operate in the same way as the present allowance for life-insurance premiums, the maximum for which is £175. According to the Associated Savings Banks' submission:

> Germany and Finland have gone further by granting exemptions from income tax on savings from income deposited with the savings banks for at least six months.

(b) Deduction from returnable income of the amount of actual savings deposited with a savings bank during the income year.

665. The Commission would recommend that the first of the above proposals should be given consideration by the Government.

Maintenance of Purchasing Power

666. Mr Walsh, appearing for the Federation of Labour, suggested to the Commission that the Government should, in the present inflationary situation, take action to preserve the purchasing power of savings in general, and of small savings in particular. He submitted that, with this object, *"a beginning be made in respect to Post Office and national savings . . . so that after three years, when withdrawing his deposit, the depositor receives, besides the interest already paid, the same purchasing power as he originally invested"*. The Commission was informed that a system of this nature is in operation in Iceland with respect to private savings.

667. The Commission cannot recommend the adoption of such a system for the following reasons:

(a) It would cover too narrow a field of investment.

(b) The cost would have to be met from taxation levied on the whole community for the benefit of this special section.

(c) Depositors would no longer have strong reason to oppose inflationary action by a Government.

(d) It would be a tacit admission by a Government that inflation was inevitable and could not be halted.

(e) If deflation should occur, depositors would not be satisfied to receive back less than they had paid in.

Premiums on Savings

668. The Associated Savings Banks in their submission gave the following details of a Swedish premium scheme approved by the Riksdag in May 1955:

> Sums up to a maximum of Kr. 1,000 (£70 approximately) each year which are deposited during 1955 and 1956 on a specially opened savings account, and which remain on that account until the end of 1960, will entitle the holder to receive a savings premium of 20% for 1955 savings, and 15% for 1956 savings, reckoned in each case on the amount saved, subject to the proviso that during the year the saver must have increased his total bank balances by not less than the sum deposited on savings account. The premium is free of tax.

669. According to *Index*, the monthly economic review published by the Svenska Handelsbanken, judged by first results this scheme has proved popular:

By the end of August about 120,000 premium savings accounts had been opened in the savings banks alone. If the commercial banks and the Post Office Savings Bank are included, the number of new accounts now exceeds 190,000.

670. The Commission would recommend a scheme of this nature for consideration by the Government.

Lottery Scheme

671. Another scheme adopted per medium of the savings banks in Germany was mentioned by Mr Sutherland. There, lotteries are run with Government approval. For every deposit of 9 deutschmarks or multiple thereof, 8 are credited to a savings account and the remaining one is paid over to a lottery pool and, after deducting expenses, lottery prizes are regularly drawn. This method, combined with the tax exemption mentioned in paragraph 664 (a), has helped to produce substantial increases in savings.

672. The Commission makes no comment on this scheme.

Trustee Savings Banks

673. From evidence presented to the Commission, it would appear that the trustee savings banks in New Zealand are very severely restricted in their activities by the Trustee Savings Bank Act 1948, which repealed the Savings Bank Act 1908 and its amendments.

674. For example, section 5 of the 1948 Act states:

1. The Head Office of each savings bank shall be situated in the city or borough indicated in the following table:

Savings Bank	Head Office
Auckland Savings Bank	Auckland.
Dunedin Savings Bank	Dunedin.
Hokitika Savings Bank	Hokitika.
Invercargill Savings Bank	Invercargill.
New Plymouth Savings Bank	New Plymouth.

2. Every savings bank may continue to have such branch offices and agencies as it has at the commencement of this Act.

3. After the commencement of this Act, no savings bank shall establish any new branch office or agency situated more than twenty-five miles from the head office of the bank.

675. The Commission agrees with this statement made in the Associated Savings Banks' submission:

. . . there cannot be too many opportunities granted to the people to save voluntarily . . .

676. There does not appear to be any valid reason why the opportunity for depositors to exercise a choice as to where they will deposit their savings, should exist in only five limited areas in New Zealand. In all other places the Post Office Savings Bank is the only savings bank available.

677. In the areas where they operate, trustee savings banks in general appear to pursue a much more aggressive policy than the Post Office in encouraging or stimulating saving by extensive use of advertising, by essay competitions among school children, and by featuring special events such as World Thrift Day (31 October each year). A noteworthy activity of the Auckland Savings Bank has been the establishment of thrift clubs of which there are 511 in operation, with accumulated savings totalling £470,000.

678. According to the evidence presented by the Associated Savings Banks, section 30 of the Trustee Savings Bank Act. *"Repayments of deposits guaranteed"* (by the Consolidated Fund) *"is given as a very definite reason why no new savings bank would receive governmental consent to be established".*

679. In the opinion of the Commission this is not a sufficient reason for preventing the establishment of new trustee savings banks in New Zealand.

680. We therefore recommend that the restrictive provisions in section 5 be removed from the Trustee Savings Bank Act 1948 and that every possible encouragement be given to the establishment of new trustee savings banks in the main centres and to the opening of branches in the smaller towns.

681. In our opinion the factor of local pride is important in the success of trustee savings banks; a substantial proportion of their funds, too, is normally made available for local investment.

682. We would draw attention to the fact that in Great Britain recent legislation provides for the establishment of savings banks in new and growing centres of population and that an attempt is being made to provide gradually a complete coverage of the country similar to that provided by the Post Office Savings Bank branches.

683. In the early years of new savings banks the Government might consider granting exemption from income tax on moneys put to reserve.

Savings Banks Operated by Trading Banks

684. In January 1955 the Australian Government granted permission to two Australian banks to carry on savings-bank business.

685. The main conditions under which they will operate are as follows:

(1) Apart from cash or moneys on deposit with other banks, the new savings banks may invest depositors' funds only in:

(a) Commonwealth and State Government securities.

(b) Securities of an authority constituted by or under Commonwealth or State Act of Parliament.

(c) Loans to building societies, the repayment of which is guaranteed by the Commonwealth or a State; and

(d) Loans for housing or other purposes on the security of land.

(2) The new savings banks must at all times hold at least 70 per cent of depositors' funds in cash, plus money on deposit with the central bank, plus securities of types (a) and (b) in (1) above.

(3) The new savings banks must at all times hold at least 10 per cent of depositors' funds in Commonwealth Treasury bills, plus money on deposit with the central bank.

(4) The banks may not accept deposits from a trading or profit-making company or body.

(5) The bank may not allow an account other than the account of a local authority, friendly society, co-operative society, or any other society, body, or club to be operated on by cheque.

686. Firmly believing that there cannot be too many opportunities for saving, the Commission would recommend that the Government should fully investigate the Australian proposals and the operations of these savings banks.

Wider Opportunity for the Small Investor

687. The Commission noted with interest the statement in the submission of the Stock Exchange Association that the *"mainstay of the average sharebrokers' business is a substantial number of small orders"*.

688. The nature of this business was indicated by the experience of one stockbroker's office in which fifty buying orders averaged £245 10s., the largest being £1,047 and the smallest £19 15s. 11d. Similar figures from another office showed the largest transaction as £1,006 and the smallest as £13 19s. 9d. In both instances a substantial number of orders was received from women.

689. The wide spread of investment is shown by the fact that 178 clients who provided orders for £300 or under followed fifty-two different occupations. The orders came from a comparatively small number of professional men and from a substantial number of married women, from students, clerks, typists, school teachers, and so on.

690. These statistics seem to the Commission to show that there is opportunity for the encouragement of investment among sections of the community which, in the past, did not usually invest savings in stocks, shares, Government loans, or local body debentures.

691. From this point of view the Commission commends the efforts made by the stock exchanges to have shares which stand at a high figure subdivided into smaller units which will bring them more easily within the reach of the smaller investor. The Commission would also draw the attention of local bodies to the advantage of issuing inscribed stock and in this way making their securities more acceptable to the small investor.

692. The Commission considers that the stock exchanges can play a considerable part in encouraging savings, and that it would be in the national interest if more facilities could be made increasingly available to the small investor, and if attention were drawn by proper means to the opportunities which now present themselves to him.

VIII. Need for New Financial Institutions

A. POSTAL CLEARING SERVICE

693. Mr D. J. Janus presented to the Commission a detailed description of the Netherlands "Postal Clearing Service". He explained also that similar systems were used in Belgium, France, Western Germany, Switzerland, Italy, and Austria. The purpose of the Netherlands system is to enable business firms and private individuals who have accounts with the Clearing Service to transfer money to each other's accounts by filling in a simple form. According to Mr Janus, the system works very efficiently, is cheap and simple, and does away with the costly and cumbersome method of money transfer as used in New Zealand.

694. The system is operated by the Post Office as an adjunct to the Post Office Savings Bank. As described to the Commission by Mr Janus, the Postal Clearing Service works in this way:

(a) Private individuals and firms desiring to make use of the service establish special credit accounts at the Post Office.

(b) When it is desired to make a payment to another holder of such an account a slip is made out in triplicate. Two copies are posted to the Clearing Service and one is retained by the payer. No postage is charged.

(c) The Clearing Service debits the account of the payer, credits the account of the payee, and sends both parties a statement of what has been done. This statement is accepted as a receipt for payment.

695. The chief advantages of a Postal Clearing Service over the cheque system as commonly operated in New Zealand appear to be that:

(a) No stamp duty is payable.
(b) No internal exchange is charged.
(c) A large number of payments can be made by the filling in of a single schedule.
(d) The risk of forgery is reduced to a minimum.
(e) The book work for bank and client is reduced to a minimum.
(f) Clearance is accelerated.
(g) Salaries, pensions, etc., are paid in this way not only by business firms, but also by Government, local bodies, schools, etc.
(h) The interest earned by the Clearing Service by lending money to the Government meets all charges.

696. This scheme seems to possess some attractive features. The Commission would recommend that the full details of its operation should be investigated by the appropriate departmental officers.

B. SHORT-TERM MONEY MARKET

697. One of the recommendations made by the Reserve Bank for the improvement of the present monetary system was that a short-term money market be established in New Zealand. The Reserve Bank considered that there was a hiatus in the present system, and that such a market would enable people with funds who were not seeking long-term investments, to invest the money for a short period. These funds would then be available to the Government and financial institutions for short-term loans. The Reserve Bank also considered that the short-term money market would assist the control of credit and would have a general stabilising influence.

698. The general arrangement recommended was that three-month (and possibly six-month) Treasury bills should be made available through the trading banks for public purchase. The minimum size bill would be either £1,000 or £5,000. They would be transferable by delivery, and there would be a right to discount the bills with the Reserve Bank at any time without penalty. The rate of interest suggested was $1\frac{1}{2}$ per cent per annum. It was not intended that the trading banks should participate and, in the first stages of development of the market, there would be no tendering for the bills, as is normal practice in the United Kingdom. In that country, Treasury bills are issued by tender every week and there exists a highly organised system of discount houses whose business is almost entirely the handling of those bills.

699. The Governor of the Reserve Bank advised the Commission that the Government had approved of the short-term money market in principle. He explained, however, that no action had been taken to bring such a market into existence since the effect on the trading-banks' cash position might be serious under the existing reserve ratio requirements. Nevertheless, the Governor considered that a time like the present, when liquidity preference was high, would be a desirable moment to establish such a market.

700. The Secretary to the Treasury supported the establishment of a short-term money market on the grounds that it would provide a desirable facility; that it would give more control over idle money; and that, through changes in the rate of interest, it could prove an effective immediate weapon in monetary control. He did not think that the 1½ per cent per annum rate of interest proposed would affect the general level of interest rates.

701. The proposal was supported in general outline by the Associated Banks. They pointed out that fixed deposits had declined relative to the money supply since pre-war days. The Associated Banks, however, considered: (a) that the trading banks should be allowed to participate in the short-term market; (b) that the Reserve Bank should apply a rediscount rate to discourage indiscriminate buying and selling of the bills; and (c) that the adoption of a rate of interest higher than that now paid by the trading banks for short-term fixed deposits would merely result in a transfer from the fixed deposits, unless the trading banks were permitted to offer a competitive rate. Trading-bank participation in the short-term market would be conditional upon a reorganisation of the reserve ratio system on the special lines suggested by the trading banks. This latter point is referred to in another section of this report where the reserve ratio system is fully discussed.

702. The Reserve Bank proposals were commented upon in a number of other submissions made to the Commission. There was no objection to the proposals in general outline, particularly as it was clear that the short-term money market would be implemented in a small way at first. The main lines of criticism were that the rate of interest offered might not be attractive enough to encourage investment; and that the proposal, even at the last stage envisaged, did not go far enough, in that the Government would be the only borrower and the funds would not be available to local bodies or for industrial finance.

703. The Commission's view is that a short-term money market should be established in New Zealand. We consider that:

- **(a) The minimum size Treasury bill should be £1,000 and that both three- and six-month bills should be offered at appropriate rates of interest.**
- **(b) The trading banks should be allowed limited participation in this market.** (See Part I of this section of the report dealing with the reserve ratio control system.)

704. We believe that a short-term money market on the above lines would assist to some degree with Government finance in that it would enable part of the Government's short-term financial requirements to be met from the existing supply of money rather than by additional borrowing from the banking system. It would also be of assistance to the trading banks and the business community. We do not think that such a market would immediately develop to any great extent in New Zealand. However, in view of the useful purposes which this market would achieve if it received sufficient support, we feel that the experiment of introducing it would be well worth while.

C. INDUSTRIAL FINANCE

705. One of the methods of improving the present monetary and financial system suggested by the Reserve Bank was the establishment of an organisation in New Zealand to provide medium- and long-term capital for the smaller industrial and commercial units.

706. In evidence before the Commission, the Reserve Bank gave the following general grounds in support of the proposal:

(a) The working population in New Zealand was likely to rise by somewhere between 400,000 and 500,000 by 1975. The capacity of the primary industries to absorb additional labour was definitely limited, and it would be necessary for the greater proportion of the future increase in working population to be employed in secondary and servicing industries.

(b) Many of the large industries operating in New Zealand today had grown over a relatively short space of time from small family units, their expansion having been financed substantially from profits made through the years and not distributed, and from reliance on bank overdraft accommodation. Of 11,358 private companies in New Zealand at 31 December 1947 (the latest figures available), 9,557 had a nominal capital of £10,000 or less; and of 1,381 public companies in existence at the same date, 486 had a nominal capital of £10,000 or less.

(c) The smaller- and medium-sized businesses generally found it more difficult to raise new capital from outside the business than did the larger units. The risks were greater and the businesses not well known.

(d) A number of other circumstances (e.g., the growth of hire-purchase and credit account sales) had also combined to require increased capital to finance a given turnover.

707. The Reserve Bank stated that it had attempted to assess the validity of these arguments as a background to the proposal for a separate organisation to undertake industrial finance. The bank's inquiries had been made *"from a large and representative group of business interests"* and the bank had gained *"a clear impression . . . that the formation of an organisation to assist industrial and commercial development is warranted"*.

708. The desirability or otherwise of such an organisation was discussed by other witnesses appearing before the Commission, and some reference was also made to it in the written submissions. The evidence of the Associated Banks and the Stock Exchange Association supported the establishment of an organisation of this nature. The only opposition to the Reserve Bank's proposal that a public company be formed for this purpose came from a limited company, The United Dominions Corporation (South Pacific) Ltd., which contended that its own activities were of the nature envisaged.

709. We note that the organisations representing various groups whose members might be expected to be interested in this proposal (e.g., the Manufacturers' Federation and Associated Chambers of Commerce) did not make representations to us on these matters. No evidence was produced to show that any reasonably worth-while and credit-worthy venture had failed in this country in recent years merely because of inability to obtain sufficient capital.

710. Our attention was drawn to the various forms of public institutions or private companies established in other countries in recent years to provide medium- and long-term finance for the smaller industries. Our comment on these developments is that each is designed to meet the particular circumstances of the country in which it is established and that they are not necessarily precedents which should be followed here.

711. One further point made to us was that a number of industrial units placed undue reliance on bank overdraft for what were really long-term capital requirements. We do not doubt that there is some truth in this contention, and elsewhere in this report we have set out recommendations which are designed to meet the situation. We refer particularly to the sections of the report dealing with capital issues control, methods of increasing savings, interest rates, and the control of creation of credit.

712. The present conditions of over-full employment appear to us to call for the fuller use of the capital equipment already in the country. We do not regard the present time as the most appropriate for the systematic promotion of further industrial ventures.

713. As long as conditions remain as they are at present, the capital for any new ventures should be provided from current savings, which it would not be if a large part of the funds came from the Reserve Bank. The creation of new money now for this purpose would have a further inflationary influence.

714. We do not consider that a case for the immediate establishment of an Industrial Finance Corporation has been substantiated, although we agree that such an organisation may prove desirable at some time in the future. The development of the country's financial institutions to meet the changing pattern of industrial activity will need to be watched closely, as it may be necessary to move quickly if lack of opportunity for employment in secondary and servicing industries appears likely at any time to affect the well-being of the community.

D. LOCAL GOVERNMENT CAPITAL FINANCE

715. Difficulties faced by local bodies in raising the money to fill approved loans were brought to the attention of the Commission at an early stage in the public hearings. In paragraphs 197 to 216 of Appendix C we trace the history of local government borrowing in some detail. Briefly, the recent history of local body indebtedness is that in 1934 the indebtedness was £77·5 million and it had fallen to about £73 million at the outbreak of the second world war. The post-war figure of about £66 million again fell steadily to its lowest point of £61·9 million, which was reached in 1951. Over the last few years the increases have been substantial, and by March 1955 the total indebtedness had reached nearly £91 million. The steady decline in indebtedness over the war and post-war years reflects the general postponement of many local body capital works which would otherwise have been started in those years. Over the same period, earlier loans were repaid as they fell due. The effect of this situation, and similar postponements of capital works in the Government and private fields, is discussed in other sections of this report.

716. The loan moneys actually raised by local bodies, and the loans sanctioned by the Local Government Loans Board over the past three years, are shown in the following table:

(£ million)

	Loan Moneys Raised	Loans Sanctioned	
		Works	Redemption
1952–53	11·6	17·9	0·2
1953–54	16·6	24·0	0·3
1954–55	15·4(1)	25·8	0·4

(1) Provisional.

717. The table shows that, despite the increase in loans approved, the amount raised during the last financial year has fallen. The smaller local bodies have found it particularly difficult to raise loan moneys, and special difficulties have also been met in the Auckland urban area.

718. A particular feature of the market for local body loan moneys has been the substantial withdrawal of institutions (Government lending institutions, private insurance companies, trustee savings banks, etc.) from this field of investment in recent years. 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, and the funds handled by these institutions have been going into alternative channels such as company shares and the purchase or erection of buildings for rental purposes. Statistics supplied to the Commission by the Local Government Loans Board give the following as the sources of funds borrowed by local bodies during the year ended 31 March 1955 under some of the loan authorities issued during that year:

	£
Private investors(1)	5,552,320
Insurance and trust companies(2)	1,234,895
National Provident Fund..	747,200
State Advances Corporation	273,040
Other companies	167,200
Other local authority funds(3)	120,000
Other sources	104,950
	£8,199,605

(1) Includes some public issues which do not show the various sources of the moneys and may include some investments by companies, etc.
(2) Includes insurance companies, savings banks, trustee companies, building societies, and trading-bank investments.
(3) Sinking funds, depreciation funds, etc., of other local authorities.

719. The foregoing statistics cover only a little over half the full amount borrowed by local bodies during the year, but they are sufficiently comprehensive to indicate the relative importance of the various sources contributing to local body loans at the present time.

720. There is no doubt that the group problems of local bodies in the raising of money to fill loans could be almost immediately overcome by varying the terms of these loans to make them more attractive, while at the same time retaining present terms in relation to other avenues of investment. However, the Government cannot escape some responsibility

for seeing that all would-be users of capital funds are treated fairly, and that no one section obtains undue advantage. The desirability or otherwise of local body loans from the point of view of the investor is largely one of the rate of interest payable. **It appears to us essential that the maximum local authority borrowing rate should be revised from time to time so as to preserve an appropriate margin above the effective rate at which the Central Government can borrow on the market.** (See also paragraphs 207 to 214 and 353 of Appendix C.)

721. Apart from the question of interest rates, the major suggestions which were put to the Commission were that an organisation – a Local Government Finance Corporation – should be established either to:

(a) Pool local body surplus loan moneys, and make them available to other local bodies who may be having difficulty in raising loans; or

(b) Carry out the pooling arrangements as above, but also raise funds centrally by the issue of corporation debentures.

722. In so far as the pooling arrangements are concerned, the Commission has noted the statement of Government policy announced on Tuesday, 29 November 1955, to the effect that the Investment Committee established to control the National Provident Board's funds would also be authorised to control a pool of local body funds that could be lent to other local bodies. This proposal apparently replaces and extends the previous activities of a private sharebroker who had been of "*considerable assistance*", according to the Secretary to the Treasury, in carrying out a limited function of this nature.

723. The Commission agrees that an organisation handling the pooling of these funds can be of considerable assistance in this field.

724. Whether or not some central organisation should actively raise funds for local body works gives rise to two main questions:

(a) Is this desirable?

(b) If so, would it then be necessary to establish a separate organisation in the form of a Finance Corporation?

725. Although the difficulties facing many local bodies in raising loan moneys were referred to on a number of occasions in evidence before the Commission, the main organisations representing various groups of local authorities did not make any written submissions on the matter, nor did they seek to appear at the public hearings. The Commission could assume from the lack of interest on the part of these organisations that they did not feel that there was any problem to be solved, but the evidence before the Commission was that the smaller local bodies, in particular, were facing serious difficulties of this nature at the present time.

726. **We do not favour the establishment at this stage of a Government-sponsored Local Government Finance Corporation, but we consider that the local bodies themselves should give this question some further consideration.** If they do so, they will need to keep the "local interest" aspect steadily in view. Evidence before the Commission showed that vigorous local publicity has undoubtedly helped to fill many local body loans. Finance Corporation debentures may appeal to investors as a first-class security, but may lack the "local interest" appeal of individual local body issues.

E. RURAL FINANCE

727. The question of establishing a separate rural bank was suggested in the written submissions of individuals who did not appear at the public hearings, but no representations regarding the need for such an institution were made by any farmers' organisation. The Commission is satisfied that, in general, the coverage of the organisations providing financial assistance for primary producers is satisfactory, and that no special rural bank is required at the present time.

728. One witness at the public hearings submitted that the industry reserve funds should be used to provide seasonal finance for primary producers. These are statutory funds and we do not consider that, having regard to the purposes for which they were established, they should be used for short-term finance.

IX. New Note Issue

729. The submission of Federated Farmers of New Zealand (Incorporated) included the following suggestion:

> The Reserve Bank should arrange a new note issue to ensure the elimination of the "hot" money in safes and safety deposit boxes and under mattresses.

730. No evidence was given in support of this proposal. Nor was it stated whether the suggested new note issue should include all denominations or only notes for larger amounts of £5 and upwards.

731. Such a measure might possibly be of some value in bringing to light evasion of taxation. On the other hand it might induce people to spend hoarded money and so increase inflationary pressures. In view of the lack of evidence, we draw attention to this suggestion without making any recommendation.

X. Overseas Trade and the Monetary, Banking, and Credit Systems

INTRODUCTION

732. We have already emphasised in this report that the New Zealand economy is still vitally dependent on overseas trade despite the marked expansion which has taken place in our manufacturing and service industries since 1934.

733. Two major problems arise from this dependence on overseas trade. First, it is necessary to ensure that we maintain at all times reserves of overseas exchange adequate to carry us through any adverse unforeseen circumstances with a minimum of disruption. This means that we should not allow persistent deficits to occur in our balance of payments. Secondly, it is desirable to take steps to protect our economy as far as possible against the effects on domestic incomes, prices, and the supply of money, of marked changes in export and import prices. It is with these two problems and the means of meeting them that this section of the report is concerned.

A. THE BALANCE OF PAYMENTS AND OVERSEAS EXCHANGE RESERVES

The Importance of Maintaining Adequate Reserves of Overseas Exchange

734. One of the major objectives of Government is to maintain full employment of labour. In New Zealand, its ability to do this is heavily dependent on the maintenance of an adequate flow of imported goods. Eighty-two per cent of our imports in 1953 were raw materials, fuels and

lubricants, and equipment associated with production. It follows that to sustain production and preserve full employment we must have adequate overseas reserves to draw upon to maintain imports if the exchangeable value of our exports falls. Adequate reserves are also necessary if, in times when our terms of trade are less favourable, we are to maintain a reasonable flow of the fully-processed imported goods which are essential to the maintenance of our standard of living. These reserves must be built up from current income in prosperous times.

735. There is no general rule for determining what is an adequate reserve of foreign exchange at any time. Factors to be taken into account in assessing the adequacy of reserves include:

(a) Government policy at the time (e.g., its ability and willingness to keep inflationary pressure under control, whether or not it is protecting the balance of payments by direct controls, and so on).

(b) The ability and willingness of the Government to borrow overseas.

736. If the Government wishes to preserve a reasonable degree of freedom in external trade, and to avoid undue reliance on overseas borrowing, it seems evident that the exchange reserves of the banking system must be maintained in a period of prosperity at a level equivalent to at least six months' overseas payments. A brief survey of the movement of the reserves since 1935 may be of assistance in assessing their adequacy at the present time.

737. The following table shows the changes which have taken place in the level of the net overseas assets of the banking system and the Reserve Bank's gold reserve between 1935 and 1955 and relates them to overseas payments and import prices in the years concerned:

Exchange Reserves of the Banking System, 1935 to 1955

Calendar Year	Exchange Reserves (1)	Overseas Payments	Percentage of Reserves to Payments	Number of Months' Payments Covered by Reserves	Index of Import Prices (Base: 1936–38 = 100)	Value of Reserves in 1936–38 Purchasing Power
	£(N.Z.) million	£(N.Z.) million				£(N.Z.) million
1935 ..	47	41(2)	116	14	96	49
1939 ..	15	65(2)	23	$2\frac{3}{4}$	102	15
1944 ..	57	98·8	58	7	167	34
1947 ..	110	190·5	58	7	226	49
1949 ..	77	165·2	47	$5\frac{1}{2}$	210	37
1950 ..	85	199·1	43	5	230	37
1951 ..	114	260·1	44	$5\frac{1}{4}$	269	42
1952 ..	84	268·8	31	$3\frac{3}{4}$	293	28
1953 ..	115	240·1	48	$5\frac{3}{4}$	277	41
1954 ..	130	287·9	45	$5\frac{1}{2}$	274	47
1955 ..	100	320·6	31	$3\frac{3}{4}$	(3)	(3)

(1) Approximate average for calendar year calculated from average of net overseas assets of banking system for calendar year and Reserve Bank's holdings of gold (at market value) as at 31 March of year concerned.
(2) Approximate only.
(3) Not available.

738. The overall reserve position of the country is somewhat better than is revealed by the above figures of the holdings of the banking system, in that the Government and private persons hold overseas securities, some of which could be realised in the event of an emergency. The following are figures of Government holdings of overseas securities since 1946:

As at 31st March—	Government Holdings of Overseas Securities(1)	As at 31st March—	Government Holdings of Overseas Securities(1)
1946	8·3	1951	21·2
1947	7·0	1952	27·2
1948	8·5	1953	24·9
1949	7·9	1954	29·4
1950	7·6	1955	31·8

(1) As shown in Public Accounts. Some of these securities are held against specific commitments and contingencies and cannot be regarded as supplementary to "net overseas assets" as reserves.

Source: Reserve Bank of New Zealand.

739. No recent figures of private holdings of overseas securities are available. However, the following figures show private holdings of overseas securities as at 1 November in the years mentioned:

1946	£68·3 million
1948	£56·4 million
1949	£55·9 million

740. It will be noted that the exchange reserves (excluding private and Government security holdings) were equal to about fourteen months' overseas payments in 1935, but by 1939 had fallen to the very low level of £15 million or to an amount equivalent to less than three months' overseas payments in that year.

741. The reserves were built up substantially during the war, and by 1947 were almost £110 million which was equivalent to about 7 months' payments in that year. The marked drop in their value between 1947 and 1949 is partly accounted for by the 20 per cent appreciation of the New Zealand pound in 1948 which, while not reducing the amounts held in sterling, reduced their value in terms of New Zealand currency. Another factor was a substantial repayment of debt domiciled overseas. And finally, the volume of imports increased so that, despite the appreciation, the New Zealand value of goods imported was well sustained. The reserves by 1949 had fallen to the equivalent of 5½ months' payments.

742. The wool boom in 1950–51 was largely responsible for building up the reserves from £77 million in 1949 to £114 million in 1951. However, high domestic incomes, the relaxation of import controls, and rising import prices also resulted in a marked rise in the value of imports in 1951. The higher reserves therefore were still equivalent to just over 5 months' overseas payments. In 1952 the continued import boom accompanied by a fall in export receipts brought the reserves rapidly down to £84 million, sufficient to finance only 3¾ months' payments. Many traders had over-stocked in relation to the immediate demand for the goods they had imported and this, with the introduction of exchange allocations, led to a fall in imports of nearly £30 million in 1953. With export receipts rising by a similar amount, the reserves were built up to £115 million, a sum equivalent to 5¾ months' payments.

743. In the latter part of 1954 and throughout 1955, with the relaxation and later removal of exchange allocations and the resurgence of inflationary pressure within the country, private imports again rose markedly. Despite high export receipts and some overseas borrowing, substantial deficits in the balance of payments followed. As a result, the exchange reserves fell to an amount equivalent to only $3\frac{3}{4}$ months' overseas payments in 1955. It is quite clear that deficits of the size incurred in 1954 and 1955 could not be sustained for long without gravely endangering the ability of this country to safeguard itself from the worst effects of any recession of trade in the future.

744. In view of our continued dependence on overseas trade, of the fact that export prices are at a high level, and of the obligation of Governments to attempt to maintain full employment even in the face of greatly reduced export incomes, it is a matter for concern that our overseas exchange reserves have been drawn down to such a considerable extent in the past two years. It seems evident to the Commission that, while export prices remain high, it would be desirable to rebuild the reserves gradually to a more adequate figure. We now proceed to discuss the means of controlling the balance of payments to achieve and maintain an adequate level of reserves.

Controlling the Balance of Payments

745. Balance of payments deficits arise when the amount of overseas exchange which New Zealand receives falls short of the amounts which are remitted overseas to buy imports or for other purposes. This may happen for several reasons, for example:

(a) Our export receipts may fall off, while our outgoings are maintained. This could occur either because we have less produce to send overseas or because persons overseas are willing to pay less than before for our exports.

(b) Our overseas payments may increase while our overseas receipts remain stable. This may occur either because our spending on imports has increased or because some persons have decided to make more investments than usual outside the country.

746. The balance of payments crisis of 1938 arose from a combination of a rise in external payments, a fall in export receipts, and large capital remittances from the country. The substantial deficits in 1951–52 and in 1954–55 arose from a marked upsurge of spending on imported capital and consumer goods, assisted by a large expansion of trading-bank credit. Fortunately, in both 1951–52 and 1954–55, export receipts were maintained at a high level.

747. Some witnesses at our hearings devoted much attention to the problem of the country's balance of payments. Several witnesses made suggestions for removing the current deficit and for maintaining equilibrium in the future. Some of these suggestions are considered in the following brief discussion of the means available to the authorities to control the balance of payments.

748. A balance of payments deficit may be overcome in several ways, the main methods being to:

(a) Increase the volume and quality of production and reduce costs in New Zealand.

(b) Restrain domestic expenditure on goods and services.

(c) Impose direct control over imports and exchange transactions.
(d) Raise the exchange rate.
(e) Raise tariffs against imported goods.
(f) Borrow overseas.
(g) Induce other countries to remove barriers to the sale of New Zealand's exports at more remunerative prices.

Increasing Production, Improving Quality, and Reducing Costs

749. The best method of controlling a balance of payments deficit (and inflation) would be to increase the production, improve the quality, and reduce the costs of the goods and services which the country produces. It is beyond the scope of this report to recommend how this should be done, although we believe that the adoption of the measures which we have recommended herein would contribute to greater efficiency in the economy as a whole. However, as a general rule, productivity increases relatively slowly, and the increase cannot be relied upon to correct a balance of payments deficit of any magnitude, especially if domestic spending is rising more rapidly than productivity.

Preventing Excessive Demand for Imports: Disinflation or Direct Controls?

750. As we have remarked, the major reason for the balance of payments deficits of 1951–52 and 1954–55 was that domestic spending expanded excessively in relation to the local goods and services which could be made available at current prices and the imported goods and services which could be provided out of the country's current overseas earnings.

751. In other words, the balance of payments deficits were merely symptoms springing from a more fundamental cause, an attempt by the country to live beyond its means by consuming and investing more than it earned by its current output. The main lesson from the experience of this period is that, if we are to avoid a recurrence of these problems in the future, the Government must adopt timely and appropriate fiscal and monetary policies to prevent excessive demand from being generated.

752. It was suggested by some witnesses, notably by the President of the Federation of Labour, Mr F. P. Walsh, that the current balance of payments deficit should be overcome by reimposing a detailed system of selective import control. Indeed, he went so far as to say that:

> If living standards, full employment, and Social Security as we know it now, are to be maintained, and the steady expansion of industry and the agricultural development so necessary to a young country such as ours, is to take place, immediate control of overseas exchange should be effected and a policy of import selection put into operation as soon as possible . . . Reserve Bank policy (on reserve ratio and discount rates) has been a complete failure and it could never be anything else. For all that the Reserve Bank can succeed in doing if it makes its ineffective policy into an effective one, is to produce unemployment and to stunt New Zealand's growth. If, however, the objective is full employment, and the maintenance and expansion of living standards, then import selection is the only possible permanent answer.

753. We do not believe that the experience of the last five years proves that to maintain a high level of prosperity and full employment it is necessary to retain direct controls over imports and exchange transactions permanently. We believe that, if adequate monetary and fiscal policies had been adopted promptly and applied resolutely, no serious

balance of payments difficulties would have arisen. We have made suggestions which we hope will help to ensure that more prompt and effective action will be taken in the future to control the level of demand in the national interest.

754. We do not intend to discuss in this report the political, administrative, and ethical arguments involved in considering whether or not to use direct controls over imports and foreign exchange. It is sufficient to say here that we recognise that there may well be occasions when it is essential in the national interest to impose direct controls. For example:

(a) We believe that it is essential to maintain direct control over capital transfers overseas.

(b) Since direct controls can effect a reduction of imports more quickly than the other methods available, there would be no alternative but to use them if the reserves of exchange fell to a dangerously low level, while balance of payments deficits continued and it was impossible to borrow overseas.

(c) There would be a strong case for their use if balance of payments deficits persisted after the level of demand had been reduced by fiscal and monetary measures to a point where any further reduction would cause serious unemployment in the country.

755. But the deficits of 1951–52 and 1954–55 occurred despite very high export prices and were accompanied by inflationary conditions internally. An attempt to meet the situation by import or exchange controls alone would not have dealt with the root cause of the problem – indeed, by preventing the high level of internal demand from being directed partly to imports, the controls would merely have aggravated internal inflation.

756. Mr Walsh acknowledged in evidence that the cause of the country's trade problem was excessive internal spending and that it was essential to reduce spending overall by appropriate budgetary policies and by credit restrictions.

757. As pointed out earlier, we are convinced that disinflationary fiscal and monetary policies are in the best interest of the country at the present time. If the Government is prepared to take adequate fiscal and monetary measures of the type recommended by us, there is every possibility that it will be able to correct our present balance of payment difficulties while maintaining a policy of placing as few direct controls as possible on external trade. If it is not prepared to take such measures, our reserves, already too low, will be further reduced and the Government may be compelled to institute a system of direct control over imports and exchange in order to prevent excessive depletion. However, if this were done and inflationary pressure were allowed to persist internally, it should be recognised that the community must necessarily continue to be confronted with rising prices and/or direct controls over domestic transactions, as well as the direct controls over external trade.

Varying the Exchange Rate

758. Some witnesses argued that more use should be made of variation of the exchange rate as a means of controlling the balance of payments in New Zealand. The following is an extract from the submission of Mr Colin Clark:

There appears to be quite a strong case for New Zealand having a flexible and freely moving exchange rate, rather than a fixed exchange rate with sterling. Exports represent a substantial proportion of New Zealand's national production, and will continue to do so. The world prices of some of New Zealand's leading exports are subject to considerable fluctuations, both upward and downward. Allowing the exchange rate to move means that the impact of such fluctuations upon the New Zealand economy, whether upward or downward, is reduced. This would almost certainly be advantageous.

There should be, of course, a forward exchange market, in which anyone concerned could get a firm quotation for purchases or sales of exchange to be made up to twelve months or more in the future.

A flexible exchange rate, at a time when export prices fell, would discourage imports, and thereby perform automatically some of what has at present to be done by legal regulation. This too would be an advantage.

759. Federated Farmers also recommended that, *after* steps had been taken to control inflation in New Zealand, the exchange rate should be freed.

760. While we recognise that it might be desirable, even necessary, to vary the exchange rate from time to time, we would not favour any attempt to institute a system of free and flexible exchange rates based upon the supply of exchange relative to the demand for it.

761. The Reserve Bank submission contained this comment:

It would be administratively difficult to operate in New Zealand a truly free market in which rates vary from day to day or from hour to hour. There is no market mechanism of this sort, such as exists in London or New York or the Continent. The dealers in New Zealand are the trading banks and the Reserve Bank. Rates might be fixed daily, but daily transactions are so erratic that it would be difficult to find a basis for fixing rates. There are also marked seasonal changes in receipts and payments, which would present difficulties.

762. In short, rates could not be allowed to vary in accordance with short-term fluctuations in the demand for and supply of exchange. The authorities would still have to decide whether a change was desirable in the circumstances and when it should take place.

763. Further, we consider that small and frequent changes in the exchange rate designed to correct the balance of payments would increase the uncertainty of overseas trade and encourage speculation. It should be remembered also that depreciation of the New Zealand pound, by raising the New Zealand price of imported goods, would give added protection to New Zealand manufacturers; appreciation, on the other hand, would expose them to greater competition from overseas. Frequent fluctuations would thus increase the uncertainties facing domestic manufacturing industry. In practice, these uncertainties could not be fully offset by forward exchange operations.

764. Again, changes in the exchange rate would inevitably be accompanied by changes in the distribution of income which might not be acceptable to important sections of the community.

765. If, for example, the New Zealand pound is depreciated in terms of sterling, primary producers' incomes are increased and the prices of imports are increased in terms of New Zealand money. Conversely, if the currency is appreciated, the primary producers' incomes are reduced as also are the prices of imports. The internal prices of New Zealand primary produce retained for home consumption would also increase with depreciation or decrease with appreciation of the New Zealand pound. An indication of the attitude of one major interest group to changes of the exchange rate was given in the evidence of Mr F. P. Walsh, President of the Federation of Labour.

766. Mr Walsh said that he held the view that variation of the exchange rate was a useful weapon to stabilise prices in New Zealand when *"we were on the up and up . . . In my opinion it would have given greater stability in that period and particularly to the people that I represent, the wage and salary earners. But to adopt that policy now it would mean that the wage and salary earners would have to carry the loss so I want to be quite frank that I would not support that policy under the present market trends of the world"*. From the viewpoint of sectional interest, the existence of substantial reserve funds held for the benefit of the primary industries in times of difficulty is another factor which would have to be considered before the exchange rate was depreciated to solve balance of payments difficulties.

767. A vital factor is that a change in the exchange rate cannot be considered in isolation or from a short-term point of view. Its repercussions upon domestic prices, incomes, and the money supply must be taken into account. Some comments of Mr Colin Clark are relevant. He drew attention to the *"risk at a time, for instance, in which a serious adverse balance of payments led to a fall in the exchange rate, which led to a rise in wages and other costs, which led to a further fall in exports, and so on, creating a vicious spiral. Such a possibility could be extremely dangerous. Everything turns on the method of adjustment of wages and other costs. If there is an automatic adjustment of wages to a Price Index, there is a danger of such a spiral, and therefore a case against a flexible exchange rate. New Zealand therefore can only consider policy on the matter of exchange rates in conjunction with wage policy"*.

768. In New Zealand, the Court of Arbitration, in making general orders, is required, *inter alia,* to take into account: "Any rise or fall in retail prices . . ." and "relative movements in the incomes of different sections of the community".

769. Both of these factors would be affected by alterations in the exchange rate. And even if minimum wage rates were not subject to the jurisdiction of the Arbitration Court, changes in the cost of living and in the distribution of income would still play a large part in their determination.

770. Under a system whereby exchange rates varied freely in response to changes in the balance of payments, a depreciation of the currency would have occurred as a result of the deficit in the balance of payments in 1954–55. But, by altering the distribution of income in favour of the farmers, already receiving high prices for their produce, and by raising costs and prices, a depreciation would undoubtedly have increased pressure for wage increases and aggravated the inflationary pressure already existing. Moreover, in these circumstances, it is doubtful whether the desired objective of correcting the balance of payments deficit would have been achieved.

771. For all the above reasons, we do not recommend the frequent variation of exchange rates (whether automatically or by Government action) as a method of controlling the balance of payments. Infrequent changes may be necessary, but their timing and extent must necessarily be left to the judgment of the Government, taking all its objectives and the existing circumstances into account.

Higher Tariffs, Overseas Borrowing and Securing More Favourable Treatment for Our Exports Overseas

772. Tariff policy is outside the order of reference of the Commission, and we do no more than mention higher tariffs as a possible method of correcting a balance of payments deficit. Overseas borrowing is considered later in this section of the report. It is beyond the scope of this report to consider the means of securing more favourable treatment or new markets for exports. However, our discussion of the International Monetary Fund and International Bank is relevant to this problem.

Internal Action to Correct a Balance of Payments Deficit: Summary

773. Many people regard any attempt to solve balance of payments problems by disinflation as totally unacceptable. Yet what are the alternatives? If, whenever they were faced with a deficit in their balance of payments, all countries met the problem by using import or exchange controls, raising tariffs, or by depreciating the exchange value of their currencies, the conditions of world trade would be chaotic and none would suffer more than New Zealand. It is in New Zealand's interest to preserve conditions of reasonable freedom of trade, reasonable stability of trade policy, and reasonable stability of exchange rates in the world as a whole; but our ability to argue that such policies should be followed by other countries is gravely weakened if we ourselves resort unduly to the measures which we deplore when they are used by others.

774. In any event, it is a mistake to believe that, if a country is running balance of payments deficits which it can no longer afford, it will avoid a fall in real income by raising barriers against imports or by depreciating its currency. If imports have to be reduced, people must do without the imported goods no matter what means are used to effect the reduction.

775. If balance of payments difficulties are due to internal inflation, the best way to get rid of them is to take steps to cure the inflation. If the difficulties are not due to internal inflation, and no outside assistance is available, the Government must choose from among import and exchange controls, higher tariffs, devaluation of the currency, or other measures designed to reduce spending as a means of correcting the position. Unfortunately, no general rules can be laid down as to what measures are most appropriate. Again, there is no substitute for judgment in choosing the course which is most suited to the prevailing political and economic circumstances.

B. PROTECTING THE ECONOMY FROM THE EFFECTS OF PRICE CHANGES OVERSEAS

The Impact of Price Changes Overseas on the New Zealand Economy

776. We have outlined in Section Five of this report the effects on the New Zealand economy of increases in export and import prices and we have concluded that these have been major factors responsible for the fall in the value of money which has occurred since 1934. On the other hand, in the absence of intervention by the authorities, a general fall in export and import prices would reduce prices and incomes, and, if continued, would curtail production and employment. This would be especially true if, as has been the case in the past, export prices fell further and faster than import prices. It is impossible to predict to what

extent export and import prices will fluctuate and when the fluctuations will occur. But there is no doubt that changes in export and import prices will occur in the future and the question arises whether there is any action which can be taken to protect the New Zealand economy from the worst effects of such changes.

Methods of Protecting the Economy Against Fluctuations Overseas

777. There are four main sets of measures available for use by Governments to counter the effects of price changes overseas. They are:

(a) Automatic variation of the rate of exchange.
(b) Occasional variation of the rate of exchange.
(c) Guaranteed price, floor price, or proceeds retention schemes.
(d) Monetary and fiscal policies.

Automatic Variation of the Rate of Exchange

778. The main proposal for a form of automatic variation of the rate of exchange put to the Commission was that submitted by Mr H. J. Kelliher and The Mirror Publishing Co. Ltd. This is discussed further in Section Eight of this report and in Appendix F, where the Commission gives its reasons for not recommending its adoption in New Zealand.

779. A less complicated scheme than that put forward by Mr Kelliher would be to vary the rate of exchange automatically in accordance with changes in an index of import prices, or of export prices, or of import and export prices combined. We do not believe that a scheme of this nature would be in the best interests of the country. Our reasons are similar to those given earlier in this section, in particular:

(a) The changes would increase uncertainty and speculation.
(b) A change designed to secure stability of prices might aggravate a current difficulty in the balance of payments.
(c) A change in an index of prices might obscure different trends of prices of the goods included in the index (e.g., wool prices might rise sharply while butter prices fell and an appreciation of the exchange rate in such circumstances might bear unduly harshly on butter producers).
(d) There is no reason to believe that alterations in the exchange rate based solely on changes in the prices of exported and/or imported goods would always be desirable in the light of current trends in other prices, in the distribution of income, in the profitability of important industries, and so on. In short, there are too many objectives of policy, and too many economic, social, and political considerations to be reconciled, for an automatic formula based on a limited index of prices to serve the best interests of society in all circumstances.
(e) We would not welcome the adoption of such a formula by major countries overseas. Since our interests are best served by relative stability of exchange rates in the world as a whole, we should maintain stable exchange rates ourselves.

Occasional Variation of the Rate of Exchange

780. The above remarks do not rule out all changes in the rate of exchange. Indeed, we feel that the changes made in 1933 and 1948 were fully justified in the circumstances of those times and had a most beneficial effect on the economy.

781. No definite and irrevocable rules can be laid down for exchange rate policy; decisions have to be made from time to time in the light not only of internal conditions and policies, but also of conditions and policies which prevail in the overseas countries with which we transact our business.

782. In the opinion of the Commission, no case has been made for changing the present practice. We consider that as a general rule the exchange rate should be kept stable, adjustments being made only to meet special circumstances.

Guaranteed Price, Floor Price, and Proceeds Retention Schemes

783. The key role of the farming industries and the important effect of fluctuations of farm prices in New Zealand's economy has been recognised by Governments during the period we have considered. Various steps have been taken to stabilise returns to farmers, through such means as the guaranteed price scheme for dairy produce, the stabilisation accounts, and later the support price scheme for meat, the floor price scheme for wool, and the wool proceeds retention scheme. (See Section Five of this report.)

784. The Commission does not view with favour any guaranteed price basis for farm products where the chief criterion of price is average cost of production and a "reasonable" standard of living for the producer; and where there is little or no regard to export prices. Such a procedure implies that, regardless of the circumstances, the community as a whole will be required to subsidise the particular farm product when any reserve funds built up in periods of favourable prices have been exhausted. Furthermore, releases from reserve accounts or the payment of a subsidy may be demanded at a time when export prices and farm incomes generally are still high, and the economy is suffering from overfull employment.

785. If the sums required were large, it would be impossible to allow the securities held on behalf of the producers to be sold on the open market. In all probability, they would have to be sold to the Reserve Bank or to the Treasury. If they were sold to the bank, there would be an increase in the volume of money as a result of the purchase of securities; if they were sold to the Treasury, the Government's overall surplus would be correspondingly reduced. In both cases the transaction could only add to inflationary pressures and cause increased demands for imports.

786. There appears to be more flexibility and merit in an equalisation or support price scheme which will counteract sharp rises or falls in prices, and as far as practicable level out the extreme fluctuations in farming returns.

787. The Reserve Bank observes:

In considering how and when reserve funds should be used to support farm prices, there is always a temptation to release money too soon. Decisions as to guaranteed or support prices should be based on the following points:

(a) The general state of the economy.
(b) The level of farm incomes in general.
(c) Relative changes (both recent and prospective) in prices of dairy produce, meat, and wool.
(d) Changes in the total and distribution of *real* national income (i.e., money income corrected for price changes).

(e) Forecasts as to whether the fall in export prices is temporary or due to some more deep-seated changes in world markets.

(f) Other financial and economic measures which have been or are likely to be adopted to deal with the economic situation.

The question of changes in real national income and the effect of the support scheme in altering the distribution of that income between different sections of the economy is of vital importance. If the fall in export prices brings about a decline in real national income and the support scheme has the effect of maintaining the real income of primary producers, this can be done only at the expense of other sections of the community and would cause considerable dissatisfaction. It will therefore be a matter of delicate judgment to fix a support price which will maintain the primary producers' share of real national income but not significantly increase it. What this means in practice can be decided only in the light of circumstances existing at the time.

788. Used in this way the present pool funds should provide reasonable protection for the primary industries. Released and spent into circulation by the farmers, they would benefit all sections of the community. On the other hand, additions to these funds might be necessary and desirable from time to time in periods of high export prices.

789. In the event of any sudden and steep rise in prices in any item of exports, which might be expected not to last long, consideration should also be given to freezing a portion of the increase and releasing the amount so withheld over a period of years as was done in the case of wool in and after 1950. Without measures of this sort, other sections of the community would no doubt claim a commensurate share of the inflated earnings of the primary producers concerned. If granted, their claims would add to costs and prices, and cause economic difficulties, and difficulties for the farming industries, when prices fell again.

790. However, we consider it important that any amounts withheld from the farmers should not be allowed to form the base of any expansion of credit and that additions should be made to our overseas reserves sufficient to provide for the demand for imports which must arise when releases are made.

The Role of Fiscal and Monetary Policies in Countering External Fluctuations

791. The extent to which fiscal and monetary policies may have to be used to counter the effects of changes in prices of exports and imports depends upon what action, if any, has been taken to vary the exchange rate or to stabilise farmers' incomes.

792. If, when overseas prices change, it is impracticable to counter the changes by varying the exchange rate, the changes in overseas prices must be reflected to some extent in the New Zealand economy. For example, it would have been quite impracticable to have prevented by domestic policies a substantial rise in the New Zealand price level as a result of the general but uneven rise in external prices which followed the outbreak of war in Korea. The objective of policy (fiscal, monetary, and stabilisation of farm incomes) in such circumstances, therefore, cannot be to prevent a rise in prices, but to ensure that spending in New Zealand does not expand excessively, and lead to a spiral of costs and prices out of line with overseas trends, to large numbers of employment vacancies and to eventual balance of payments difficulties. The means available to the Government and monetary authorities to achieve this end have been fully discussed in previous sections of this report.

Dealing with a Recession in Export Prices

793. Steps appropriate to deal with a fall in export prices expected to be temporary, would consist of measures to keep up the flow of imported goods and of measures to maintain spending in New Zealand.

794. The key to an effective full employment policy in New Zealand lies in maintaining adequate reserves of foreign exchange in times of prosperity, for employment and living standards can be maintained in the face of falling export receipts only if we can maintain an adequate flow of imports. Unless we could borrow overseas, we could maintain imports in the face of a fall in export prices or a deterioration of our terms of trade only by drawing on exchange reserves.

795. The type of domestic economic policy which might be adopted in such circumstances (i.e., where it is possible to maintain imports by drawing on reserves in a period of falling export prices which is expected to be temporary) is discussed in a supplementary statement to the Commission by the Reserve Bank on 19 September 1955:

No one's *real* income need be cut, but money incomes could (and probably should) fall to the extent that the consumers' price index has fallen – which would not be much. People whose incomes are relatively fixed would gain in real purchasing power. Farmers' incomes could be supported by use of reserve funds, and credit policy could be eased. Government revenue would fall only slightly, and the volume of Government expenditure could be maintained with little if any budget deficit. No tightening up of import control would be necessary, though there might be demands for more tariff protection if import prices fall more than do local costs.

In the circumstances assumed here, the use of more liberal credit policies would probably be needed, for two reasons. The first is to ensure that the needed inflow of imports is obtained. It is not enough to be *willing* to use reserves or external borrowing as a means of keeping up the inflow. There must also be the internal *demand* for the goods. Secondly, some measure to support demand is needed because otherwise the drop in export prices is likely to have a spiralling effect on incomes and spending.

If these conditions prevail it would largely be a case of "business as usual". The course of events should cause nobody to lose confidence.

796. If the recession were more severe it is unlikely that a drop in the volume of goods and services available for use could be avoided. The greater the reserves which had been built up, the less the drop would be. In such circumstances, it would be necessary for the community to reduce its spending to a level appropriate to the reduced volume of goods available. A reduction of spending would probably occur automatically as a result of loss of confidence by business men in the face of the fall in export prices and a major problem for Government might be to prevent this from becoming cumulative. It would then have to vary its fiscal, monetary, and farm stabilisation policies to ensure that spending was maintained as nearly as possible at the most desirable level, and that any loss of real income which was inevitable was spread fairly among the various sections of the community.

Conclusion on Protection of the Economy from Overseas Fluctuations

797. Although it is not necessary that the New Zealand economy should follow every fluctuation of economic activity in its major markets overseas, it is impossible to protect ourselves completely from such fluctuations. There is no simple formula or automatic device which will provide a satisfactory solution to the problems which arise from changes

in overseas prices. We must rely on the judgment of the Government and its economic advisers, in the circumstances prevailing at the time, to cushion the impact of these changes as far as possible and to prevent the New Zealand economy from itself accentuating the effects which spring from them.

C. OVERSEAS BORROWING

798. It is necessary to consider the desirability of borrowing overseas as an aid to policies designed to assist economic development, maintain economic stability, preserve equilibrium in the balance of payments, and protect New Zealand from the worst effects of recessions in export prices.

799. When the Central Government or private individuals or firms borrow overseas, or when persons overseas invest in New Zealand, the overseas exchange available to the country is correspondingly increased. Thus New Zealand can afford to buy more imported capital or consumer goods and services than it could if it had to live completely within its own resources. In other words, overseas borrowing and overseas investment in New Zealand permit part of the country's investment programme to be financed from the savings of people overseas, instead of by increased voluntary domestic savings (i.e., reduced consumption) by expansion of the money supply, or by higher taxation.

800. Overseas borrowing normally involves a contract to meet an annual interest charge and to repay the loan to persons overseas in the future, while overseas investment in New Zealand normally implies expectation of the payment of an annual dividend to the overseas investors. In either event, the sums involved have to be found from the country's future earnings of overseas exchange, and there is so much less available to buy imported goods and services for use in New Zealand at the time of payment.

801. Nevertheless, overseas borrowing and overseas investment may assist the growth of industries producing exports or making products of types which are at present imported. If this is so, the annual interest or dividend payments and the sums required for repayment may be more than offset by the additional earnings or saving of exchange. New Zealand, for example, could not have achieved its present volume of exports and standard of living so rapidly without the overseas funds which it borrowed in the past.

802. In deciding whether or not it should borrow overseas, the Government must take four main factors into account:

(a) The extent of the public and private capital development which it deems necessary in the public interest, and its relation to the voluntary private savings which can be expected, and the Government surplus which it is considered practicable to achieve.

(b) The existing state of the country's economy, labour market, balance of payments, and external reserves.

(c) The existing burden of the country's external debt.

(d) The country's probable ability to service additional debt in the future.

The Necessary Extent of Public and Private Capital Development

803. As remarked earlier, New Zealand's population is growing at a very rapid rate by comparison with the rate of growth in many other countries. To maintain real income per head, a very large programme of public and private investment has been necessary and will continue to be necessary for some time to come. There is no doubt that some of the investment projects which have been undertaken, particularly in the private sector, could have been deferred with benefit to the community as a whole. But, even if the less essential projects were weeded out, investment would still remain at a very high proportion of the national income.

804. In the view of the Treasury:

The minimum rate of investment required at the present time exceeds the savings which can be expected from a community which has become accustomed to high standards of living and therefore high levels of expenditure on consumption goods. In fact the level of savings has been high, but the capital requirement is now so heavy that it will be necessary to have recourse to some overseas borrowing to finance additional development.

The Present State of the Country's Economy, Internal and External

805. In the past few years the country has been suffering from continuous inflationary pressure and recurrent balance of payments difficulties despite a high level of export receipts. Overseas exchange reserves have now been reduced to such a level that it would be most unwise to draw them down any further to sustain the present volume of domestic spending.

The Present Burden of External Debt

806. The following table indicates that the payment of interest on New Zealand's public overseas debt now takes up a very small proportion of the country's annual export earnings.

Interest on New Zealand's Overseas Debt, 1911 to 1955

—	Amount	Percentage of Export Value
As at 31 March—	£(N.Z.)million	
1911	2·2	10·0
1920	4·2	8·2
1930	7·0	14·6
1940	5·7	9·5
1941	5·4	7·6
1942	5·4	7·8
1943	5·4	7·1
1944	6·6	8·8
1945	6·7	8·5
1946	7·0	7·9
1947	4·7	4·4
1948	4·7	3·4
1949	3·3	2·2
1950	2·8	1·8
1951	2·6	1·3
1952	2·6	1·0
1953	2·6	1·1
1954	2·6	1·1
1955	2·8	1·1

807. It is impossible to predict the future prospects for the sale of New Zealand's exports, or the extent to which the volume of exportable produce will be increased or the need for imports reduced as a result of the development programmes at present being undertaken in the public and private sectors. It is therefore difficult to judge the country's ability to service additional debt in the future. However, given the present low level of the overseas debt, and in the absence of any serious grounds for pessimism as to future export receipts, there would appear to be little danger in adding to the country's overseas debt commitments to some extent, if this is deemed desirable in the interests of stability, development, and the balance of payments.

808. However, in the Commission's view, undue reliance should not be placed on overseas borrowing as a means of achieving stability, both internally and in the balance of payments, at the present time, when export prices are high and our difficulties are principally due to internal inflationary pressure. The main attack on these problems must come from domestic monetary and fiscal policies, although overseas borrowing, in strictly limited amounts, may be useful as a supplement to appropriate domestic policies.

809. A further reason why too much reliance should not be placed on overseas borrowing at present is that suitable sources of borrowing are rather limited. Access to the London market, which is our traditional source of borrowing, is subject to permission by the United Kingdom authorities. Naturally the United Kingdom authorities must have regard to the effects of unrequited exports on the United Kingdom economy, and to the competing claims of other borrowers.

810. A special problem is that of borrowing from the dollar area. Fairly strict control has been maintained over dollar imports by successive New Zealand Governments but, except for a year or two following the "wool boom", the country has been in deficit in its balance of payments with the dollar area, thus necessitating net drawings by New Zealand on the sterling area's dollar reserves. Some other sterling area countries, notably Australia and India, which have also been in deficit with the dollar area, have borrowed dollars quite extensively in recent years, thus relieving to some extent the pressure on the sterling area's reserves. Since these reserves cannot be regarded as satisfactory at the existing level, and since the preservation of the sterling area system is in New Zealand's best interests, we consider it desirable for New Zealand to continue to restrict its drawings on the dollar pool as far as possible. **To this end, and on the assumption that dollar imports will be restricted to items which are essential to the country's economic development, the Commission considers that New Zealand could quite properly borrow in the dollar area in conformity with general sterling area policy.**

811. It would be desirable that, if possible, loan finance from overseas should be available, in addition to the country's reserves of foreign exchange, for use in a time of serious emergency. As indicated earlier in this section, New Zealand's ability to maintain a reasonable degree of economic stability in the face of a serious decline in export receipts depends on its ability to sustain deficits in the balance of payments in order to maintain the flow of essential imports. **The country's position in this respect would be strengthened to some extent if an arrangement**

could be made with the United Kingdom Government to extend short-term credits to New Zealand, if required, at a time of general recession. This arrangement would be of benefit not only to New Zealand, but also to British exporters at such a time. Preferably, such an arrangement should be made before the eventuality, which it is designed to meet, arises. We would, therefore, recommend that the Government discuss the question with the United Kingdom authorities at an early date.

812. No discussion of overseas borrowing would be complete without reference to the International Monetary Fund and the International Bank for Reconstruction and Development. The question of whether or not New Zealand should join these institutions is considered in the next section of the report.

D. THE INTERNATIONAL MONETARY FUND AND THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

Introduction

813. Since 1 July 1944, when the first exploratory International Monetary Conference was held at Bretton Woods, New Hampshire, United States of America, the question of joining the International Monetary Fund, which was subsequently set up, has been the subject of frequent controversy in New Zealand.

814. The Fund and its sister institution, The International Bank for Reconstruction and Development, were set up to provide machinery for international financial co-operation in the period of post-war reconstruction and thereafter. It was thought that international trade and financial transactions might well be hampered by temporary difficulties during progress towards freer international trade. The International Monetary Fund was therefore designed to assist in stabilising international exchange rates, to provide short-term financial assistance to member countries, and to hasten the removal of barriers to the free flow of international payments. The Bank was set up to promote international lending and to finance reconstruction and development projects.

815. The following statement by the Treasury summarises briefly the course of events affecting the Fund and the Bank since 1944:

The expectations of future trends on which the Fund was established were not justified by events. Instead of a period of progress towards freedom of international payments interrupted by minor difficulties which could be overcome by short-term assistance from the Fund—there developed a series of dollar crises owing to a continuing lack of balance between the dollar and non-dollar worlds. The Fund had neither the power nor the funds to cope with major crises and accordingly only minor use has been made of the Fund's resources.

During the last few years international trade has been more stable and the imbalance between the dollar and non-dollar world has been gradually reduced. Commonwealth countries have agreed on what has become known as the "Collective Approach" which has as its objective convertibility for sterling and a world of freer trade and payments. As progress is made towards this objective the International Monetary Fund is likely to play an essential and important part in international trade and payments, particularly in the event of a recession.

The prediction that there would be scope for an international organisation to supply capital for reconstruction and development has been amply fulfilled. There has been and there still is a great need for a flow of capital particularly from the dollar area and the International Bank is a useful instrument for increasing that flow of loan moneys.

816. The purpose of the International Monetary Fund are set out as follows in *"Article I – Purposes"* – of the Articles of Agreement.

(i) To promote international monetary co-operation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems:

(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy:

(iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation:

(iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade:

(v) To give confidence to members by making the Fund's resources available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity:

(vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balance of payments of members.

The Fund shall be guided in all its decisions by the purposes set forth in this article.

Purposes of the Bank

817. The purposes of the Bank are:

(i) To assist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes, including the restoration of economies destroyed or disrupted by war, the reconversion of productive facilities to peacetime needs, and the encouragement of the development of productive facilities and resources in less developed countries:

(ii) To promote private foreign investment by means of guarantees or participations in loans and other investments made by private investors; and when private capital is not available on reasonable terms, to supplement private investment by providing, on suitable conditions, finance for productive purposes out of its own capital, funds raised by it and its other resources:

(iii) To promote the long-range balanced growth of international trade and the maintenance of equilibrium in balance of payments by encouraging international investment for the development of the productive resources of members, thereby assisting in raising productivity, the standard of living, and conditions of labour in their territories:

(iv) To arrange the loans made or guaranteed by it in relation to international loans through other channels so that the more useful and urgent projects, large and small alike, will be dealt with first:

(v) To conduct its operations with due regard to the effect of international investment on business conditions in the territories of members and, in the immediate post-war years, to assist in bringing about a smooth transition from a wartime to a peacetime economy.

The Bank shall be guided in all its decisions by the purposes set forth above.

Membership of the Fund and Bank

818. There are now fifty-six members of both the Fund and Bank. U.S.S.R., Poland, Czechoslovakia, Liberia, Argentine, Portugal, Spain, Switzerland, Eire, and New Zealand are the more important non-members.

Should New Zealand Join?

819. Among those who favoured New Zealand joining the Fund and the Bank were Mr Fussell, Governor of the Reserve Bank, Mr Ashwin, Secretary of the Treasury, and Mr Whyte, Chairman of Associated Banks. Among those opposed to joining were the New Zealand Social Credit Association, Mr Otto (representing Mr H. J. Kelliher and The Mirror Publishing Co. Ltd.), Dr McElroy, and several other witnesses.

820. No witnesses who appeared before the Commission expressed themselves as being opposed to the purposes of the Fund. It appears to the Commission that a country heavily dependent on world trade like New Zealand has a great deal to gain from any agreements which go some way to achieving the objectives set out above. The history of the inter-war years demonstrated conclusively the folly of each nation's attempting to solve its trade and employment problems by measures which inevitably destroy the prosperity of others, and the desirability of international co-operation in the fields of trade and finance. Prima facie, therefore, there are strong grounds for New Zealand joining the majority of other countries in these attempts at co-operation in the field of international finance.

821. It is not intended in this report to outline in detail the organisation and rules of the Fund and Bank, since information on these matters is readily available in other publications. We regard our task to be a careful examination of the arguments for and against joining the Bretton Woods institutions.

Arguments Against Joining

Loss of Sovereignty in Respect of Exchange Rates and Exchange Restrictions

822. Members of the Fund lose most of their freedom to alter their exchange rates at will, in that they agree to accept the authority of the Fund in this matter and are required to consult with the Fund before taking action.

823. For changes up to 10 per cent in total the Fund can raise no objection. In respect of another 10 per cent the Fund must concur or object within seventy-two hours. For further alterations the Fund is entitled to a longer period (not specified) in which to declare its attitude. (Article IV.)

824. A member making an unauthorised change in the par value of its currency may be denied the use of the Fund's resources and may be expelled from the Fund in terms of Article XV (2) (b). France at one time was denied access to the Fund's resources, but no country has been expelled on these grounds.

825. The Fund must concur in a change of par values if it is satisfied that the change is necessary to correct *"a fundamental disequilibrium"*. This term is scarcely capable of precise definition and its interpretation is in the hands of Fund members.

826. That the interpretation of members is generous in practice is shown by the number of occasions on which member countries have been permitted to vary their exchange rates since the Fund came into operation. In this connection, Article IV specifically states that, provided a proposed change is to correct a fundamental disequilibrium, the Fund shall not object to a change in par values because of the domestic, social, or political policies of the member.

827. The Commission is of opinion that the original proposals not only provided for the requirements and limitations necessary to make the Fund workable, but also provided a generous measure of flexibility, thus ensuring that the rules were sufficiently adaptable to deal with special circumstances and contingencies affecting member countries.

828. Members of the Fund accept as an objective the elimination of exchange restrictions and discriminations, and in certain circumstances are required by the rules to obtain the approval of the Fund before introducing new exchange controls. We note, however, that member countries of the International Monetary Fund, in meeting the requirements of the Agreement, have not been prevented from taking any necessary steps to protect their balance of payments by way of import and other related controls.

829. As Mr Fussell said in evidence " . . . *if the course of events in the member countries during the years since they joined the Fund is studied, you will see what a high degree of flexibility and recognition of domestic affairs and ways of life have been recognised by the Fund*". Dr McElroy admitted that his former objection to joining the Fund because exchange rates were controlled had been modified as a result of the sympathetic way in which the rules had been interpreted over the years.

830. Both with regard to exchange rates and exchange restrictions, countries certainly surrender to the Fund part of their freedom of action but what happens in practice is rather that a degree of "sovereignty" is pooled by the member countries. There can be no freedom without restriction. In the opinion of the Commission, any limited loss of "sovereignty" or freedom involved is fully justified for:

(a) There is need for rules in international affairs, and an organisation to administer and enforce the rules. A limited surrender of freedom is essential to the maintenance of any ordered society.

(b) No country makes a unilateral surrender of its right to take exchange action without consultation; there is an equivalent surrender by all other member countries.

(c) Trade and commerce could not flourish among countries if they continually placed hindrances in the way of meeting current commitments, or, regardless of the interests of their trading partners, imposed exchange restrictions or depreciated their currencies. The rules of the Fund are therefore intended to prevent such unneighbourly practices, and in the course of time to remove hindrances already existing. Provision is made for the variation of exchange rates and imposition of exchange controls where this is clearly necessary, but the Fund makes it obligatory for the interest of others to be considered before action is taken. This is to New Zealand's advantage.

(d) The fact that fifty-six countries remain members of the Fund indicates that most countries regard membership of the Bretton Woods institutions as worth while.

(e) The fact that the approval of the Fund is required before certain actions can be taken by a member country does not mean that approval will rarely be given or arbitrarily withheld. In practice, the Fund has exercised its authority reasonably. This is shown by the 1949 devaluation by the United Kingdom and thirty-six other countries.

(f) New Zealand should not suffer any additional "loss of sovereignty" by joining the Fund and Bank. The principles of the Fund are not inconsistent with our trade and exchange policies. Mr Fussell said in evidence: " . . . *I do not know any country that carries out the ideals of the Fund more thoroughly than New*

Zealand does". In any case the Government has already undertaken to follow the principles of the Fund. At a recent session of the Contracting Parties to the GATT, New Zealand was granted a waiver from signing a special exchange agreement. The terms of the waiver recognised that New Zealand has taken no exchange action which has frustrated the intent of the GATT and that the New Zealand Government has given assurances that it will continue to act in exchange matters in a manner fully compatible with the principles of the International Monetary Fund and in accordance with the intent of the GATT.

(g) If membership should prove unsatisfactory, New Zealand would be entitled to withdraw from the Fund and the Bank. The process is simple. Any debts it may have incurred before withdrawing would, of course, have to be settled as provided in the Articles of Agreement and it would be liable for contingent liabilities to the Bank, so long as any part of the loans or guarantees contracted before it withdrew, were outstanding. There is, however, no present indication that there would be any need to withdraw.

831. For the reasons given above, the Commission considers that the contention that a loss of sovereignty is involved is not a soundly based argument against joining the Fund and Bank.

Domination by the United States or an International Financial Oligarchy

832. It was suggested to the Commission that the Fund and Bank are potent instruments of United States "imperialism" and that the aim of the United States is world domination especially in the sphere of trade and commerce. It is obvious that, irrespective of the existence of the Fund and of the Bank, the United States by virtue of its size and wealth is already dominant in the world economy. It is relevant to note, however, that, in the Fund, the United States has 27,750 votes (27·6 per cent of the total) compared with 25,900 of the Commonwealth countries (26,650 if New Zealand joined), but has only one executive director compared with four from Commonwealth countries.

833. Some Social Credit witnesses seemed concerned that the United States might, by manipulation of the Fund, force other countries to accept unwanted imports of American surplus goods and prevent them from taking adequate measures to protect themselves from deflation and unemployment. A realistic appraisal of the operations of the Fund since the war does not give any reasonable grounds for fears along the lines indicated above. Nor was any evidence brought before the Commission to support the allegation that the Fund or Bank were in any way dominated or controlled by "Wall Street" or by any conspiracy of international financiers, either independently or in association with communists.

834. From this aspect, New Zealand would surely be in a better position to place its views on international finance before the United States and other countries if it became a member of the Fund, than if it remained outside the main organ of international co-operation in this field.

Loss of Imperial Preference

835. It has been stated that membership of the International Monetary Fund would mean the end of our right to continue imperial preference. The Fund has nothing to do with imperial preference which comes within the scope of GATT (The General Agreement on Tariffs and Trade), of which New Zealand is already a member.

Financial Costs of Membership

836. If we had joined the Fund and the International Bank in 1945 we would have been required:

(a) To pay to the Fund and the Bank 10 per cent of our official holdings of gold and United States dollars, say about £1·6 million altogether.

(b) To make available to the Fund, in New Zealand currency and securities, £16·7 million.

(c) To make available to the International Bank, on call in New Zealand currency, £3·2 million.

(d) To make available to the International Bank, if borrowers default for substantial amounts (a remote contingency), up to £14·3 million.

837. If this scale of contribution were retained, our immediate payments would be small – approximately £1·6 million in gold or dollars. The present market value of the gold held by the Reserve Bank is £12 million. The New Zealand currency could (and normally would) be in the form of securities, not cash. The potential "burden" is remote and is not a great one, especially as any funds actually made available to the Fund or Bank would probably assist our exports, and would (in the case of the Fund) add to our own drawing rights.

Intervention by Fund in Internal Policies

838. Several witnesses feared such intervention, but the Fund has no authority over the internal policies of member countries. The assertion that the Fund attempts to bring about deflation or unemployment is groundless. The Governors of the Fund, too, are naturally interested in the well being of their own countries.

Court of Appeal

839. Mr Jordan, counsel for the Social Credit Association, laid great stress on the fact that there was no Court of Appeal from decisions of the Board of Governors of the Fund and he considered that the Court of Appeal might well be the Court of International Justice. The experience of the past nine years does not appear to have disclosed any need for such an appeal authority. As Mr Ashwin said, *"It is all based on trying to run it on a basis of co-operation"*.

Repurchase Requirements

840. When a member buys foreign currency from the Fund it pays in its own currency. The Fund's holding of that member's currency is thereby increased. Later the member may be required to repurchase its own currency from the Fund and may have to use gold, dollars, or other convertible currency for this purpose. If the currency originally purchased by the Fund was inconvertible, the provisions for repurchase could become onerous. However, the importance of this question will decrease as more currencies become convertible.

We Have Nothing to Gain

841. This view was voiced by several witnesses including Mr Otto, who said *"The main objection"* to our joining the Fund *"is that as far as trade and commerce are concerned we would have nothing to gain and as far as financial assistance and support are concerned it would be relatively insignificant . . ."*

Question:

There is no inherent vice in our joining but we have nothing to gain?

Mr Otto:

We have nothing to gain.

842. The Commission would comment that the traditional attitude of New Zealand with regard to international organisations has not been based purely on what we would gain, but rather in many cases, for example the International Labour Organisation, on what we could give. But from a purely selfish point of view we have a great deal to gain by lending every possible support to any organisation designed to foster or smooth the path of world trade, for there are few countries so dependent on trade with others as New Zealand.

Lack of Success

843. The view that the International Monetary Fund had failed to achieve its objectives and that many members had violated its rules and principles was given by some witnesses as a reason why New Zealand should not join. The Commission would make three comments on this view:

(a) The measurement of success is always difficult and it would indeed be a bold man who would assert that conditions of world trade and finance would today be better if the International Monetary Fund and the International Bank had not been established.

(b) It would not be reasonable to suggest that New Zealand withdraw from the United Nations because the success achieved has been less than many of us have hoped for.

(c) Like any organisation, the Fund has some members who do not fully observe its rules and principles. It is not always wise summarily to expel such members. Provided that there is some evidence of a desire generally to work towards the objectives of the organisation, it is often better to keep offenders within the framework of the Fund while making provision for continual consultation on the desirability of their policy. We do not therefore see any reason why New Zealand should stay outside the Fund because it has not expelled all members who have committed breaches of its rules.

Arguments in Favour of Joining the Fund and Bank

844. The above list of objections to joining is not exhaustive, but covers the main points brought to the notice of the Commission. Arguments in favour of joining the Fund and Bank are now reviewed.

845. The International Monetary Fund and the International Bank for Reconstruction and Development are a genuine attempt at international co-operation. New Zealand should certainly be able to subscribe to the main objectives which are:

(i) International co-operation.
(ii) Stability in exchange rates and orderly changes when necessary.
(iii) A reduction in exchange controls.
(iv) Provision of supplementary exchange reserves in time of need.
(v) Provision of capital for the development of less-developed areas.

Promotion of International Co-operation

846. On these points, Mr Ashwin said, " . . . *it does pay us to be a member of any international organisation that tends to promote economic stability in the world generally and particularly stability in world trade . . . We sell more than about 40 per cent of our production overseas*".

847. The Commission feels it highly desirable that there should be a forum, such as the Fund provides, for the continuous study and review of the problems of international finance, with the object of facilitating co-operation in financial matters among the nations and making recommendations in good time to deal with any serious difficulties which might arise. New Zealand should make its due contribution in this field and not leave it to others. The work which the International Bank is doing in providing finance, and a certain amount of technical assistance, to under-developed areas is also worthy of support.

Commonwealth Co-operation

848. As a Commonwealth member whose future is inextricably bound up with that of the United Kingdom, and as a member of the sterling area, it is in New Zealand's interest to join the International Monetary Fund. At present she is the only Commonwealth country which is not a member.

Availability of Loans from Fund and Bank

849. In the event of difficulties developing in regard to the balance of payments, we would have access through the Fund to additional monetary reserves (sterling and non-sterling currencies) of at least £18 million over a four-year period. Though not substantial, these could be of some value in the event of depressed export markets; and there is the likelihood (judging by recent experience of several member countries) that the Fund would allow us greater or more rapid access to its resources in special circumstances. The potential value of the Fund as a means of supplementing the exchange reserves of its members is not limited to the present rules and quotas. New Zealand might be accepted as a member with a higher quota than that agreed upon at Bretton Woods and thus be entitled to higher drawing rights. The Fund has already indicated that it can waive the limit on annual drawings, and quotas can be reviewed from time to time.

850. No witnesses questioned the success of the International Bank. Several Commonwealth countries, including India, Australia, and South Africa, have received substantial loans from it. New Zealand would be eligible for similar accommodation and as Mr Ashwin said, "*It might be*

a useful source of capital at a time when we cannot provide for our necessary development from our own resources or from money we can borrow in London". However, to be eligible to approach the Bank, we must first join the Fund. As mentioned in the last section, it may well be that, at the present time, when the United Kingdom has dollar exchange difficulties of her own, New Zealand, instead of drawing on the sterling areas dollar pool, could assist by securing part of her dollar requirements for capital goods by arranging a loan from the Bank.

Conclusion

851. **The Commission is of the opinion that the arguments in favour of joining the International Monetary Fund and International Bank for Reconstruction and Development heavily outweigh the objections to that course, and recommends that New Zealand should seek membership of these two world organisations.**

XI. Better Information as the Basis of Policy

A. STATISTICAL INFORMATION

852. During the public hearings of the Commission different witnesses expressed the opinion that an effort should be made to extend the collection of statistics in the economic field.

853. There was general appreciation of the work carried out in the past by the Department of Statistics, and the Commission joins in this appreciation.

854. Both the Governor of the Reserve Bank and the Government Statistician suggested a number of avenues of further desirable activity. After considering these suggestions, the Commission is satisfied as to the need for certain additional information and recommends the following extended programme of statistical collection:

(a) Stocks of commodities (including primary products) held by exporters, importers, manufacturers, and wholesalers.

(b) Surveys of hire-purchase and instalment trading, and operations of discount and finance businesses.

(c) Statistics of mortgage indebtedness.

(d) Statistics of capital expenditure, past and prospective.

(e) More comprehensive statistics of house and other building construction.

(f) Farm costs.

(g) Family living cost studies.

(h) Compilation of further industry sector accounts.

(i) Statistics of deposits with stock and station agents and other trading and financial concerns.

NOTE.—The acceptance of deposits is a form of finance subject to some risk unless special care is taken by the business concerned to preserve the necessary degree of liquidity in its assets to meet possible sudden demands for repayment. For this reason we consider that full information should be collected so that the authorities may be aware from time to time of the magnitude of the deposits and be in a position to take any necessary action should difficulties arise or if they were expected.

855. In connection with the collection of statistics in general, we would offer the following comments. There are a number of different Departments and agencies collecting statistics at present, with the result that a degree of irritation has developed in the business community due to indications of overlapping. We consider that an attempt should be made to channel all statistical inquiries as far as practicable through the Department of Statistics which has had very wide experience in eliciting information from the public.

856. If the foregoing suggestion were accepted, over-lapping would be largely avoided, relations between the collecting agency and the public would be improved, a more satisfactory response would be given to inquiries, and, ultimately, more reliable and up-to-date information would become available. We consider also that care should be exercised to ensure that returns are not requested at unnecessarily frequent intervals.

B. STATUTORY RETURNS BY THE TRADING BANKS

857. The Reserve Bank informed the Commission of a proposed amendment to the monthly statutory return which the trading banks are at present required to make. The Reserve Bank suggested that the following items should be included in the return:

PROPOSED STATUTORY RETURN

Principal Liabilities

1. Demand deposits in New Zealand.
2. Time deposits in New Zealand.[1]
3. Demand liabilities elsewhere than in New Zealand.
4. Time liabilities elsewhere than in New Zealand.
5. Bills payable in New Zealand.[2]
6. Balances due to other banks.
7. Other liabilities (excluding shareholder's funds).

[1] Including wool retention accounts which would continue as footnote.
[2] Bills payable settlement London, etc., including transit items to be included under 3 and 4. Bills payable in New Zealand may not be of sufficient importance for a separate heading.

Principal Assets

1. Reserve balances held at Reserve Bank of New Zealand.
2. Gold and bullion held in New Zealand.
3. Reserve Bank notes.
4. Subsidiary coin held in New Zealand.
5. Overseas assets in respect of New Zealand business:
   (1) In London.
   (2) Elsewhere than in London.
6. Aggregate advances in New Zealand:
   Aggregate discounts in New Zealand:
   (a) By London/Overseas Office.
   (b) In New Zealand.
7. Securities held in New Zealand:
   (1) Government.
   (2) Other.
8. Balances with and due from other banks.
9. Land, buildings, and furniture in New Zealand.
10. Bills receivable and items in transit in New Zealand.[1]
11. All other assets.

[1] Bills receivable and items in transit – London and overseas to be included under 5.

858. The Commission commends this suggestion. We propose, in addition, that the following items might be shown separately in the return:

(a) Reserve balances at the Reserve Bank required to satisfy current minimum reserve requirements.
(b) Reserve balances held in excess of the amounts required to satisfy current minimum reserve requirements.
(c) Liabilities to the Reserve Bank and/or the Treasury incurred in order to satisfy minimum reserve requirements.
(d) Other liabilities to the Reserve Bank and/or to the Treasury.
(e) An assessment of the amounts by which overdrafts of customers are in excess of the limits granted.

C. FORWARD EXCHANGE

859. The question of forward exchange has attracted considerable attention since 1950 when the administration began to dismantle the import control system. A submission on this question was made to the Commission by Mr P. Cropper, of Auckland, and Mr Kelliher devoted a short section to it in his detailed criticism of Reserve Bank policy.

860. Mr Cropper in a foreword to his submission claimed that:

The condition of the New Zealand economy rests almost solely on receipts from the very large part of our national product which is sold abroad.

He offered the opinion that we could estimate very closely the volume of these exports and could make well informed calculations of probable returns but that:

Nobody in the banking system or the Government can make a truly informed guess as to New Zealand's total forward commitments for exchange at any given moment, now that import control is largely removed.

861. Mr Fussell's examination at the public hearings on 28 September 1955 contains a passage bearing on this last point:

Question:

I think the position is that our imports to date so far this year are pretty well a record, aren't they?

Mr Fussell:

For the first seven months they were £138 million. The record figure is for the first seven months of 1952 when they were £139 million.

Question:

Do you think that there is likely to be a reduction in the rate of imports for the remainder of the year?

Mr Fussell:

All I can say is we are striving to make it so . . .

Question:

Would it not likely be the position, Mr Fussell, that orders would already have been placed before now for those imports that are likely to come in for the remainder of the year?

Mr Fussell:

I should think so . . . but the position is that we have no means of knowing what arrangements for payment importers have made because I can say this, that the sum total of the arrangements between the Reserve Bank and the trading banks that we are aware of, and the sum total of the arrangements for exchange between the importers and the trading banks, does not indicate that imports will be much in excess, if at all, of what they were last year.

And later on the same day:

Question:

. . . if the imports for this current year are to be kept within the figure of 1954 (£217½ million), those for the remaining four months of the year would not have to exceed £60 million?

Mr Fussell:

That is so, so far as payments are concerned.

[NOTE—Payments for imports for the calendar year 1955 were in fact £246·4 million.]

862. It appears to the Commission that a strong case can be made for some system which would, as Mr Cropper suggests, enable at least *"a well informed guess"* to be made.

863. Briefly, Mr Cropper proposed in his submission that:

(a) The trading banks should issue exchange reservations, on behalf of the Reserve Bank as required by customers in accordance with conditions laid down from time to time by the Reserve Bank. All such bookings of forward exchange in excess of £100 should be reported weekly by the trading banks in detail. An appropriate holding charge should be made for any exchange other than sterling bought forward by the Reserve Bank.

(b) No goods should be admitted into New Zealand unless exchange cover had been secured, except where no remittance was required in payment.

(c) A sliding "Scale of Margins" should be published setting the rates of cover required for bookings of exchange up to six months ahead. The scale would favour the booking of exchange well ahead of delivery dates. The rate of cover would be used to regulate the demand for exchange and thereby the rate of importations.

(d) The gambling instinct is so ingrained that provision should be incorporated in this plan to make gambling in exchange bookings unattractive, which could be done.

(e) The "Scale of Margins" should be such that regular traders would be required to furnish roughly half to two-thirds of the cover which they would have to find under regular letter of credit business of the same total volume, provided they booked their full exchange needs about six months ahead.

(f) Increases should be made in the "Scale of Margins" without notice, when it appeared that demands for exchange were exceeding estimated future receipts.

(g) So long as any particular currency is in short supply, "rationing" appears to be unavoidable and should be on the single consideration of essentiality.

(h) The future balance of payments position should be under constant review, once a system by which forward commitments could be accurately gauged was in force. Changes in the "Scale of Margins" should be made without delay whenever a decided trend up or down was apparent, but as seldom as practicable.

864. Mr Kelliher, in his submissions, gave a brief description of a scheme similar to that put forward by Mr Cropper and added this comment: *"In neglecting to institute a Forward Exchange Contract System the Reserve Bank has failed in its duty to the Commercial Community"*.

865. Mr Whyte, Chairman of the Associated Banks, stated under cross-examination that he was not in favour of a system of forward exchange. He suggested that it *"would be hamstringing trade . . . replacing another form of control for the one which we previously had"*. Mr Whyte also considered that *"the prime responsibility"* for the control of overseas exchange must rest with the Reserve Bank.

866. Mr Fussell was also questioned on this subject and raised the following objections:

(a) There would need to be a charge, and a penalty for not using the exchange.

(b) If the charge were low and penalty low, importers would ask for more than they could use.

(c) Alternatively, if the charge and penalty were high, importers would tend to import goods even if they were not really required rather than pay the Reserve Bank for nothing.

(d) The Reserve Bank would lose control of its own reserves by allocating ahead and thereby creating a firm obligation.

867. The Commission would comment in regard to these objections that forward exchange is a form of control but is only of a very general nature and therefore is not really comparable with import control or even exchange control. In our opinion the achievement of a reasonable foreknowledge of commitments warrants some sacrifice of freedom. Without any forward exchange system, and certainly without foreknowledge of commitments, the Reserve Bank appears in any case to have lost control of its exchange reserves. Under a forward exchange system the bank would have a much more accurate picture of what was going to happen.

868. Under a forward exchange system the Reserve Bank would at least allocate the funds, whereas under the present system it appears that importers can commit the Reserve Bank's funds without even notifying the Bank of what they have done.

869. The Commission does not suggest that forward exchange could or should operate as a system of import control, but does consider that it would give at least an indication or a guide to importers' outstanding orders. This is a matter on which little if any information appears to be available today. Such information appears to the Commission to be essential if the future policy of the Reserve Bank and the Government is to be soundly based.

870. Mr Cropper's scheme is too complicated and cumbersome. However, the Commission considers that some system of forward exchange is of vital importance in the control of overseas reserves and it therefore makes the following suggestion for consideration by the monetary authorities:

(a) All importers *before* placing or confirming any overseas order should notify their own trading bank and receive an acknowledgment in writing.

(Note—This acknowledgment slip would be numbered (e.g., B.N.Z. 1629) and this serial number would be the bank reference throughout the currency of the transaction.)

(b) The trading banks should notify the Reserve Bank each week of the value, number, and currencies involved in the acknowledgments issued, and the date when it is anticipated payment will be required.

(c) The penalty for failure by the importer to carry out this procedure should be a surcharge of, say, 10 per cent levied by the Reserve Bank on the exchange required when it is called for by the importer.

871. The Commission considers that this penalty would ensure compliance with the above requirements. The Reserve Bank would know week by week the extent to which the country's overseas funds were committed.

D. PROPOSAL TO ESTABLISH AN ECONOMIC RESEARCH INSTITUTE

872. The Reserve Bank made a strong recommendation to the Commission that an institution to conduct original research in the economic field should be set up in New Zealand. The bank emphasised that the present extent of such research was relatively small compared with what was needed and that it fell far behind what was being done in other countries.

873. It pointed out that there was no organisation in New Zealand comparable with the following overseas institutions:

The Economic Research Council in the United Kingdom.
The Nuffield College in the United Kingdom.
The National Institute of Economic Research in the United Kingdom.
The Australian National University.
The National Bureau of Economic Research in the United States of America.
The Brookings Institution in the United States of America.
The Central Planning Bureau in the Netherlands.
The Konjunkturinstitutet in Sweden.

874. Most of the work being done by Government institutions in New Zealand is limited to the day-to-day investigations necessary for the determination of important matters of policy, and there is need for long-term systematic research which would ultimately prove helpful to both Government and private enterprise.

875. The following are some of the matters suggested as suitable subjects for research:

(a) The relationship between export values and national income, and between national income and demand for imports.

(b) The relationship between savings, capital expenditure, and the balance of payments.

(c) Savings in general—how, when, where, and why?

(d) Factors affecting the rate of growth of production in New Zealand with particular reference to capital, population, and immigration.
(e) The impact on the New Zealand economy of changes in the terms of trade.
(f) Factors affecting:
  (i) Propensity to export.
  (ii) Propensity to import.
  (iii) Propensity to consume in New Zealand.
(g) Market analyses covering:
  (i) Broad factors affecting overseas markets.
  (ii) Demand determinants in the United Kingdom market.
(h) The effect of tariff and other forms of protection on the standard of living and the balance of payments.
(i) The effect of taxation on investment and enterprise.
(j) Financial organisation and agencies in relation to developmental requirements.
(k) Effect of wage changes in a dependent economy.
(l) Stabilisation policies—objectives, techniques, and effects.
(m) The administration and effects of price and other controls.
(n) The effects on the economy of hire-purchase and other instalment trading.

876. The Governor of the Reserve Bank expressed the view that such research would best be carried out by an *"absolutely independent institution"* rather than, for example, as a branch of the Reserve Bank, although the bank was prepared and willing to undertake the responsibility.

877. We are satisfied that there is need for such an organisation, of modest size and scope commensurate with our population and financial resources. We are most firmly of the opinion that it should be a completely independent body, and not an appendage of the Reserve Bank or any similar concern.

878. We do not envisage the organisation as a further addition to the group of authorities already collecting statistics in this country. Its primary function would be economic research. Any additional statistics necessary for its work should, as far as possible, be obtained through the Department of Statistics.

879. From the viewpoint of economy in the use of existing facilities and of the desirability for relative independence, it appears to the Commission that the most suitable arrangement would be for such an organisation to be attached to the Economics Department of one of the University colleges. The appropriate institution would be Victoria University College because of its situation in the capital city where close contacts could be established with Government Departments, the Reserve Bank, and with the head offices of many business concerns.

880. We consider that such a research institute should be financed by contributions from the Reserve Bank, the Department of Statistics, Victoria University College, and any other bodies such as Chambers of Commerce, Manufacturers' Federation, Bureau of Importers, Retailers' Federation, organisations of workers and employers, trading banks, and any private concerns which may be sufficiently interested to give the venture material support.

881. It seems to us that a body functioning in the independent manner in which the Council for Educational Research conducts its activities would serve the purposes contemplated.

882. We recommend therefore that steps should be taken to establish an Economic Research Institute to undertake investigations in the fields and on the lines set out above.

XII. Co-ordination of Policy

A. STATUTORY DEFINITION OF THE RELATIONSHIP BETWEEN THE GOVERNMENT AND THE RESERVE BANK

883. Before 1930 it was widely held that central banks should be free from Government control except the very broad direction that could be incorporated in legislation. In practice, because of personal and other factors, some central banks enjoyed more, and others less, independence than strict interpretation of the legislation seeemed to allow. The framers of the statute setting up the Reserve Bank of New Zealand, however, clearly contemplated considerable independence for the Reserve Bank.

884. The *Reserve Bank of New Zealand Proposal,* a pamphlet published in 1933 over the signature of the Right Hon. J. G. Coates, includes this passage:

> The State prescribes the system—be it gold standard, sterling exchange, or any other standard—and the duty is cast upon the bank to control the operation of that system.

885. The same pamphlet quotes Sir Ernest Harvey, a director of the Bank of England, as saying in 1927:

> A central bank in its management and policy should be free from government controls and the influence of politics.

886. In line with these views, section 17 of the Reserve Bank of New Zealand Act 1933 gave the Reserve Bank considerable autonomy in monetary policy:

> It shall be the primary duty of the Reserve Bank to exercise control, within the limits of the powers conferred on it by this Act, over the monetary circulation and credit in New Zealand, to the end that the economic welfare of the Dominion may be promoted and maintained.

887. The experiences of the depression brought a substantial change of opinion towards increasing the responsibility of Government for monetary policy with a corresponding lessening of the autonomy of the central banks in such matters. This change in outlook was a necessary accompaniment of the wide acceptance by Government of greater responsibility for the general control of the economy.

888. Despite the terms of section 12 of the 1933 Act, the Governor of the Reserve Bank said in his 1935 annual report to shareholders:

> The Board accepts the view that the ultimate responsibility for the monetary policy of the Dominion must rest with the Government of the day, but holds that it is the duty of the Bank to tender to the Government impartial advice on monetary and financial matters and to exercise its own judgment in carrying out those functions entrusted to it.

889. How this change of opinion has developed and how it has been reflected in legislation establishing or affecting central banks is shown in the following extract from *How Money is Managed* by Paul Einzig, published in 1954:

To the generation that has grown up since the suspension of the gold standard in 1931 it may appear almost incredible that a quarter of a century ago many Central Banks had practically a free hand in deciding the choice of the means of their country's monetary policy, and that very often they determined even its ends. Today the only power left in the hands of the Central Banks is the implementation of monetary policy decisions taken by Governments. It is only in the sphere of the technique of monetary practice that Central Banks still have a reasonably free hand.

890. The Reserve Bank of New Zealand Amendment Act of 1936 appears to have confirmed legislatively the allocation of responsibility set out in the extract from the 1935 annual report cited above. The relevant portion of section 10 (1) of the Amendment Act, described in the marginal note as *"Restatement of general functions of Reserve Bank"* reads:

It shall be the general function of the Reserve Bank, within the limits of its powers, to give effect as far as may be to the monetary policy of the Government, as communicated to it from time to time by the Minister of Finance. For this purpose, and to the end that the economic and social welfare of New Zealand may be promoted and maintained, the Bank shall regulate and control credit and currency in New Zealand . . .

891. Apparently even the degree of control over the Reserve Bank's operations given by the above amendment was not considered adequate by the Government, because in 1939 the following additional provision was enacted:

Section 2. In the exercise of their functions and powers under the principal Act the Governor and the Board of Directors shall have regard to any representations that may be made by the Minister of Finance in respect of any functions or business of the Reserve Bank, and shall give effect to any decision of the Government in relation thereto conveyed to the Governor in writing by the Minister of Finance.

892. It seems that this section enabled the Government not merely to dictate general monetary policy, which it could already do under the 1936 amendment, but also, if it so desired, to have the power of final decision, in the event of any difference of opinion between the Government and the Reserve Bank, as to how any functions or business of the bank were to be carried out.

893. The Reserve Bank of New Zealand Amendment Act of 1950 made no change in that portion of the 1936 provision requiring the bank to *"give effect as far as may be to the monetary policy of the Government"*. It, however, repealed section 2 of the 1939 amendment and substituted the following provision:

Section 3 (1). In the exercise of their functions and powers under the principal Act the Governor and the Board of Directors shall give effect to any resolution of the House of Representatives in respect of any functions or business of the Reserve Bank.

894. Both the Governor of the Reserve Bank and the Secretary to the Treasury expressed the view that in the event of any disagreement between the bank and the Government as to monetary policy, the bank could refuse to comply with a Government direction and could force the Government to obtain a resolution of the House of Representatives. The following extract from the transcript of evidence shows the attitude of the Governor of the Bank on this question:

Question:

Supposing the Government of the day – whatever Government it was – decided on a wholesale creation of credit, and said "That is our monetary policy" and conveyed that to you through the Minister of Finance. Do I take your answer as meaning that legally you think you could resist that communication of the Government's intention?

Answer:

I am convinced that I could, and I certainly would.

895. We think it is at least open to question whether the legal position is consonant with the attitude of the Governor of the Reserve Bank. Whatever the intention of the 1950 amendment, we are not satisfied that it modified in any way the provision of the 1936 amendment, which directs that the general function of the bank is *"to give effect, as far as may be, to the monetary policy of the Government, as communicated to it from time to time by the Minister of Finance"*.

896. We now examine the provision requiring the Governor and the Board of Directors of the bank, in the exercise of their functions and powers under the Act, to give effect to any resolution of the House of Representatives. If this provision is intended to relate to major questions of monetary policy – such as any expansion of credit decided upon by the Government – it could prove very cumbersome at a time when Parliament was not in session. Again, there are important questions of policy such as alterations in the exchange rate upon which it is impracticable to have discussions in Parliament before action is taken. Further, the section does not provide any assurance that the views of the Reserve Bank would be necessarily or fully publicised. It is significant that the Governor of the Bank stated that he did not think the section in question would ever be invoked in practice.

897. We suggest that the Reserve Bank of New Zealand Act be revised to make clear and explicit the respective functions of the Government and of the bank in relation to monetary policy. In our view, the Government must accept full and final responsibility for all decisions of policy in this field. We consider, therefore, that there should be no provision requiring a resolution of the House of Representatives to enable the Government to give directions to the Reserve Bank. In our view any such provision merely detracts in the public mind from the full and final responsibility of the Government in matters of monetary policy.

898. In essence, our view is that the terms of the Reserve Bank of New Zealand Act do not allocate the responsibility for monetary policy with sufficient clarity. Indeed, the Reserve Bank stressed to the Commission the need for *"clarification of the statement of the functions of the Bank"*. We recommend legislation to make it clear and explicit that:

(a) It is the function of the Reserve Bank to give effect to the monetary policy of the Government as communicated to it by the Minister of Finance.

(b) The bank is to advise the Government on matters relating to monetary policy, banking, and foreign exchange.

(c) The bank is to keep the Government fully informed about the measures it is adopting or proposes to adopt to give effect to the monetary policy of the Government.

(d) If there is any difference of opinion between the bank and the Government as to the measures adopted or proposed to be adopted under (c) above, the bank is to give effect to a decision of the Government conveyed to it in writing by the Minister of Finance.

(e) The Government is to decide such important questions as exchange rate policy. The Government, and not the bank, is to have the final authority to determine the London - New Zealand exchange rate. (At present the legal right to fix the exchange rate rests with the bank by virtue of section 16 (3) of the 1933 Act.)

(f) The Government is to have the power to initiate and direct a change in the reserve ratio. (At present section 45 (2) of the 1933 Act provides for changes to be made *"by the Governor of the bank acting with the authority of the Minister of Finance".)* We consider that the bank should have power to initiate changes in the ratio and that the Minister of Finance should also have that power which he could exercise if the bank did not initiate any change which he considered necessary. Such a provision would make it quite clear that the ultimate responsibility for the level of trading-bank advances rests with the Government.

899. We consider that statutory amendments along the above lines would make it quite clear that the full responsibility for decisions upon monetary policy rests with the Government; and that the functions of the bank are those of an adviser on monetary policy, and of an instrument for carrying out the Government's monetary policy.

900. In respect of reserves of overseas funds, section 17 (1) of the 1933 Act as substituted by section 4 (1) of the amendment Act of 1950 provides that *"it shall be the duty of the Bank to maintain reserves which, in the opinion of the Board of Directors, will provide a reasonable margin for contingencies, after taking into account prospective receipts and disbursements of overseas funds, and having regard to the economic position within New Zealand"*. In our opinion this is not a responsibility which should properly be imposed upon the Reserve Bank when so many of the policy decisions which affect the state of our reserves of overseas exchange are made not by the bank but by the Government.

901. Along with certain other amendments which are discussed elsewhere in this report, the Reserve Bank suggested that the *"existing powers of the bank in respect of exchange control, which are provided in emergency regulations, could be provided in the Reserve Bank Act on a permanent (but permissive) basis"*.

902. We agree that the Government's power to control overseas exchange transactions should have the direct authority of statute rather than the mere authority of regulations (Finance Emergency Regulations). It is widely recognised that control of capital transactions is necessary as a permanent feature and in our view there should be a statutory provision empowering the Government to control current transactions as well. This appears necessary because of the possibility of sudden crises. The detailed provisions could be prescribed by regulation.

903. While any decision to adopt, abandon, or modify exchange control is a question of Government policy, in our opinion the administration of the policy should be in the hands of the Reserve Bank as, of course, it is at present.

904. The following passage from *Central Banking* by M. H. de Kock ably summarises the main principle which should be followed in the revision of legislation relating to the respective spheres in monetary policy of the Government and the Reserve Bank:

While the Government admittedly should lay down the monetary policy of the country, the central bank is obviously in the best position to assist the Government in the formulation and carrying out of such policy. From this point of view alone, it is in the interests of the Government and the country as a whole to get independent advice and an objective judgment from the central bank of such vital and complicated matters as money, banking and exchange.

905. We consider that the Government must retain the right of final decision upon questions of policy, and the right to detail the measures adopted to give effect to such decisions. At the same time it is the responsibility of the Reserve Bank that it should offer to the Government of the day objective, competent, and fearless advice on all questions of monetary policy.

B. PROPOSAL TO ESTABLISH AN ECONOMIC ADVISORY COUNCIL

906. Written submissions presented by Mr H. J. Kelliher and The Mirror Publishing Co. Ltd. incorporated a proposal for the establishment of a permanent *"Council of Economic Advisors"*.

907. It was suggested that the Council should be: *"an independent authority . . . responsible directly to our elected Parliamentary Representatives through Cabinet, and performing the task of co-ordinating all spheres of economic and financial activity"*.

908. The following additional extracts from Mr Kelliher's submission will serve to convey his conception of the constitution and functions of the Council:

The Council of Economic Advisors should be similar in status to Judges of the Supreme Court – who are high ranking public servants outside of and above politics, not subject to Party pressure not dependent on votes, and of such professional standing as to assure the public of their probity and integrity. For the purpose of assuring continuity of policy, members of the Council should be appointed for a minimum term of say 7 years, so that the term of office of each one of them would extend over two triennial elections.

In carrying out the economic and financial policy of the Government of the day, the Council should be directly responsible to Cabinet and not to the individual Ministers whose portfolios might be affected by its decisions.

In fulfilling its obligations under its Statute of Establishment, the Council of Economic Advisors might on occasion come into such conflict with Cabinet on matters of economic or financial policy, as could not be resolved by discussion and conciliation. In such an event it would be necessary for the Council to have the right of recourse to the House of Representatives so that the subject matter of the dispute could be examined and debated by the elected representatives of the people.

The procedure for the resolution of such conflict would be similar to that contained in the Central Bank legislation of the Netherlands and that of Australia.

909. It was suggested that the appropriate functions of the Council could be:

1. General supervision of the banking policy of both the Reserve Bank and the Trading Banks, with a view to fostering the restoration of traditional freedoms between banker and client, and the restoration to the Crown of the exclusive right of issue of money through its Central Bank.

2. In accordance with current economic needs, securing the adoption of comprehensive policies designed to achieve the required level of current savings having regard to investment needs, achieving the effective mobilisation of such savings, and achieving its allocation to the most desirable and necessary investment purposes in the Public, Local Body and Private Sectors.

3. Supervising of the operation of insulation techniques so as to achieve the most desirable level of those incomes, costs and prices which are affected by external forces; and to this end to determine an equitable co-ordination of the income decisions of various producer organisations – thus achieving long term stability in primary production, with the necessary incentives and dis-incentives in respect of both production and marketing.

4. Co-ordinating the policies of the various wage fixing authorities in the implementation of a "Productivity Wage" system, and fostering the implementation of a State policy of guaranteed full employment.

910. In reply to questions, however, Mr W. S. Otto, who was Mr Kelliher's witness, made it clear that the Council would be set up for the purpose of *"advising in the co-ordination of the economic and financial policy of the Government for the time being"*. Mr Kelliher cited in support of his proposal a statement by Professor H. Belshaw, that there was *"need for an advisory agency of Government, not simply Treasury, to analyse economic trends and structural changes on the basis of which an economic budget can be framed"*.

911. Mr Otto also quoted *"with very great approval"* the following extract from a pamphlet issued by the National Party prior to the 1949 general election:

In the campaign for honest money we will place responsibility for control of credit and the maintenance of a stable price level in the hands of a non-political currency commission with judicial status.

912. While the Commission is not prepared to recommend the adoption *in toto* of the foregoing proposals, it is convinced that it would be desirable to set up an Economic Advisory Council.

913. We are of the opinion that, while the Government must govern and take full responsibility for its administration, it is entitled to receive all possible assistance by way of advice before decisions are made upon the many and ever-increasing number of difficult and complex economic questions which come before it. In considering legislation to be submitted to Parliament, there also appears to be a greater need than formerly for thorough preliminary analysis because of the abolition of the Second Chamber.

914. We suggest as a possible basis the following constitution:

(a) The Council to consist of five independent permanent members of unimpeachable integrity, not otherwise actively associated in any business or Government activity, but eminently qualified by virtue of past attainments and experience in economics, banking, and commerce.

Note.—We would see no objection to the nomination of employees provided they are granted leave of absence without pay while serving as members of the Council.

(b) The members to be appointed by the Governor-General by Order in Council after the receipt of nominations made in the following manner:

(i) Two to be nominated by the Minister of Finance.

(ii) Two to be nominated by the Senate of the University of New Zealand.

(iii) One to be nominated by the Associated Banks in New Zealand.

NOTE.—In proposing the sources of nomination we have not mentioned the Reserve Bank or the Treasury as we regard the Minister of Finance as being representative of those institutions.

(c) The members to be appointed for a minimum of five years.

915. We propose the powers, duties, and functions of the Council should be:

(a) To act purely as an advisory agency without administrative duties of any kind.
(b) To analyse the entire economy and to review the economic situation from time to time in the light of changing circumstances.
(c) To advise the Government on appropriate economic policies.
(d) To present a report annually upon the state of the country's economy which shall be laid before Parliament.
(e) To submit supplementary reports from time to time when the Council deems fit to do so, such reports also to be laid before Parliament.
(f) To make confidential reports on any economic, monetary, banking, or fiscal question at the request of the Minister of Finance or of Cabinet.
(g) To confer with the Minister of Finance or Cabinet when required.
(h) To have power to call upon any Government Department, the Reserve Bank, any trading bank, and any savings bank for such statistical or other information as it may require to enable it to perform its functions.
(i) To initiate and recommend avenues of additional economic research.

916. We believe that such a Council would also serve certain aspects, which are acceptable to us, of the proposals made to the Commission by the New Zealand Social Credit Association Incorporated and Mr J. Hogan.

917. We recommend accordingly the establishment of an Economic Advisory Council upon the foregoing lines.

C. THE RELATIONSHIP OF MONETARY POLICIES TO BUDGETARY AND OTHER ECONOMIC POLICIES

Introduction

918. We noted in the historical review in Section Three that, during the period 1935 to 1939, both budgetary and monetary policies were directed towards the elimination of serious unemployment, and that the combined policies of increased Government expenditure, expansion of credit, and lower interest rates exercised a considerable influence towards economic recovery, reinforcing as they did the effects on the New Zealand economy of improvements in overseas conditions.

919. During the war, monetary policy played only a minor role. The main methods used by the Government to influence the economy and the price level were direct controls and budgetary policy. A comprehensive series of direct controls was supported by a budgetary policy

designed to remove from the hands of the general public as large a proportion as possible of the increasing flow of purchasing power in New Zealand arising from war expenditure and from substantial surpluses of exports over imports.

920. The post-war years saw military expenditure replaced by expanded private and Government capital expenditure as a powerful internal cause of inflation. Rising overseas prices and, from time to time, export surpluses also contributed substantially to the pressure. Up to 1949, because of the use of direct controls, and continued high taxation and borrowing from the public, major use of monetary policies was considered unnecessary.

921. Thus between 1935 and 1949, the economy responded first to a combination of budgetary and monetary policies and later (during wartime and the few years thereafter) to a combination of direct controls and budgetary policy. Since 1949 the strong inflationary influence of rising overseas prices has continued, with sharply rising private capital investment. We have no doubt that from 1950 onwards (when many direct controls had been discontinued) the economy would have benefitted considerably from the application from time to time of stronger monetary and budgetary policies designed to hold down the general level of demand for both consumer goods and services and for capital expansion.

Effects of Establishing the Reserve Bank

922. Before discussing the use of budgetary policy we recapitulate briefly the effects of the establishment of the Reserve Bank on the respective spheres of responsibility of the Government, the Reserve Bank, and the trading banks:

(a) The trading banks were relieved of direct responsibility for the adequacy or otherwise of the total reserves of overseas exchange held by the banking system.

(b) The effective factor limiting the ability of the trading banks to increase advances in New Zealand was changed from the overseas exchange held by the trading banks to the balances held by the trading banks at the Reserve Bank.

(c) Because of the operation of the Reserve Bank, the trading banks could no longer by their own actions place an upper limit on total bank credit in New Zealand.

(d) On the other hand the Government now had power to expand the level of bank credit in New Zealand by borrowing from the Reserve Bank to finance Government expenditure and to contract the level of bank credit by repaying its debt to the Reserve Bank from an overall surplus of taxation and other receipts over Government expenditure.

(e) Likewise the Government acquired power to expand the lending base of the trading banks by borrowing from the Reserve Bank and spending the money, and to contract the lending base by repaying (from taxation or other moneys received from the public in New Zealand) the Government debt to the Reserve Bank.

(f) The Reserve Bank was empowered in 1936 to enlarge or contract the effective lending base of the trading banks by varying the reserve ratio, with the approval of the Government.

923. The effect of the above changes was to remove from the trading banks the direct responsibility for the overall level of bank credit in New Zealand. Deliberate control by the Government thus replaced the automatic imposition of an upper limit through the need of the trading banks to maintain their own reserves of overseas exchange. Government control both of the total bank credit in New Zealand and of trading-bank advances is exercised through the Reserve Bank.

The Control of Total Trading-bank Advances

924. Although the Reserve Bank has been in operation for over twenty-one years, it was not deemed necessary to place any restraint on the upper limit of trading-bank advances until after 1950.

925. In January 1950 the trading-banks' balances at the Reserve Bank amounted to £89 million, whereas the statutory minimum deposit of 7 per cent of free deposits and 3 per cent of fixed deposits amounted to only £12·5 million. In such circumstances, it was clearly the responsibility of the Reserve Bank to ensure that the very liquid position of the trading banks was not used as the base for an undue expansion of trading-bank credit.

926. To say this does not in any way lessen the obligation upon the trading banks to act with responsibility and, in particular, to co-operate in whatever policy is laid down by the authorities. Neither does it detract from the responsibility of the Government to support its own monetary policy by budgetary and other measures.

Wider Use of Budgetary Policy

927. We have commented on the use of budgetary policy to overcome unemployment and later to contribute to wartime stabilisation. We now examine the change to the general use of the Budget as an instrument of economic policy over the last twenty-five years.

928. Paul Einzig explains in *How Money is Managed* that:

> The nineteenth century idea of a sound Budgetary policy was that its aim must be simply to keep down expenditure, cover it with the aid of taxation, and, if possible, produce a revenue surplus for the gradual reduction of the public debt.

In other words, the aim of budgetary policy was mainly to keep the cost of government down to a minimum and to levy only enough taxation to cover that cost.

929. The deliberate and systematic use of the Budget to influence the level of spending and of economic activity generally is a comparatively new development which received much impetus during the 1930's, when Governments deliberately budgeted for deficits as one of the means of overcoming economic depression, by increasing the amount of purchasing power in the hands of the people. Einzig also indicates that the use of the Budget to further general economic aims arose partly because it was found during the depression that the traditional means of monetary policy did not produce the desired results:

> The strength of the case for supplementing conventional measures of monetary policy by budgetary measures came to be realised during the thirties, as a result of the evidence showing that the conventional measures were largely ineffective in the prevailing conditions. One country after another tried in vain to bring about a trade revival with the aid of the time honoured device of "cheap money".

It was found that low interest rates signally failed to induce producers and consumers to borrow and spend. The need for direct Government intervention to stimulate trade by means of public expenditure came to be realised in many countries.

930. The fundamental reason for employing both monetary and budgetary policies and for fully integrating them is, therefore, that under modern conditions neither monetary policy nor budgetary policy is by itself an adequate means of discharging the very wide tasks which face the modern State, including the maintenance of full employment, stabilising the price level, and controlling the demand for imports.

931. Any degree of restraint imposed by monetary policies on the expansion of commercial and industrial activity in New Zealand could be completely nullified by the Government's own financial operations if its fiscal policy ran counter to its monetary policy. Credit restraint imposed to reduce the demands for consumer goods and services could, for example, be made ineffective by a Budget deficit. On the other hand, it could be strongly reinforced by a Budget surplus through which purchasing power could be taken out of the hands of the public.

932. In evidence before the Commission very great stress was put upon the use of monetary policy and particularly on the policy of restricting trading-bank advances and raising interest rates in order to limit both the demand for imports and upward pressure on prices in New Zealand. **While we regard these monetary policies as essential instruments of economic policy, we are convinced that monetary policy is by no means the only instrument available to the Government. Nor is it the most important instrument.**

933. In certain circumstances it is not enough for the Government to give attention only to the total volume of money and credit. It must also control in various ways the extent of the credit granted in particular sectors of the economy. As we have pointed out elsewhere, the adoption of appropriate policies in such fields as public finance (including housing finance), interest rates, and capital issues would ease considerably the pressure on the banks for additional credit and reinforce Reserve Bank measures to limit the expansion of credit.

934. To a very large extent the Government must pursue its broad objectives by influencing the general level of demand in the community. To do this it has to secure recognition that a basic purpose of taxation and of Government borrowing should be to reduce purchasing power in the hands of the public which would otherwise be excessive. Similarly, in appropriate circumstances tax reductions should be directed towards leaving more purchasing power in the hands of the public and so stimulating inadequate demand for goods and services, both locally produced and imported.

The Need for Public Understanding

935. Throughout the report we have emphasised the major role of budgetary policy which brings management of the economy directly into the sphere of politics. It follows that the final decision in major questions of economic policy rests with the people themselves.

936. If the community is to rely on the Government to guide the economy towards the objectives of stability, productivity, and security, it must be prepared to accept necessary measures which will, in the short run, adversely affect some individuals and interest groups.

937. A real difficulty in the way of adopting comprehensive budgetary and monetary policies designed to combat inflation is the problem of securing the necessary public support for such policies. In a depression there is not the same difficulty because such policies as cheap and plentiful money and Budget deficits operate to the immediate personal advantage of many members of the community. In wartime, too, support is usually forthcoming for drastic measures, when the people are under the impulse of patriotic motives.

938. The latest Economic Report of the President of the United States contains the following relevant passage:

> Governmental measures of monetary and fiscal restraint are not as readily accepted as are measures of economic stimulation. The manufacturer who sees an opportunity to expand his activities by borrowing cannot always understand why his bank is so short of funds that he must put up with a smaller loan than he requested. Nor can the homebuilder or merchant or consumer. Nor, for that matter, can the banker. To each participant in the economic process a shortage of credit may appear as a restriction on his own opportunities. But the basic shortage under conditions of high prosperity is on the side of physical resources, not on the side of money or credit. If credit on easy terms were available to everyone at a time when the economy is already working close to capacity, the consequence would be a scramble for limited resources and a cumulative bidding up of prices. If taxes were simultaneously reduced, this inflationary process would only be speeded up. A government that sought to prolong prosperity by such devices would be taking a road that all too often has ended in disaster.

939. When the electorate accepts anti-inflationary policies in the interests of internal stability and external solvency it is merely facing the facts. As the Economic Report quoted above says of the United States:

> . . . the degree to which people accepted and approved the programme of fiscal and monetary restraints as the better part of wisdom, testify to our increasing maturity as a nation in dealing with the problem of economic instability.

Financing of Government Capital Expenditure from Taxation

940. We believe that, under circumstances prevailing at present or likely in the foreseeable future in New Zealand, it will be necessary for Governments to use monetary and budgetary policies to deliberately influence the general level of demand. At present these policies should be directed towards checking the level of demand by limiting and at times reducing the total amount of purchasing power in the hands of the public. We do not regard the control of trading-bank advances and small increases in interest rates as adequate without strong support from the Budget.

941. Public understanding and acceptance of Government measures is more than ever necessary, because an increasing proportion of Government expenditure, including capital expenditure, is being financed from taxation. It is by this means that the Government can do most to offset the inflationary effects of capital expenditure. When the level of voluntary private savings is inadequate it is necessary for the Government to "save" by using taxation to finance capital expenditure.

942. The substantial amount of capital expenditure financed from taxation and other revenue is clear from an analysis of General Government Revenue and Expenditure published by the Department of Statistics. It shows the following balances of revenue over current expenditure compared with Central Government capital expenditure(1):

Year Ended March	Central Government Capital Expenditure(1)	Excess of Revenue Over Current Expenditure
	£ million	£ million
1938–39	16	1·5
1949–50	39	9·0
1950–51	41	28·3
1951–52	41	43·5
1952–53	55	28·7
1953–54	57	30·7
1954–55	59	54·2

(1) This total excludes debt repayment, purchases of land, and a number of other items which are not "capital investment" in the economic sense.

Clear Presentation of the Budget and the Public Accounts

943. We consider that the position set out above should be made clear in the presentation of the Budget and in the Public Accounts as well as in the statements prepared by the Department of Statistics. This practice of financing capital works from taxation is beneficial to the whole economy and we think it should be fully explained and shown more clearly in the Public Accounts.

944. It is likely that the Government will find it necessary to finance an increasing proportion of its total expenditure from taxation.

945. An essential part of the explanation of monetary and budgetary policies is the publication of clear and comprehensive statements of the Government's own financial transactions. We realise that considerable progress has been made in recent years in presenting such information. We have noted particularly the statements contained in the Estimates of National Income and Expenditure prepared by the Department of Statistics and the summary of the Public Account which appears as Table 1 of the 1955 Budget and as Table 23 in the 1955 Economic Survey. We consider there is room for further improvement in the presentation of statements showing the effects and explaining the purpose of the Government's financial transactions.

Further Public Information Required

946. In our opinion a clearer statement of the Public Accounts will not in itself be enough to bring public understanding and stimulate public interest. Any such improvement should be supplemented by other means. To some extent this already is being done through Government publications which include the Economic Survey, an explanatory annual review of the economy presented by the Minister of Finance. These surveys are authoritative, clear, and informative, and, if widely circulated, should assist public understanding of New Zealand's problems and the measures being taken to meet them.

947. The Reserve Bank publishes a considerable amount of information about the working of the banking system and its relation to the whole economy. Its monthly bulletin, its annual report, and other publications all contain matter of real value. Some contribution is also made by the trading banks in the quarterly reviews published by two of the banks. However, though excellent in content and clear in exposition, the articles in these publications are often directed to a special audience and their distribution is limited.

948. The Commission is of opinion that much more than this could and should be done. As a matter of policy there should be a continued and systematic explanation of Government monetary and other economic policies and their purposes against the background of national circumstances.

Conclusion

949. The Government is entitled to the best possible assistance not merely in formulating its monetary, budgetary, and other economic policies, but also in placing these policies before the public in an objective manner. We believe that the Economic Advisory Council which we have suggested, could play an important part by submitting for the consideration of the Government and for the information of the public an annual report on the New Zealand economy, with recommendations as to the policies which should be adopted.

950. We also believe that a longer parliamentary term would enable the results of policy to become apparent, and to be understood in better perspective. With a longer term, Governments would have a better opportunity of initiating measures which might be temporarily unpalatable but which in the longer run would provide their own justification.

951. In the final analysis, we are convinced that, whatever machinery is set up to assist or advise the Government on financial and economic policy, the responsibility for policy decisions and for explaining them to the public rests with the Government itself.

Section Ten

SUMMARY OF MAIN FINDINGS AND CONCLUSIONS

(NOTE.—This section contains only a bare summary of the Commission's findings and conclusions. It should be read subject to the qualifications and additional details contained in the other paragraphs identified by the report paragraph numbers in brackets.)

Assessment of the Present Monetary, Banking, and Credit Systems in New Zealand

952. In assessing the present systems, it is necessary to recognise:

(a) That there is a limit to the amount which any country can produce or obtain by overseas trade for distribution among its citizens, and that this limit cannot be escaped by any manipulation of the monetary, banking, and credit systems. (Paragraphs 360 and 361.)

(b) 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. (Paragraph 367.)

953. 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. (Paragraph 368.)

954. 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. (Paragraph 369.)

955. The Commission does not agree with the first of the above criticisms of the systems. (Paragraph 370.) **The second criticism is valid, but 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.** (Paragraph 371.)

956. None of the major proposals for reform of the existing systems put to the Commission seems to us to provide an acceptable solution to this problem of instability of prices. (Paragraph 372.)

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

958. We do not believe that there was any practicable means of preventing the increase in overseas prices which has occurred since 1935 from generating a considerable increase in prices, incomes, and the volume of money in New Zealand. (See Section Five of this report.) (Paragraph 374.)

959. However, 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. (Paragraph 375.)

960. 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. (Paragraph 376.)

961. 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. (Paragraph 378.)

962. 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. (Paragraph 405.)

963. 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. (Paragraph 419.)

964. 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. (Paragraph 420.)

Main Causes of Inflation in New Zealand

965. 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. (Paragraph 252.)

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

966. The Commission rejects the contention that the operations of the New Zealand trading banks under the existing banking system are illegal. (Paragraph 433.)

967. 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. (Paragraph 445.)

968. 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. (Paragraph 446.)

Social Credit Submissions

969. The case prepared by the New Zealand Social Credit Association Incorporated for submission to the Commission did not conform with what many people have come to accept as Social Credit theory and policy. (Paragraph 449.)

970. 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 deficiences 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 proposals 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 ultimately result in the abolition of private ownership of property. (Paragraph 502.)

Submission of Mr H. J. Kelliher and The Mirror Publishing Co. Ltd.

971. The Commission's conclusion on these 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 creditworthy 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. (Paragraph 545.)

972. 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. (Paragraph 546.)

(NOTE—See also paragraphs 433 and 966 regarding the legality of trading-bank operations in New Zealand, and paragraphs 600 and 975 regarding trading-bank profits.)

Proposals for a Commodity-backed Currency

973. Adoption of these proposals is not recommended. (Paragraph 549.)

The Trading-bank System

974. The Commission's views on methods of controlling bank credit are:

(a) In consultation with the trading banks the monetary authorities should try to assess the levels of bank credit which are likely to be in the best interests of the country in the months ahead, should inform the trading banks promptly and clearly of the credit policy decided upon, and should give them a direct financial incentive to co-operate in this policy.

(b) The policy should be as direct and simple in operation as possible and should be capable of prompt adjustment to meet changing circumstances. It should allow for competition among the banks for business. The public should be fully informed of the current policy and the means being used to carry it out.

(c) Several different methods of control could be used to implement these principles. (See paragraph 571.) **However, no reserve ratio system will automatically provide the banks with a financial incentive to co-operate with the policy of the authorities, who must be prepared to vary the minimum reserve requirements quickly and resolutely in order to make them effective.**

(d) No limit should be placed on the power of the authorities to raise these requirements to whatever level is deemed necessary in the public interest. But, if reserve requirements are fixed at very high levels, it might sometimes be equitable to allow the banks interest on part of the balances which they are required to keep at the Reserve Bank, or to permit them to take up Treasury bills held by the Reserve Bank.

(e) More use should be made of changes in bank overdraft interest rates as an aid to credit policy. The banks should be permitted to fix rates of interest on overdrafts within a fairly wide range on the understanding that the average rate of interest charged will be at a level deemed desirable by the authorities.

(f) The banks should be requested to use this right to fix overdraft rates within a wider range in such a way as to strengthen the selective advance control policy, which we recommend should be retained while inflationary circumstances prevail.

(g) If an effective system of control of total bank credit (advances, discounts, and investments) is adopted, the banks should be allowed to invest in Government securities.

(h) The operation of the reserve ratio system of control would be improved if:

(i) Notes and coin held by the banks were included together with the balances at the Reserve Bank, for the purpose of meeting the minimum reserve requirements.

(ii) Fluctuations in bankers' cash were reduced by the introduction of a system of pay-as-you-earn taxation and the staggering of payment of taxes by companies and farmers.

(iii) The trading banks were from time to time to examine existing overdraft limits critically with a view to eliminating unexercised limits considered unnecessary.

(i) Successful use of monetary policy requires considerable skill and judgment by the authorities. In a country like New Zealand, which is especially subject to disturbances arising from external trade as well as to those arising from technical change and changes in the mood of business and consumers, it is essential that policy should be flexible. Adjustments should be made promptly either to meet changing circumstances, or if the authorities find that they have previously made an incorrect diagnosis. A change of monetary policy is not a sign of weakness, but a sign of increased knowledge and alert appreciation of changing conditions. (Paragraph 597.)

975. After carefully examining the profits of the New Zealand trading banks as a group for each of the years 1943 to 1954 the Commission is satisfied that the profits were reasonable during this period. (Paragraph 600.)

976. Nevertheless, because of the apparent uneasiness of a considerable section of the public in regard to bank profits and because of the advisability of inducing the utmost public confidence in the administration of the trading-bank system, we recommend that the Government should take power forthwith to enable it to investigate the profits of the trading banks if at any time in the future such a course appears to be advisable in the public interest. (Paragraph 601.)

977. It is recommended that consideration be given to:

(a) Abolishing or reducing the inland exchange charge made for the collection of cheques.

(b) The fixing of the half-yearly charges for keeping customers' accounts in a manner more commensurate with the work involved. (Paragraph 608.)

978. Steps should be taken to transfer the accounts of marketing authorities (other than the Dairy Products Marketing Commission) to the trading banks. (Paragraph 611.)

979. There is no reason why statutory marketing organisations merely by virtue of the fact that their accounts are held at the Reserve Bank should receive preferential treatment over other marketing organisations with respect to interest charges. We therefore recommend that the rate of interest payable on an advance granted by the Reserve Bank to a statutory body should be similar to that which it would be required to pay if its finance were obtained from the trading banks. (Paragraph 612.)

Interest Rates

980. **The past policy of cheap money is unfitted to the conditions obtaining in New Zealand today.** (Paragraph 637.)

981. **In our opinion a continuing policy of fixed low interest rates contributes to inflationary pressure. Under today's conditions such a policy tends both to discourage savings and to increase spending by facilitating borrowing.** (Paragraph 638.)

982. **An easing in the annual expenditure on building construction including dwellings is desirable, both from a short-term point of view and in the interest of the long-term stability of the building industry. We believe that a rise in interest rates would operate as a restraint on the present rate of building construction and that it should be used for this purpose.** (Paragraph 640.)

983. **In inflationary circumstances it is a mistake for the Government to endeavour to hold down rates of interest by refraining from borrowing to finance its own capital expenditure and meeting its requirements by drawing on accumulated cash balances or by increasing its borrowing from the banking system. Either course is directly inflationary.** (Paragraph 642.)

984. **An ultimate objective should be the complete freeing of interest rates from control so that supply and demand will bring about periodic variations best suited to the conditions from time to time obtaining.** We realise, however, that a sudden complete removal of long-standing controls may have serious repercussions while inflationary circumstances persist. **In the meantime, therefore, we recommend that progress be made towards the above ultimate objective by forthwith increasing in some degree the whole pattern of interest rates.** (Paragraph 644.)

985. **It appears to us essential that the maximum local authority borrowing rate should be revised from time to time so as to preserve an appropriate margin above the effective rate at which the Central Government can borrow on the market.** (Paragraph 720.)

[Since the above was written maximum interest rates have been increased in a number of instances.]

Control of Borrowing by the Public

986. **So long as it is necessary to retain the Capital Issues Committee, we consider that its decisions would be more widely acceptable if the personnel were changed by reducing the number of State servants on the Committee and correspondingly increasing the number of members selected or appointed from the business community.** (Paragraph 647.)

987. **The Commission makes the following recommendations in regard to matters which at present come within the purview of the Capital Issues Committee:**

(a) **That the limit of issues of capital which may be made without the consent of the Committee (now fixed at £10,000) should be raised appreciably.** The present restrictions encourage complicated procedures in order to avoid the need for making application to the Committee.

(b) That the issue of preference shares should be freed from control, with the exception of:

(i) Redeemable preference shares.

(ii) Cases where the preference dividend is non-cumulative.

(c) That the fixing of the appropriate premium on an issue of shares should be left to the discretion of the directors of the Company concerned.

(d) That the Committee should not refuse permission to companies to issue capital on the grounds that the proceeds of the issue are to be used to reduce or repay bank overdrafts. Such a policy tends to increase the difficulties of controlling bank credit. It should be a condition of any consents granted under this recommendation that the proceeds of any such issues should be applied to the reduction or extinction of bank accommodation previously granted. (Paragraph 649.)

988. In New Zealand there are no satisfactory statistics available on any section of hire-purchase trading, and it is therefore impossible for the Commission to make any statement on the question as to whether hire-purchase trading is actually increasing in total or not. (In our recommendations regarding improved statistical information we recommend that statistics of hire-purchase trading be collected.) (Paragraph 652.)

The Stimulation of Private Savings

989. Trustee savings bank and Post Office Savings Bank interest rates should be increased as part of the general interest rate policy. (Paragraph 663.)

990. Consideration should be given to allowing savings-bank interest up to a fixed maximum to be excluded from returnable income for income-tax purposes. (Paragraphs 664 and 665.)

991. A proposal for guaranteeing the purchasing power of "small savings" is not recommended. (Paragraph 667.)

992. A scheme of premiums on savings is recommended for consideration by the Government. (Paragraph 670.)

993. The restrictive provisions in section 5 of the Trustee Savings Bank Act 1948 should be repealed and every possible encouragement should be given to the establishment of new trustee savings banks in the main centres and to the opening of branches in the smaller towns. (Paragraph 680.)

994. The Government should fully investigate the recent Australian legislation authorising trading banks to carry on savings-bank business. (Paragraph 686.)

995. It would be in the national interest if more facilities for investment on the stock exchange could be made available to the small investor. (Paragraph 692.)

Need for New Financial Institutions

996. Proposals for a Postal Clearing Service should be investigated by the appropriate departmental officers. (Paragraph 696.)

997. A short-term money market should be established in New Zealand. (Paragraph 703.)

998. A case for the immediate establishment of an Industrial Finance Corporation has not been substantiated, but such an organisation may prove desirable at some future time. (Paragraph 714.)

999. Establishment at this stage of a Government-sponsored Local Government Finance Corporation is not favoured by the Commission. (Paragraph 726.)

The Balance of Payments

1000. It is a matter for concern that our overseas exchange reserves have been drawn down to such a considerable extent in the past two years. (Paragraph 744.)

1001. A balance of payments deficit may be overcome in several ways, the main methods being to:

(a) Increase the volume and quality of production and reduce costs in New Zealand.

(b) Restrain domestic expenditure on goods and services.

(c) Impose direct control over imports and exchange transactions.

(d) Raise the exchange rate.

(e) Raise tariffs against imported goods.

(f) Borrow overseas.

(g) Induce other countries to remove barriers to the sale of New Zealand's exports at more remunerative prices. (Paragraph 748.)

1002. The major reason for the balance of payments deficits of 1951-52 and 1954-55 was that domestic spending expanded excessively in relation to the local goods and services which could be made available at current prices and the imported goods and services which could be provided out of the country's current overseas earnings. (Paragraph 750.)

1003. In other words, these balance of payments deficits were merely symptoms springing from a more fundamental cause, an attempt by the country to live beyond its means by consuming and investing more than it earned by its current output. The main lesson from the experience of this period is that, if we are to avoid a recurrence of these problems in the future, the Government must adopt timely and appropriate fiscal and monetary policies to prevent excessive demand from being generated. (Paragraph 751.)

1004. We do not believe that the experience of the last five years proves that to maintain a high level of prosperity and full employment it is necessary to retain direct controls over imports and exchange transactions permanently. (Paragraph 753.)

1005. It is recognised that there may well be occasions when it is essential in the national interest to impose direct controls. For example:

(a) We believe that it is essential to maintain direct control over capital transfers overseas.

(b) Since direct controls can effect a reduction of imports more quickly than the other methods available, there would be no alternative but to use them if the reserves of exchange fell to a dangerously low level, while balance of payments deficits continued and it was impossible to borrow overseas.

(c) There would be a strong case for their use if balance of payments deficits persisted after the level of demand had been reduced by fiscal and monetary measures to a point where any further reduction would cause serious unemployment in the country. (Paragraph 754.)

1006. The deficits of 1951–52 and 1954–55 occurred despite very high export prices and were accompanied by inflationary conditions internally. An attempt to meet the situation by import or exchange controls alone would not have dealt with the root cause of the problem – indeed, by preventing the high level of internal demand from being directed partly to imports, the controls would merely have aggravated internal inflation. (Paragraph 755.)

1007. Frequent variation of exchange rates (whether automatically or by Government action) as a method of controlling the balance of payments is not recommended. (Paragraph 771.)

1008. If balance of payments difficulties are due to internal inflation, the best way to get rid of them is to take steps to cure the inflation. If the difficulties are not due to internal inflation, and no outside assistance is available, the Government must choose from among import and exchange controls, higher tariffs, devaluation of the currency, or other measures designed to reduce spending as a means of correcting the position. (Paragraph 775.)

Protecting the Economy from Effects of Price Changes Overseas

1009. There are four main sets of measures available for use by Governments to counter the effects of price changes overseas. They are:

(a) Automatic variation of the rate of exchange.
(b) Occasional variation of the rate of exchange.
(c) Guaranteed price, floor price, or proceeds retention schemes.
(d) Monetary and fiscal policies. (Paragraph 777.)

1010. In the opinion of the Commission, no case has been made for changing present practice in regard to exchange rates. We consider that, as a general rule, the exchange rate should be kept stable, adjustments being made only to meet special circumstances. (Paragraph 782.)

1011. The Commission does not view with favour any guaranteed price basis for farm products where the chief criterion of price is average cost of production and a "reasonable" standard of living for the producer; and where there is little or no regard to export prices. (Paragraph 784.)

1012. There appears to be more flexibility and merit in an equalisation or support price scheme which will counteract sharp rises or falls in prices, and as far as practicable level out extreme fluctuations in farming returns. (Paragraph 786.)

1013. In the event of any sudden and steep rise in prices in any item of exports, which might be expected not to last long, consideration should also be given to freezing a portion of the increase and releasing the amount so withheld over a period of years as was done in the case of wool in and after 1950. (Paragraph 789.)

1014. It is important that any amounts withheld from farmers under equalisation and support schemes should not be allowed to form the base of any expansion of credit and that additions should be made to our overseas reserves sufficient to provide for the demand for imports which must arise when releases are made. (Paragraph 790.)

1015. If, when overseas prices change, it is impracticable to counter the effects of the changes by varying the exchange rate, the changes in overseas prices must be reflected to some extent in the New Zealand economy. For example, it would have been quite impracticable to have prevented, by domestic policies, a substantial rise in the New Zealand price level as a result of the general but uneven rise in external prices which followed the outbreak of war in Korea. The objective of policies (fiscal, monetary, and stabilisation of farm incomes) in such circumstances, therefore, cannot be to prevent a rise in prices, but to ensure that spending in New Zealand does not expand excessively, and lead to a spiral of costs and prices out of line with overseas trends, to large numbers of employment vacancies, and to eventual balance of payments difficulties. (Paragraph 792.)

Dealing with a Recession in Export Prices

1016. Steps appropriate to deal with a fall in export prices, expected to be temporary, would consist of measures to keep up the flow of imported goods and of measures to maintain spending in New Zealand. (Paragraph 793.)

1017. The key to an effective full-employment policy in New Zealand lies in maintaining adequate reserves of foreign exchange in times of prosperity, for employment and living standards can be maintained in the face of falling export receipts only if we can maintain an adequate flow of imports. Unless we could borrow overseas, we could maintain imports in the face of a fall in export prices or a deterioration of our terms of trade only by drawing on exchange reserves. (Paragraph 794.)

1018. Although it is not necessary that the New Zealand economy should follow every fluctuation of economic activity in its major markets overseas, it is impossible to protect ourselves completely from such fluctuations. There is no simple formula or automatic device which will provide a satisfactory solution to the problems which arise from changes in overseas prices. (Paragraph 797.)

Overseas Borrowing

1019. Undue reliance should not be placed on overseas borrowing as a means of achieving stability, both internally and in the balance of payments, at the present time, when export prices are high and our difficulties are principally due to internal inflationary pressure. The main attack on these problems must come from domestic monetary and fiscal policies, although overseas borrowing, in strictly limited amounts, may be useful as a supplement to appropriate domestic policies. (Paragraph 808.)

1020. New Zealand could quite properly borrow in the dollar area in conformity with general sterling area policy. (Paragraph 810.)

1021. New Zealand's external financial position would be strengthened to some extent if an arrangement could be made with the United Kingdom Government to extend short-term credits to New Zealand, if required, at a time of general recession. (Paragraph 811.)

New Zealand Membership of the International Monetary Fund and the International Bank

1022. It appears to the Commission that a country heavily dependent on world trade like New Zealand has a great deal to gain from any agreements which go some way to achieving the objectives of the International Monetary Fund and Bank. The history of the inter-war years demonstrated conclusively the folly of each nation's attempting to solve its trade and employment problems by measures which inevitably destroy the prosperity of others, and the desirability of international co-operation in the fields of trade and finance. (Paragraph 820.)

1023. The contention that a loss of sovereignty is involved is not a soundly-based argument against joining the Fund and Bank. (Paragraph 831.)

1024. No evidence was brought before the Commission to support the allegation that the Fund or Bank were in any way dominated or controlled by "Wall Street" or by any conspiracy of internatinal financiers, either independently or in association with communists. (Paragraph 833.)

1025. A number of other arguments for and against New Zealand membership of the Fund and Bank were considered. (Paragraphs 835 to 843.) **The conclusion is reached that the arguments in favour of joining the International Monetary Fund and International Bank for Reconstruction and Development heavily outweigh the objections to that course, and accordingly the Commission recommends that New Zealand should seek membership of these two world organisations.** (Paragraph 851.)

Better Information as a Basis of Policy

1026. After considering a number of suggestions the Commission is satisfied as to the need for additional information and recommends an extended programme of statistical collection. (Paragraph 854.)

1027. Amendments should be made to the monthly statutory return which the trading banks are required to make to the Reserve Bank. (Paragraphs 857 and 858.)

1028. A scheme requiring importers to notify their own trading banks before placing or confirming overseas orders is suggested for consideration. (Paragraph 870.)

1029. Consideration should be given to including unexercised overdraft authorities in statistics of the volume of money. (Paragraph 153.)

1030. Steps should be taken to establish an Economic Research Institute. (Paragraph 882.)

Co-ordination of Monetary Policy with Budgetary and Other Economic Policies

1031. The Reserve Bank of New Zealand Act should be revised to make clear and explicit the respective functions of the Government and of the bank in relation to monetary policy. In our view the Government must accept full and final responsibility for all decisions of policy in this field. We consider, therefore, that there should be no provision requiring a resolution of the House of Representatives to enable the Government to give directions to the Reserve Bank. In our view any such provision merely detracts in the public mind from the full and final responsibility of the Government in matters of monetary policy. (Paragraph 897.)

1032. The Commission recommends legislation to make it clear and explicit that:

(a) It is the function of the Reserve Bank to give effect to the monetary policy of the Government as communicated to it by the Minister of Finance.

(b) The bank is to advise the Government on matters relating to monetary policy, banking, and foreign exchange.

(c) The bank is to keep the Government fully informed about the measures it is adopting or proposes to adopt to give effect to the monetary policy of the Government.

(d) If there is any difference of opinion between the bank and the Government as to the measures adopted or proposed to be adopted under (c) above, the bank is to give effect to a decision of the Government conveyed to it in writing by the Minister of Finance.

(e) The Government is to decide such important questions as exchange-rate policy.

(f) The Government is to have the power to initiate and direct a change in the reserve ratio. (Paragraph 898.)

1033. In respect of reserves of overseas funds, section 17 (1) of the 1933 Act, as substituted by section 4 (1) of the amendment Act of 1950, provides that "it shall be the duty of the Bank to maintain reserves which, in the opinion of the Board of Directors, will provide a reasonable margin for contingencies, after taking into account prospective receipts and disbursements of overseas funds, and having regard to the economic position within New Zealand". In the opinion of the Commission this is not a responsibility which should properly be imposed upon the Reserve Bank when so many of the policy decisions which affect the state of our reserves of overseas exchange are made not by the bank but by the Government. (Paragraph 900.)

1034. The Government's power to control overseas exchange transactions should have the direct authority of statute rather than the mere authority of regulation. (Finance Emergency Regulations.) (Paragraph 902.)

1035. The Commission considers that the Government must retain the right of final decision upon questions of monetary policy and the right to detail the measures adopted to give effect to such decisions. (Paragraph 905.)

1036. An Economic Advisory Council should be established. (Paragraph 917.)

The Need for Comprehensive Monetary and Budgetary Policies

1037. Under modern conditions neither monetary policy nor budgetary policy is by itself an adequate means of discharging the very wide tasks which face the modern State, including the maintenance of full employment, stabilising prices, and controlling the demand for imports. (Paragraph 930.)

1038. To a very large extent the Government must pursue its broad objectives by influencing the general level of demand in the community. (Paragraph 934.)

The Need for Public Understanding

1039. Throughout the report, we have emphasised the major role of budgetary policy which brings management of the economy directly into the sphere of politics. It follows that the final decision in major questions of economic policy rests with the people themselves. (Paragraph 935.)

1040. If the community is to rely on the Government to guide the economy towards the objectives of stability, productivity, and security, it must be prepared to accept necessary measures, which will, in the short run, adversely affect some individuals and interest groups. (Paragraph 936.)

1041. A real difficulty in the way of adopting comprehensive budgetary and monetary policies to restrain inflationary pressures is the problem of securing the necessary public support for such policies. In a depression there is not the same difficulty because such policies as cheap and plentiful money and Budget deficits operate to the immediate personal advantage of many members of the community. In wartime, too, support is usually forthcoming for drastic measures, when the people are under the impulse of patriotic motives. (Paragraph 937.)

1042. The Commission considers that the Government will find it necessary to finance, from taxation, an increasing proportion of its expenditure, including capital expenditure, and we think that this should be clearly explained to the public in the Budget and in other reviews of the public finances. (Paragraph 944.)

1043. We consider there is room for further improvement in the presentation of statements showing the effects and explaining the purposes of Government financial transactions. (Paragraph 945.)

1044. There should be a continuous and systematic explanation of Government monetary and other economic policies and their purposes against the background of national circumstances. (Paragraph 948.)

1045. Whatever machinery is set up to assist or advise the Government on questions of financial and economic policy, the responsibility for policy decisions and for explaining them to the public rests with the Government itself. (Paragraph 951.)

Conclusion

1046. The foregoing summarises the conclusions and recommendations of the Commission, arrived at after a close examination of the New Zealand monetary, banking, and credit systems.

1047. In presenting this report the Commission acknowledges the most valuable assistance it has received not only from the evidence of those who were invited to explain the existing systems, but also from the submissions of those who advocated changes or alternatives.

1048. The Commission trusts that this report will serve to bring about a better and wider understanding of the monetary, banking, and credit systems, and that it will be of assistance to those charged with the heavy responsibility of promoting the "economic, financial, and social welfare of the people of New Zealand".

APPENDICES

Appendix A

WITNESSES WHO APPEARED AT THE PUBLIC HEARINGS AT THE DIRECT REQUEST OF THE COMMISSION

	Organisation Represented
Mr B. C. Ashwin	The Treasury.
Mr Colin Clark	......
Mr E. C. Fussell	Reserve Bank of New Zealand.
Mr F. H. Mullins	New Zealand Stock and Station Agents Association.
Mr E. C. W. Nathan	Stock Exchange Association of New Zealand.
Mr L. G. Oxby	Life Offices Association.
Mr J. M. Peterson	Dunedin Savings Bank.
Mr P. L. Porter	Capital Issues Committee.
Mr T. N. Smallwood	State Advances Corporation of New Zealand.
Mr F. E. Sutherland	Associated Savings Banks of New Zealand.
Mr A. B. Taylor	Local Government Loans Board.
Mr H. W. Whyte	Associated Banks in New Zealand.
Mr G. E. F. Wood	Department of Statistics.

WITNESSES WHO APPEARED AT THE PUBLIC HEARINGS AT THEIR OWN REQUEST TO PRESENT THEIR VIEWS OR THOSE OF SOME ORGANISATION OR OTHER PERSON

	Organisation or Person Represented
Mr L. Adams, Auckland	......
Mr A. E. Aiken, Waverley	......
Mr F. Allen, Auckland	......
Mr W. Appelbe, Raglan	......
Mr G. Aubury, Torbay	......
Mr B. Beckerleg, Auckland	Dominion Empire and World Federation.
Mr J. Begg, Dunedin	......
Mr R. W. Bolton, Tauranga	......
Mr E. W. Boulton, Auckland	......
Mr W. B. Bray, Auckland	......
Mr D. Brophy, Auckland	......
Mr J. R. Burfitt, Auckland	......
Mr L. Butler, Inglewood	......
Mr W. S. Cederholm, Wellington	......
Mr C. W. Clift, Hastings	British Israel World Federation (N.Z.) Incorporated.

	Organisation or Person Represented
Mr P. Cropper, Auckland .	......
Mr R. E. Dawson, Wellington .	Harbours Association of New Zealand.
Mr S. Dellabarca, Eastbourne .	......
Mr G. W. Dodds, Wellington .	Board of Promoters of an organisation to be called New Zealand Incorporated.
Mr A. K. Dyne, Christchurch .	......
Dr J. C. Finlay, Auckland .	......
Mr T. N. Gibbs, Wellington .	Ex-shareholders Committee of the Bank of New Zealand.
Mr O. G. Hansen, Orini . .	......
Mr J. Hogan, Wellington . .	......
Mr W. J. Hyde, Wellington .	......
Mr D. J. Janus, Palmerston North	......
Miss M. H. M. King, Dunedin Mr R. G. Young, Hamilton	New Zealand Social Credit Association Incorporated
Mr A. Leigh Hunt, Wellington .	Dominion Settlement and Population Association Incorporated.
Mr G. E. Littlejohn, Wellington .	......
Mr J. F. Lockington, Christchurch	......
Mr A. F. Long, Auckland .	......
Dr R. G. McElroy, Auckland .	......
Mr W. P. MacDougall, Hamilton	......
Mr M. G. Mackay, Days Bay .	......
Mr G. L. Marshall, Marton .	......
Mr G. V. Mullenger, Auckland .	......
Mr W. S. Otto, Auckland .	Mr H. J. Kelliher and The Mirror Publishing Co. Ltd.
Sister C. Peters, Wellington .	......
Mr A. V. Pettman, Auckland .	......
Mr H. L. Pickering, Scargill .	......
Mr A. G. Potter, Waiuku . .	......
Mr M. G. T. Priest, Thames .	......
Mr W. Robinson, New Plymouth	......
Mr A. G. Sainsbury, Auckland .	......
Mr B. A. K. Savage, Wellington .	Wellington Trust, Loan, and Investment Co. Ltd., the Equitable Building and Investment Co. Ltd., and the Wellington Investment, Trustee, and Agency Co. of New Zealand Ltd.
Mr D. Seymour, Hamilton .	New Zealand Society for Economic Individualism.
Mr J. T. Shaw, Invercargill .	Invercargill Savings Bank.
Mr T. F. Simpson, Lower Hutt .	......
Mr H. Stewart, Auckland . .	......
Mr N. B. Stocks, Christchurch .	......
Mr R. E. Taylor, Auckland .	......
Mr W. H. Thompson, Hamilton .	......
Mr P. E. Tingey, Wellington .	......
Mr J. Turnbull, Wellington .	New Zealand Public Service Association Incorporated

Name	Organisation or Person Represented
Mr F. P. Walsh, Wellington	New Zealand Federation of Labour.
Mr W. Weld, Christchurch	......
Mr L. K. Wilson, Piopio	......
Mr N. M. Wordsworth, Te Kopuru	......

COUNSEL WHO APPEARED AT THE PUBLIC HEARINGS, AND THE PERSON OR ORGANISATIONS THAT THEY REPRESENTED

Counsel	Organisation or Person Represented
Sir Wilfrid Sim, Q.C.	Associated Banks in New Zealand.
Dr O. C. Mazengarb, Q.C.	Mr H. J. Kelliher and The Mirror Publishing Co. Ltd.
Mr F. B. Anyon	British Israel World Federation (N.Z.) Incorporated.
Mr W. L. Ellingham	Wellington Trust, Loan, and Investment Co. Ltd., the Equitable Building and Investment Co. Ltd., and the Wellington Investment, Trustee, and Agency Co. of New Zealand Ltd.
Mr F. C. Jordan	New Zealand Social Credit Association Incorporated.
Mr D. R. Hoggard	Bank of New Zealand.
Mr S. M. Macalister	Invercargill Savings Bank.

Appendix B

PERSONS OR ORGANISATIONS WHO MADE WRITTEN SUBMISSIONS TO THE COMMISSION

Name	Major Submissions
Mr S. J. Attenborrow, Mangonui	The Government should create its own credit and not borrow from the trading banks.
Mr H. F. Bateman, Hastings	Abolish half-pennies and substitute penny half-penny coins; banks to pay interest on current account deposits.
Mr L. Brittain, Oratia	Internal currency should be completely independent of overseas currency; all currency to be free from political control.
Mr E. M. Broadbent, Tolaga Bay	Money is defined as a debt, ultimately recoverable from the assets of the debtor; coin is the only possible debt-free money.
Mr E. A. Brown, Tikipunga	An Upper House should be re-established in Parliament, consisting of two or three Godly Jews and the remainder Godly Christian Gentlemen to deal with finance; the United States and the Commonwealth should be closer together spiritually.
Mr N. S. Brown, Pleasant Point	Average tax assessment to be fixed for each trader; profit above this to be taxed at a decreasing rate.
Mr A. J. Butterfield, Hawea Flat	The whole banking system should be run by the State; honest international trading is essential.
Mr M. E. Constanticatos, Athens, Greece	The gold standard is a *"straight jacket"* under which the central bank and the trading banks pursue divergent policies; credit substitutes cannot fill a gap arising from deficient gold production; the *"fantastic and arrogant endeavour to subject the wealth value of gold to conscious management"* in the late twenties and early thirties led to world-wide economic nationalism.
Mr G. S. Crimp, Wellington	Local Body Corporation, Industrial Finance Corporation, and Mortgage Corporation to be established; present Government loans have drawbacks as gilt-edged securities; field of approved trustee securities needs widening.
Mr A. A. Currie, Wellington	Independent Social Credit submission; abolish taxation and create credit for Government annual outlay; obtain development moneys by loans from the public.

Name	Major Submissions
Mr K. T. Cusack, Oamaru	Gold mining should be encouraged to improve overseas currency earnings; progress payments to prospectors and subsidy on gold produced.
Mr K. W. Dalrymple, Bulls	To simplify farming income returns, the end of the taxation year for farmers should be changed from 31 March to 31 July.
Mr F. Dawson, Angaston, Australia	Issue of a national dividend direct to consumers; price control would be necessary; restraints on use of manpower should be removed.
Mr L. G. de Garis and Dr M. C. de Garis, Geelong, Victoria, Australia	The unit of money to be based on the unit of labour; money then will be accessible to all workers as a credit, not a debt; reconsideration necessary of the effects of "Double Account" book-keeping.
Mr W. Delaney, Runanga	All countries should adopt a universal guaranteed standard of currency; new money should be issued for development works and cancelled later if inflation exists; the State should press ahead with Crown land development.
Mr J. H. de Marr, Auckland	The money system should be based on the security of real property; a Money Board should be established in each main city in New Zealand; interest on the mortgage bank notes would be the main source of future Government and local body income; the banks and lending institutions would relend this money as they do now; transport should be financed by an annual tax on every dwelling and a sales tax on property as well as by fares.
Mr L. Duggan, Auckland	A limited inquiry into monetary affairs cannot produce anything beneficial; an open public Commission of Inquiry is necessary to establish a new moral order of civilisation.
Mr J. S. Eliott, Middlemarch	A commodity-standard currency is recommended, the unit being fixed on an index figure representing the export value of meat, wool, butter, and cheese; decimal coinage; variable exchange rate to keep the return to the producers steady; an Exchange Commission to fix the rate from time to time.
Mr R. Ewing, Canterbury, Victoria, Australia	Abolish private ownership; guarantee the right to an individual to occupy a home and to obtain basic necessities; operate all activities without finance and financial profit; issue a basic weekly amount to all consumers, and a second form of purchasing power to active workers for goods other than necessities; cancel all purchasing power when used for goods or services.

Name	Major Submissions
Mr C. Farmer, East Bridgford, Notts., England	Establishment of a State-held commodity reserve to support and stabilise the value of a currency.
Federated Farmers of N.Z. (Inc.), Wellington	Government to curtail its spending; a new note issue is required; foster competition; protect essential local industries by tariffs; abolish import and exchange control; after all these have been done, free the exchange rate.
Mr A. N. Field, Nelson	The New Zealand money system should be related as closely as possible to the national production of real wealth; a commodity unit based on butter, meat, cheese, and wool should be established; internal bills of exchange should be included in Reserve Bank's reserve against note issue; 100 per cent reserve against bank advances; no surrender of sovereign control over money system.
Financial Publications Ltd., Wellington	Copy of an article on *Financing Local Bodies,* by E. F. W. Sumner, forwarded; this article suggests that the establishment of a Local Authorities Finance Corporation has considerable potentiality; other major recommendations made concern interest rates, income-tax concessions, Government guarantees, and overseas borrowing.
Mr A. C. Foddy, Taupo	Special assistance to the aged, including cheap money for the building of homes.
Mr D. Gilberd, Whangarei	Interest rates should be linked to cost of living; restrictions on farmers should be removed; wage payments should be based partly on hours, partly on results.
Mr A. E. Grassby, Winnipeg, Canada	Amortisation periods are frustratively below depreciation and dividend limits; the greatest evils are inadequate capital investment, inadequate amortisation of such investments, inadequate national debt, and the use of confiscatory taxation instead of voluntary and compulsory savings.
Mr D. P. Green, Auckland	Sufficient single immigrants should be brought into New Zealand to fill the thousands of vacant jobs; married immigrants only complicate the present problem.
Mr K. Grieve, Auckland	Reserve Bank to be the sole source of credit; the trading banks to lend only their cash in hand or by borrowing from the Reserve Bank; Reserve Bank credit to be directly available for Government and local body works and for housing.

Name	Major Submissions
Mr J. C. Guillet, Bradford, Yorkshire, England	Treasury to have the right to create interest-free money for Government and local body expenditure, but recover this in taxation at the end of each year; later, this scheme might be extended to agriculture, housing, and industry.
Sir James Gunson, Auckland	Abandon controls and import licensing; abolish the Capital Issues Committee and the Reserve Bank; free rates of interest; revise the Customs Tariff to protect and stimulate all essential economic useful secondary industries and to provide revenue without undue restriction.
Mr E. T. Hensman, Wellington	Mutual respect between labour and management is necessary. There should be more saving; in times of prosperity unnecessary expansion of capital expenditure should be controlled; deferred projects or direct credit issues could be used in less properous times.
Mr H. S. Herbert, Morrinsville	Interest should be abolished.
Mr M. Hewitt, Cambridge	Stability of the internal economy is important; the exchange rate should be free to find its own level; a Rural Bank or Rural Credit Union is suggested to finance farm development; financial policy should be subject to Government control at national level, but scope is necessary for mutual or private enterprise at lower levels.
Mr G. F. Holibar, Titirangi	Credits from the Reserve Bank and Bank of New Zealand for national and local body works to be available on an interest-free basis apart from actual cost incurred; a unit of financial wealth to be created for every additional unit of real wealth coming into existence.
Mr F. Holloway, Christchurch	New Zealand should have a currency pound of its own; the recent five-shilling pieces were issued in an illegal manner; *"credit pounds"* should be used to finance public utilities.
Mr F. E. Hooke, Kawau Island	The Commission should make a clear statement on bank lending and deposit creation; idle deposits at trading banks should be used interest free for Government works; did the wool freeze prevent inflation?; radio advertising cost should not be deductible; motor imports should be kept down.
Mr K. F. Hopper, Whangaparaoa	Raise interest rates; borrow £500 million from Britain for farm development. The Reserve Bank is preventing the trading banks from financing desirable farm developments.

Name	Major Submissions
Mr H. A. Hosking, Rotorua	Demonstrations of Social Credit principles forwarded.
Mr J. F. Johnson, Whangarei	Hospital Board loan finance for the next three to five years to be provided by a special Government loan; failing this the Hospital Boards' Association to set up a loans committee to put the suggestion into effect.
Mr N. Kelly, Tokomaru	Usury should be forbidden; the charging of interest abolished.
Mr B. H. Kingston, Auckland	A standard of value to be fixed as equal to one hour of unskilled labour; external exchange rates to be fixed in relation to wage rates in other countries; this system to be extended throughout the British Commonwealth.
Mr W. S. Lang, Auckland	An inconvertible paper currency method designed to stabilise the value of money is suggested to meet the problem of regulating labour and money within a proper background of law and order and of culture.
Mr W. Leach, Thames	Nationalise the banking system over the next three years; a limit of 4½ per cent on farm and other mortgages; all Government borrowing apart from Post Office Savings Bank to be from the Reserve Bank.
Mr J. Long, Dunedin	The Reserve Bank should have the sole prerogative of issuing currency; no interest should be charged on redeemable Reserve Bank advances to State and local authorities; Reserve Bank should not be subservient to Government.
Mr R. L. McEwen, Palmerston North	The charges made by the trading banks for the various services performed should be more closely related to the costs of the actual service given to each client; abolish inland exchange charge.
Dr R. McNair-Wilson, Sway, Hampshire, England	The amount of money in circulation should be, at all times, enough to prevent it acquiring any scarcity value of its own; the British Commonwealth should work together to promote the maximum exchange of goods and services.
Mr R. C. Macfarlane, Napier	Debt-free finance – *"Service Credit"* – to be used for Government and local body works and for repayment of Government debt.
Mr J. W. Marshall, Palmerston North	Financial speculators use the credit of the community to exploit the public.
Meat and Wool Ltd., Wellington	Copies of two leading articles supplied – one comments on Kelliher booklet *Why Your £ Buys Less and Less*; the other points to the low financial return received by many farmers for extra work they may put in.

Name	Major Submissions
Mr W. T. Metcalfe, Onewhero	The causes of inflation are social security payments, monopolies, shortage of manpower, enormous company profits, advertising, low rates of interest, and sheltered industries.
Mr O. Metzger, Nelson	Refers to an article by Philip Pye, M.A., on Gesell's *Free Economy*. Would abolish interest by making the use of money as a means of saving impossible; this *"Free-Money"* would depreciate at a fixed rate, say, 5 per cent per annum.
Mr A. W. Moore, Frankton Junction	A special farm finance department to be set up in the Bank of New Zealand; this would not be subject to the credit restrictions imposed from time to time on a national basis; or extended operations of the State Advances Corporation to provide all farm finance on a more liberal scale.
Mr S. J. Moore, Nelson	Points out the depreciation in the value of an insurance policy taken out in 1919.
Mr W. T. Morpeth, New Plymouth	New Zealand pound to be at a premium with sterling; exchange alteration to be carried out as a normal function of financial policy.
Mr R. A. Morrison, Dunedin	The true facts relating to the establishment of the Reserve Bank should be published to preserve its integrity.
Mr C. M. Moss, Takapau	Remove all controls that restrict the free importation of goods and materials; declare that the Reserve Bank note is legal tender to any amount; Reserve Bank to declare a buying and selling rate for gold.
Mr H. S. Newbury, Norfolk Island	All money should be interest free at its source; it should also be debt free at its source to repay the Government and local body debts and to finance consumer credits.
Mr E. I. Nilsson, Kaitaia	Non-productive works should be financed from current revenue, not by borrowing; industries should be less highly protected; New Zealand must populate or perish.
Northland Hospital Board, Whangarei	A Local Bodies Loan Corporation, free from political control, to be established; money to be raised from the public by £5 bearer bonds and annual issue of debentures or stock; Corporation to have power to accept sinking funds and reserves for investment.
N.Z. Financial Times Co. Ltd., Wellington	Forwarded copies of articles by Dr R. G. McElroy. (Dr McElroy later appeared at the public hearings of the Commission.)

Name	Major Submissions
Mr K. O'Brien, Hastings	All future production to be financed by 100 per cent advance from the banks; depreciation on capital assets at fixed rates to be paid to the banks and cancelled; no controls over prices or profits.
Mr J. C. Parcell, Cromwell	Reserve Bank interest-free credits for Government and local body capital purposes, repayable by an annual sinking fund; similar interest-free finance for housing and farming; an Empire Exchange Pool to facilitate Commonwealth trade.
Mr I. V. Payne, Auckland	Non-revenue-producing projects should be financed by rates or taxes; revenue-producing projects should be financed from a common pool guaranteed by the common wealth.
The Peacemaker Foundation, Palmerston North	Suggested that this Commission should make an interim report; that a committee of experts should be appointed to examine monetary theory in the light of the potential of the radiation age; that the committee's report be published and the public hearings reopened in twelve months time.
Mr A. C. Pegler, Rotorua	Payout to meat producers to be reduced in buoyant times; reduce legal barriers imposed by lending institutions on house-building loans.
Mr A. R. Perry, Lower Hutt	Biblical and other quotations directed against usury or interest on loans and supporting Social Credit principles.
Mr C. E. Phillips, Auckland	A comprehensive submission covering the establishment of a company called New Zealand Ltd. to control the nation's assets and to distribute the national income.
Mr J. Price, Auckland	Comprehensive submission covering twenty-six lines of suggested action dealing with many phases of monetary system.
Mr K. Redmond, Wellington	Interest on Government loans to be adjusted from time to time to correspond with current market rate.
Mr S. Riddle, Kerikeri	The State, through a non-political authority, to have the sole right to create money.
Mr J. A. Ritchie, Auckland	The trading banks should be restrained from making large profits by using the peoples' credit.
Mr H. J. Robinson, Hamilton	All wages paid to be at award rates of pay and at ordinary time rates.

Name	Major Submissions
Dr W. P. Roelofs, Soest, Netherlands	Full employment is based on adequate and effective demand which, in a money economy, is determined by monetary-financial factors; preceded by the socialisation of land ownership, a combination of a tax on money (Gesell), State grants to the public, and State borrowing from the public at adequate interest to grant it to the public again, is suggested to maintain a stable general price level and to lead to a rate of interest equal to zero.
Mr T. Shaw, Westport	The *man-hour* to be used as a standard of value; Government works to be used to provide employment when necessary.
Mr J. J. Smith, Hawera	No more borrowing from overseas; no restriction on credit; reduce interest rates for house building.
The Social Sciences Movement of Australia, Kew, Victoria, Australia	Governmental action to establish open markets; control the general price level by controlling note issue; and adopt businesslike taxation.
Mr B. E. S. Tait, Dunedin	All emergency and abnormal expenses such as arise in wartime to be paid by a special issue of State-guaranteed money redeemable over twenty years by a 5 per cent taxation levy; the Christian principles of preventing usury and fostering goodwill and commonsense to be followed.
Mr G. K. Tavender, Black Hill, South Australia	There is a persistent shortage of purchasing power which can be bridged by the issue of debt-free money by the Reserve Bank to the Government for its expenditure and for the stabilisation of prices.
United Dominions Corporation (South Pacific) Ltd., Wellington	Pointing out that the company was engaged in industrial finance in New Zealand; that further financial assistance without inflationary consequences could be given if certain conditions were met.
Mr J. E. Van Panhuys, Havelock North	A postal current account system similar to that in the Netherlands should be established in New Zealand.
Sir Alliott Verdon-Roe, Hampshire, England	Debt money is the root cause of inflation, heavy taxation, strife, and war; the general level of prices will determine how much new debt-free money can be issued from time to time; Postal money should replace cheques and reduce taxation.
Mr E. C. Wadsworth, Takaka	Governments have made too large a proportion of the people dependent on the State; there is too much money in the hands of young people; our natural resources are being depleted beyond reason.

Name	Major Submissions
Mr W. H. Wakinshaw, Surbiton, Surrey, England	*"Consumer money"* is suggested to divert the increase in production to its rightful owners in the individual and the community; a comprehensive economic and monetary policy for New Zealand is outlined.
Wanganui Electors' Association, Wanganui	Arbitration Court, with expert assistance, to draw up national balance sheet to show any shortage in peoples' purchasing power; Reserve Bank to issue debt-free money to make up any ascertained shortage.
Mr I. W. Weston, Christchurch	Supports the principle of an international commodity currency to facilitate world trade and stability of international markets.
Mr P. Williams, Timaru	The economic advantage of teaching Esperanto to New Zealand youth.
Mr C. F. Woods, Nelson	The need for the issue of new debt-free money is indicated by the wages lost from unemployment; debt-free money should be issued for both capital expenditure and wages (including relief).
Dr F. P. Worley, Taupaki	It is the rapidity of the present changes and not their nature or direction which is the chief cause of present trouble; depreciation in the value of money as a consequence of past happenings is inevitable; manipulation of currency to increase inflation or long-term fixing or control of major components of the system should be resisted; the elements of instability in our capitalistic system constitute its source of power; the trading banks must be strong but must not misuse their power.

Appendix C

THE DEFINITION OF "MONEY" AND A HISTORY OF THE MONETARY, BANKING, AND CREDIT SYSTEMS IN NEW ZEALAND FROM 1934 TO 1955

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Section One: Expansion and Contraction of the Supply of Money

I. WHAT IS MONEY?

1. Since money is such an important factor in our lives, it may seem surprising that it is difficult to decide just what money is. But, in practice, it is not a simple task to draw the line between things which are obviously money and those which are nearly money but not quite.

2. The only things which must legally be accepted in payment are Reserve Bank notes and coin. Even with coin, there are limitations, for a tender of payment is legal tender only up to forty shillings in silver and cupro-nickel coin and up to one shilling in bronze coin.

3. But in everyday usage money is anything which is immediately available and generally acceptable in payment for goods and services or in settlement of a debt. A definition confined to legal tender money would exclude deposits on current account, transferable by cheque, which are the most important means of payment in use in New Zealand today. These are entries in the books of a bank acknowledging the indebtedness of the banker to clients who have lodged notes, coin, or cheques in their accounts at his bank, or sold him foreign exchange or some other asset. When he is directed to do so by cheque, the banker will immediately supply notes or coin or transfer to other persons sums standing to his client's credit. Since these current account deposits are immediately available and generally acceptable, and since nowadays a very large proportion of transactions is financed by transfers of such deposits by cheque, there is obviously a strong case for including them as part of the supply of money.

4. Accordingly, the Reserve Bank has chosen the following items as the components of the money supply in New Zealand:

(a) The coin in circulation;

(b) The value of notes issued by the Reserve Bank minus those held by the trading banks to pay out to customers who want to convert deposits into notes;

(c) The "demand liabilities of the Reserve Bank" (excluding the deposits held there as a reserve by the trading banks), which is another way of saying the credit balances of the Government, some of its Departments, and certain statutory marketing organisations which have the privilege of banking with the Reserve Bank; and

(d) The "demand liabilities of the trading banks", which means the deposits of customers on current account at the trading banks.

5. There is, however, no universal agreement on what should be included in the money supply. Most countries agree that coin, notes in circulation, and demand liabilities of the trading banks are money. But many (e.g., Canada, the United States, and Ceylon) exclude Government deposits at the central bank; and others include items which are left out in New Zealand (e.g., Australia includes time deposits with the trading banks and deposits with all savings banks).

6. For New Zealand, we consider that it is appropriate that Government deposits at the Reserve Bank should continue to be regarded as part of the money supply for statistical purposes. Presumably they are excluded overseas because Governments may sometimes accumulate balances at the central bank as an anti-inflationary measure; but in New

Zealand, at least up till the present, it is more reasonable to regard the Reserve Bank's demand liabilities, apart from the trading banks' deposits there, as sums liable to be spent in the near future.

7. We consider that it would also be desirable in future to include the unexercised portion of overdraft authorities granted by the trading banks. In some other countries, when a trading bank makes a loan, it credits the customer's account to the full amount of the loan and he pays interest on this amount until it is repaid. Current account deposits, and therefore the volume of money, are immediately increased by the full amount of the loan whether or not the deposits are immediately or fully used for payments. In New Zealand, the practice is for the banker to grant his customer an overdraft limit, i.e., authority to overdraw his account up to a specified amount, the borrower paying interest only on the amount by which he is overdrawn at any time.

8. But the unused limit is, in principle, similar to a deposit standing to a customer's credit at the bank. He may at any time draw cheques up to the authorised amount, and the sums so drawn will be just as acceptable as cheques drawn against a deposit account. It may be argued that some of the unexercised overdraft authorities are purely nominal and not likely to be fully used. This is true, but we have been informed in evidence that many deposits on current account at the trading banks also lie idle for fairly long periods. What matters, according to the definition of money which we have adopted (and the Reserve Bank approves one which is very similar) is that the thing concerned should be "immediately available and generally acceptable in payment". Unexercised overdraft authorities clearly satisfy these criteria.

9. A fairly strong case can also be made for including in the volume of money savings-bank deposits, which can be withdrawn on demand, and deposits on call at various trading concerns, such as stock and station agents. In particular, deposits at the Invercargill Savings Bank are transferable from one customer to another by cheque and so appear to satisfy our criteria of moneyness. In general, however, savings-bank deposits themselves are not generally acceptable in payment. Withdrawals are made in the form of notes or coins from savings-bank tills, or, for larger payments, in the form of cheques drawn on the balances which the savings banks hold at the trading banks or, in the case of the Post Office, at the Reserve Bank – and all of these are already included in the volume of money. Similarly, some stock and station agents allow customers to transfer deposits placed with them to other people by order or cheque. Normally, however, such a transfer would at the same time involve the transfer to the payee of a deposit to the credit of the agency firm at a trading bank – and this is already included in the volume of money.

10. On balance, then, we feel that the Reserve Bank is justified in excluding deposits at savings banks and trading companies in its calculations of the money supply. But they are obviously important sources of purchasing power (e.g., about £113 million was withdrawn from the Post Office Savings Bank alone in the year ended March 1955) and the total of these deposits must certainly be taken into consideration by anyone who is attempting to estimate potential demand for goods and services. In this connection, it is surprising that there are no reliable figures of the total value of deposits on call at stock and station agencies and other trading concerns. This is an omission which we recommend should be remedied as soon as possible.

11. There are other things which can be fairly quickly converted into money but which are not themselves money. For example, time deposits at the trading banks or at some other financial institutions are in theory not available for withdrawal until an agreed period has expired. In practice, it is possible in special circumstances to arrange for a release from such an agreement but since this does not appear to be customary, it seems preferable to exclude time deposits from the money supply. Again, Government securities and some company shares can be converted quickly – although not necessarily without loss of capital value – into money by sale on the Stock Exchange, but it would be unreasonable to class them as money.

12. When all this is taken into account it is clear that the selection of items for inclusion in official statistics of the money supply must be to some extent arbitrary. As the Statistics Division of the International Monetary Fund has appropriately stated, *"assets put in the category of money are not money to some holders and assets excluded from the category of money are money to others. Since there is no wholly satisfactory definition of money, there is no clear boundary to separate the monetary system from financial institutions of all kinds"*. We shall return to the importance of this point when we discuss the "creation of money".

II. HOW OUR MONEY SUPPLY COMES INTO EXISTENCE

13. The evidence given before the Commission has made it obvious that the way in which our supply of money comes into existence is not generally understood. Many witnesses seemed to think that the trading banks have a monopoly of the creation and destruction of money and that all money is created as an interest-bearing debt to the trading banks. Some argued that, if they wished, the banks could greatly increase the money supply without cost to themselves; one of the official Social Credit witnesses went so far as to say that a trading bank did not require either shareholders' funds or deposits to enable it to create money. In the light of statements such as these, it seems desirable to discuss in some detail the means by which our money supply may be expanded or reduced.

COIN AND NOTES

14. The right to mint coin is a prerogative of the Crown. Nowadays coin comprises only a very small proportion of the total volume of money; and its supply is varied purely in accordance with the public demand for it. The Reserve Bank advises the Treasury from time to time how much coin it estimates will be required by the public, and the Treasury orders the necessary supplies from the Royal Mint. These are sold to the Reserve Bank at their full nominal value for distribution and the Reserve Bank in turn sells them to its customers, especially the trading banks and the Post Office Savings Bank, when they find it necessary to replenish their supplies to meet the demands of their depositors for coin. The trading banks and the Post Office pay for the coin by drawing on their deposits at the Reserve Bank.

15. Until 1934 each trading bank in New Zealand issued its own notes, but from 1 August of that year the Reserve Bank became the sole note-issuing authority. As with coin, the supply of notes varies solely in response to the demands of the public. If their customers want to convert a larger proportion of their deposits than usual into notes, the trading banks and the Post Office Savings Bank must buy the notes from the

Reserve Bank at their full nominal value, by drawing on their deposits there. In transactions of this kind, no change takes place in the total volume of money; the value of notes and coin in circulation increases, but this is offset by a fall in customers' demand deposits at the trading banks or in the deposits of the Post Office at the Reserve Bank. As is shown in the table given in Section Four of the report, the value of notes and coin in circulation has risen considerably since 1935. It will be observed, however, that the proportion of notes and coin to the total money supply has remained fairly constant at about 20 per cent. The increase in the value of notes and coin in circulation is an indication of increased spending by the public and is mainly a reflection of the increased volume of bank deposits which has been generated during the period.

BANK MONEY

(a) *The Creation and Destruction of Bank Money*

16. Bank money is the most important type of money in existence today. This includes demand deposits at the trading banks and at the Reserve Bank (except for the reserves of the trading banks at the Reserve Bank) and unexercised overdraft authorities. Bank money may be created in four main ways:

(i) When a customer lodges notes or coin to the credit of his account with a bank. This transaction does not affect in any way the total volume of money, because the notes or coin have merely been withdrawn temporarily from circulation.

(ii) 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 or the proceeds of a loan raised with an overseas lender. These transactions increase the volume of money as new bank money has come into existence.

(iii) 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. These transactions increase the volume of money as new bank money has come into existence.

(iv) 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 or coin.

(v) When a trading bank grants an overdraft limit to a customer. The volume of bank money increases immediately because the customer is then in a position to draw cheques against the overdraft authority to the amount of the limit granted to him. On the Reserve Bank definition, an increase in the volume of bank money does not occur until the borrower spends the money advanced and the recipient lodges the cheque with his bank as a demand deposit. This transaction also increases the volume of money because the customer has acquired purchasing power which he did not possess previously.

For the sake of clarity it has been assumed in each of the examples given above that the customer of the bank is making the lodgment in a credit account. If, however, the customer is working on a bank overdraft, bank money is still increased unless the customer's overdraft limit is at the same time reduced by an amount corresponding with the lodgment.

17. Conversely, the volume of bank money may be reduced:

(i) By customers converting their demand deposits or unexercised overdrafts into notes and coin;
(ii) By customers buying, with deposits or unexercised overdraft limits in their name at the trading banks or the Reserve Bank, overseas exchange to meet obligations overseas;
(iii) By banks selling their holdings of securities or other assets;
(iv) By a reduction of advances by the Reserve Bank; or
(v) By a reduction of overdraft limits by the trading banks.

18. It is important to recognise the difference in the effect on the volume of money between lending or the purchase of assets by a bank on the one hand and lending 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., the supply of bank money existing before the transaction is not affected, 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 overdraft limit from 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.

19. We should note that the well-known maxim that every bank loan creates a deposit and therefore increases the volume of money is subject to many qualifications; for an advance may be used to buy overseas exchange; or a cheque drawn against the overdraft may be used by the recipient to wipe out an overdraft; or notes and coin may be withdrawn from the bank by the borrowers and retained in circulation by the public. In none of these cases are deposits increased. Nor does every repayment of a bank loan involve the destruction of a deposit; for repayment may be made from a new advance or as the result of the lodgment of overseas exchange with the bank or as the result of the lodgment of domestic currency previously held in circulation by the public. But, in general, it is true that, when banks increase their lending or their purchases of other assets, the volume of demand deposits and, therefore, the volume of money is increased; and that, when their lending or purchases of other assets is reduced the volume of demand deposits and, therefore, the volume of money is reduced.

(b) *The Principles of Commercial Banking*

20. 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. The principal functions of a trading or commercial bank today are similar to those which certain goldsmiths began to undertake in England at about that time, in that:

(i) They receive and take custody of money on behalf of customers, who thus avoid the risk of loss or theft involved in keeping notes and coin on their premises or person.

(ii) They exchange overseas money for domestic money and, vice versa, for customers who engage in business or travel overseas.

(iii) They provide their customers with a convenient means of payment, by undertaking to transfer sums standing to the customer's credit at the bank to other people, when directed to do so by cheque. (In times past, the trading banks could also issue notes to their customers in exchange for coin deposited with them, but the provision of notes is now, nearly everywhere, the monopoly of a central bank.)

(iv) Within limits, and subject to various controls, they make loans to people or firms deemed credit worthy; and lend to the Government or local bodies by buying their securities.

21. The main reason why a bank is able to make the latter loans is that, although its depositors can at any time withdraw their deposits in legal tender money or require the bank to transfer their money to customers of other banks, the banker, in practice, is called upon to pay out very little legal tender money in normal circumstances. This is so for several reasons:

(i) A few customers will never use the sums which they have deposited and some will let them lie idle for considerable periods. Evidence given by the Chairman of the Associated Banks and the Governor of the Reserve Bank indicated that, early in 1955, there were deposits of between £60 million and £85 million which had remained inactive in the accounts of customers of New Zealand trading banks for a considerable period of time.

(ii) Especially in a community where there are only a few banks, many of the cheques drawn by customers will be paid to other customers of the same bank. In these cases the bank will not have to transfer legal tender money to other banks, but merely debit one customer's account and credit another's.

(iii) Even though customers are constantly withdrawing notes and coin or making payments to customers of other banks, they are also constantly making further deposits of notes, coin, or cheques drawn on other banks, which more or less offset the withdrawals.

22. Thus, a banker can normally be certain that, on balance, he will have to convert only a very small proportion of his customers' deposits into notes and coin at any one time. He has no need, then, to keep a reserve of coins and notes equal to the total of the deposits standing to the credit of his customers; he can obviously lend some money out at interest for short periods without any danger of his being unable to meet his customers' demands for notes and coin as required.

23. Loans could be made either directly in notes and coin or by giving the borrower a title to notes and coin. Most borrowers find the latter more convenient and take their loans in the form of an overdraft limit with the bank which they can draw on by cheque at any time. Whichever method of lending he adopts, the banker obviously incurs more promises to repay notes and coin than he could immediately honour at any one time if all his depositors chose to ask for repayment at once. Also, whichever method of lending he adopts, he obviously increases the amount of money available to the community when he increases his loans. The people who have left money with him still have the deposits with which he has credited them and which they can use at any time to make payments; but he is either issuing more bank money or putting into circulation some of the notes and coin to which others already hold title. He can thus be said to be creating money as a result of his lending.

24. The fact that banks "create money" in this way is not a new discovery, as some witnesses implied. For example, in the *Economic Writings of Sir William Petty* (1623–87), Vol. II, page 446, we find:

Question 26:

What remedy is there if we have too little Money?

Answer:

We must erect a Bank, which well computed, doth almost double the effect of our coined Money.

And Francis Cradocke, a London merchant appointed by Charles II as a member of the Board of Trade, said:

A Banke is a certain number of sufficient men of Credit joined together in a stock, as it were, for keeping several men's cash in one Treasury and letting out Imaginary Money (i.e. Credit) at interest for three or more in the hundred per annum, to tradesmen or others that agree with them for the same; and making payment thereof by assignation, passing each man's account from one to another, yet paying little money.

Mr H. D. Macleod, from whose book *The Theory of Credit*, written in 1894, the above quotation comes, defined a banker as *"A Trader who buys Money and Credits, Debts or Rights of action payable at a future time by creating and issuing Credits, Debts, or Rights of action payable on demand"*. Several other quotations on this subject are given in Part II of Appendix D.

(c) *The Limits to the Creation of Money*

25. The more a banker lends, the more profit he can make, but the more also he contracts to repay or transfer in legal tender money. In the past, some bankers have gone beyond the bounds of prudence in their lending and, faced with a more rapid demand than they had expected by their customers for notes and coin or for transfers of their deposits to customers of other banks, have found themselves with insufficient reserves, and unable to call in their loans quickly enough to fulfil their obligations. Their depositors' faith in them having gone, they were forced to close their doors (e.g., according to one authority in the United States, where there are many small local banks, *"the history of bank failures and losses to depositors has been a grievous one . . . only about one half the banks in existence in 1915 are still solvent"* (in 1955). New Zealand has been fortunate in the relative stability of its banking system. The financial strength of the trading banks here has never been called into question

since the 1890's, but, at that time, the Bank of New Zealand was kept in operation only through the help of the State, and the Colonial Bank had to be wound up, its sounder accounts being taken over by the Bank of New Zealand.

26. It was soon learned that the primary duty of a banker – and a basic necessity if bank lending was to be possible at all – was to safeguard the deposits entrusted to him. If depositors began to fear that their banker could not meet their demands for legal tender money or transfers of their deposits, they would naturally want immediately to convert their deposits into money which was generally acceptable, rather than retain title to notes or coin which might be repudiated when presented. A "run on the bank" would begin. The large-scale withdrawal of notes and coin would destroy the basis on which the banker's lending had been built and force him to call in loans, often at great inconvenience to the borrowers, in order to meet his commitments to depositors.

27. Prudent bankers, therefore, always keep reserves of bankers' cash (i.e., notes, coin, or balances at the central bank) and of overseas exchange, which bear a reasonable proportion to their customers' deposits. A banker's lending is therefore obviously limited by the amount of legal tender money which people are willing to leave with him, and by the availability of credit-worthy borrowers who want the type of relatively short-term loan which he is prepared to make. Once the ratio between his reserves of banker's cash and overseas exchange and his liabilities to repay are at the minimum which he has found to be prudent, he can lend no more unless he obtains more reserves. Naturally, competition between bankers to acquire reserves as a basis for lending has led to the virtual elimination of charges for keeping deposits. In some cases it has led to the payment of interest on deposits, especially when a person is willing to leave money on deposit for a stipulated period, thus reducing the immediate risks of the banker's being asked to pay out legal tender money to customers or to other banks.

28. The banker is unable to create unlimited amounts of money by a stroke of his pen as sometimes alleged. Before he can lend to any extent he must have substantial reserves which he can maintain only if a substantial volume of deposits is left with him by his customers. And his customers are willing to leave deposits with him only if they know that they can make payments with them or convert them into notes and coin on demand. The banker thus attracts the deposits necessary for lending primarily by providing an acceptable means of payment. It has truly been said that the "success of the banker as a provider of means of payment depends upon his success as a lender and borrower; and his success as a lender and borrower depends upon his success in providing a means of payment. The two aspects of his business are interdependent".

29. The fundamental principles of bank lending outlined above have remained basically the same for three centuries and apply in New Zealand as in other countries. However, we must now examine the peculiar features of the New Zealand banking system and the principal changes which have taken place in the system since 1934.

(d) *Banking in New Zealand in 1934*

30. When the Parliamentary Monetary Committee reported in 1934, the Reserve Bank had not yet begun operation. The provision of both notes and bank money was still solely in the hands of the six trading banks which were operating in New Zealand at that time. As the Committee's report points out, the major factor then governing the lending of the banks and the supply of money available in New Zealand was New Zealand's overseas trading position. The notes and deposits of the banks were generally in practice, if not by law, convertible into sterling on demand in the same way as the goldsmith's notes and deposits had been convertible into gold in the seventeenth century. Sterling funds were therefore the basic reserves of the trading banks at that time. But, of course, only a proportion of their liabilities was likely to be converted into sterling at any one time. The banks could therefore lend to private individuals or to the Government, thus adding to the volume of money available. But, as is the case with all bankers, the extent to which they could lend was limited. Prudence demanded that a reasonable reserve of overseas exchange in relation to their liabilities should be maintained at all times. If they expanded their lending too far in relation to their sterling funds, they were in danger of creating a greater demand for overseas exchange than they could meet; for, by expanding their lending, they would facilitate greater spending on imports, either directly by some of those obtaining the overdrafts, or indirectly by some of those who obtained control of the extra money made available to borrowers who spent it within New Zealand.

31. The banks maintained offices in London which received the proceeds of sales of New Zealand goods and services overseas. The exporter would either be credited with a demand deposit or have his overdraft reduced at his bank in New Zealand to the extent of the New Zealand equivalent of his overseas earnings; the bank would add the sterling to its balances in London. On the other hand, New Zealand importers settled their debts to traders overseas through the banks. An importer would pay to his banker by cheque the New Zealand equivalent of his debt overseas, thus either reducing his deposits at the bank or increasing his overdraft; the bank would pay the overseas trader by drawing on its reserve of sterling in London. In addition, loans raised by the New Zealand Government or private citizens overseas would raise the sterling balances of the banks, and add to deposits or reduce advances in New Zealand; the opposite would apply when loans were repaid.

32. If New Zealand's overseas receipts exceeded the payments made outside the country during any period, the banks accumulated larger reserves of sterling exchange; at the same time, the deposits of customers tended to rise and advances in the first instance to fall in New Zealand as a result of repayment. But the rise in their reserves of sterling encouraged and enabled the banks to restore and increase their advances, if they could find credit-worthy borrowers. Thus, a surplus in the balance of payments generally led to easier credit conditions in New Zealand. The volume of bank money available in New Zealand rose (i) because of the extra deposits made available to people and firms in New Zealand as a result of the excess of overseas receipts over payments, and (ii) because people and firms were granted increased overdraft limits by the banks, which, when used, subsequently led to an increase in demand deposits or notes in circulation.

33. Conversely, if overseas payments exceeded overseas receipts, the banks' sterling reserves fell while, in New Zealand, advances in the first instance tended to rise as bank customers felt the need for accommodation and deposits to fall. When this happened the banks normally became more conservative in their lending policies to ensure that the drain on their sterling balances did not become so great as to force them to suspend the conversion of notes and deposits into sterling on demand. The volume of bank money then tended to fall (i) directly because of the excess of overseas payments over receipts, and (ii) because of the banks' decision not to renew some overdrafts which were repaid, leading to a fall in the overdraft limits, demand deposits, or notes available.

34. Thus, before the institution of the Reserve Bank, changes in New Zealand's balance of payments, and the consequential changes in the banks' reserves of foreign exchange, were the primary factors governing the volume of money made available in New Zealand.

35. With the provision of money entirely in the hands of six competitive trading banks, five of which had their head offices outside the country, and four of which were mainly Australian institutions, there was little possibility of a co-ordinated financial policy being adopted in the national interest. The tendency was for advances to be excessively expanded when export receipts were buoyant, and for advances to fall considerably when export receipts were reduced. Thus, monetary developments tended to accentuate, rather than to offset, the internal effects of economic fluctuations overseas. It was recognition of these defects that led the New Zealand Government in 1934 to set up a central bank which would have a monopoly of the issue of notes, act as the banker of the Government and of the trading banks, and control currency and credit in the national interest.

(e) *Banking in New Zealand Since 1934*

36. The setting up of the Reserve Bank in 1934 did not, of course, reduce the importance of New Zealand's trade position as a factor governing the volume of money and the national income in New Zealand; nor did it alter the fundamental principles of bank lending. But it led to some important changes in the structure of the monetary system which we must now consider.

37. We do not at this point deal in detail with the structure and functions of the Reserve Bank and the trading banks, but merely with those aspects of their business which have a direct bearing on the creation and destruction of bank money.

38. The Act establishing the Reserve Bank gave it a monopoly of the issue of notes in New Zealand. It was at first required to convert these notes into sterling on demand (at a rate of exchange to be determined by itself), and to keep a minimum reserve equivalent to 25 per cent of its notes and other demand liabilities in the form of gold and sterling exchange. (In 1950 the latter provision was altered and the bank was required merely to maintain reserves of gold or sterling exchange, or foreign money which could be converted into gold or sterling exchange, which in the opinion of the Board of the Bank would provide a "reasonable margin for contingencies after taking into account prospective receipts and disbursements of overseas funds, and having

regard to the economic position within New Zealand.") As a result of these provisions of the Act, the primary responsibility for safeguarding the exchange reserves of the banking system passed from the trading banks to the Reserve Bank.

39. The Reserve Bank also took over from the Bank of New Zealand in 1934 the banking business of the Government. It now held the deposits of the Government and its various Departments; it could make advances to or buy securities from the Government; it could buy securities itself on the open market in New Zealand; and later it was also given power to make advances to Government Departments or statutory organisations engaged in marketing primary produce. Thus the trading banks no longer had a monopoly of the creation of bank money in New Zealand.

40. Even before the Reserve Bank came into operation it could not have been said that the creation of bank money was purely a private monopoly, because the State had a controlling interest in the Bank of New Zealand which did the largest volume of banking business in the country, and which was eventually nationalised as from 1 November 1945.

41. But the creation of the Reserve Bank and its subsequent complete nationalisation in 1936 left no doubt not only that the Government could issue additional money through the Reserve Bank, but also that the actual amount of bank money put into circulation could be controlled by State authorities in the public interest.

42. The Government and the Reserve Bank obtained powerful weapons with which to regulate the ability of the trading banks to lend. For example, if the Government borrowed money from the Reserve Bank and spent it on public works, most of the Reserve Bank notes, or cheques drawn on the Reserve Bank, which were paid out to those doing the work, would eventually be lodged with the trading banks. The banks would present them to the Reserve Bank for payment and would be credited with the equivalent amount as a deposit. This deposit, which was in any case convertible into sterling, was just as good as an addition to their reserves of foreign exchange as a basis for extra lending to the public, if they could find sufficient credit-worthy people wishing to borrow.

43. Conversely, if the Government decided to accumulate at the Reserve Bank some of the money which it collected by taxation or borrowing from the public instead of spending it, the balances of the trading banks at the Reserve Bank would be reduced; for the cheques drawn on the trading banks by taxpayers or subscribers to Government loans would be paid by the Government into the Reserve Bank, which would take payment from the trading banks by reducing their balances at the Reserve Bank. Since the banks were still bound by the necessity to maintain a sufficient ratio between their reserves (which now included their balances at the Reserve Bank) and their obligations to their depositors, their ability to lend would also be reduced.

44. The trading banks were required by the 1934 Act to maintain at the Reserve Bank balances equal to not less than 7 per cent of their demand liabilities and 3 per cent of their time liabilities. Deposits to build up these balances could be made in the form of gold or foreign exchange or Reserve Bank notes (or in practice, of course, cheques

drawn by the Government on their balances at the Reserve Bank which could readily be converted into notes if desired). In special circumstances deposits could be made in the form of securities acceptable to the bank. The original purpose of these clauses in the Act was not mainly to provide a method of controlling the lending operations of the trading banks, but in the words of the then Minister of Finance:

> The centralisation of the cash resources of the commercial banks not only provides a method of control for the central institution, but greatly strengthens the whole banking system. In one pool the combined reserves will safely support a much greater credit structure than the same aggregate amount held by half a dozen banks. The analogy of a water-supply is appropriate. If everybody in a town had a few buckets of water and held on to them when a fire started, the whole town would be destroyed. If, however, the whole supply is collected in a central reservoir the outbreak could be dealt with effectively as soon as it was discovered. At present each commercial bank has to carry sufficient reserves to meet any possible financial strain, but with the central institution to fall back on an appreciably smaller cash reserve is needed.

45. An important change in this provision was made in 1936 when the Governor of the Reserve Bank was given power, with the authority of the Minister of Finance, to vary the proportions of their liabilities which the trading banks were required to keep at the bank, although he could not reduce these proportions below the original figures of 7 per cent and 3 per cent. This change made it possible for the trading banks' ability to lend to be varied directly by raising or lowering the minimum reserve ratios. The only country which had adopted such a system of variable reserve ratios before 1936 was the United States.

46. A simple example will illustrate the way in which variation in the ratios may influence bank lending. Assume that the banks have balances at the Reserve Bank of £7 million against their customers' demand deposits of £100 million and that the statutory minimum reserve ratio is 7 per cent in respect of demand deposits. (For simplicity, we shall ignore the requirement in respect of time deposits.) If the Governor of the bank and the Minister of Finance wish to reduce the level of bank lending, they may raise the ratio to say 9 per cent. The banks would then require a deposit of £9 million at the Reserve Bank to fulfill their minimum requirements. Since they cannot create £2 million of gold, overseas exchange, or Reserve Bank notes themselves, they are forced in the first instance to borrow that amount from the Reserve Bank to keep within the law, at a rate of interest prescribed by the Board of the bank. The Reserve Bank could, if it wished, vary the reserve requirements, and the rate of interest at which it would lend to the trading banks, in such a way as to make it completely unprofitable for the banks to continue borrowing from it. Thus the banks could be induced to take steps to avoid the necessity of borrowing from the Reserve Bank. They would be likely to attempt to build up their balances at the Reserve Bank and to reduce their customers' deposits by being more cautious in granting new overdrafts and by reviewing existing overdraft limits. They could also sell some of their securities or other assets or, as a last resort, call in advances from some of their customers. The Reserve Bank's ability to raise the minimum reserve ratios and the rate of interest at which it will lend to the banks therefore provides it with a powerful means of curbing lending by the trading banks if this is deemed desirable. Conversely, the power to lower the ratios again could be used if it was thought desirable to increase the trading banks' ability to lend.

47. The Government took other steps during the war to control the level and direction of lending by the trading banks. Firstly, in January 1942, with the co-operation of the trading banks themselves, a policy of selective control of bank advances was introduced by the Reserve Bank. This was designed to prevent the expansion of bank credit for speculative and luxury purposes, for purchases of property, and so on. Although it was not specifically designed to reduce or limit the total of advances it was bound to restrict their expansion to some extent. With some modifications this policy has been continued up till the present time. Secondly, from 1943 onwards, as a matter of Government policy, the trading banks were precluded from increasing their holdings of Government securities, and their existing holdings of Government stock were repaid as they matured. This policy has been continued up till the present time, with the exceptions that after 1950 the trading banks were permitted to maintain their existing holdings of Government stock and, in 1954, were invited to take up £12 million of State Advances Corporation stock.

48. As a result of these changes, not only is the ability of the trading banks to create bank money limited today, as in the past, by the necessity to maintain a prudent ratio between their reserves and their customers' deposits, but it can also be controlled in the public interest through variation by the Reserve Bank of the reserve ratios and its discount rate. Alternatively, the cash reserves of the trading banks and therefore their ability to lend can be increased or reduced by Government borrowing from the Reserve Bank on the one hand or by the Government building up balances or paying off its debt there on the other. Moreover, the direction of the trading banks' lending is influenced to some extent by the selective advance control policy and by control over the purchase of securities. These are important changes in the structure of the banking system in comparison with the situation existing before 1934.

49. It is important, however, not to over-emphasise the extent of the changes which have taken place in the past two decades. As we saw earlier, prior to 1934, the volume of bank money put into circulation in New Zealand depended mainly on the country's overseas trading position and the level of its exchange reserves. Some witnesses seemed to feel that these factors now neither did, nor should, influence the extent to which bank money could be created in New Zealand. For reasons given below we believe that this view is mistaken. It appears to have its roots in circumstances which have been peculiar to the period which we are considering, and which cannot be counted upon to recur in the future.

50. In 1938 it was made clear that we cannot ignore the limitations imposed by the country's overseas exchange reserves on the extent to which the volume of money can be expanded in New Zealand, at least when the citizens of the country are free to spend or send their money overseas as they wish. In that year, our exchange reserves fell to a dangerously low level as a result of a combination of a decline in export receipts, heavy spending on imports stimulated by expansion of Reserve Bank and trading bank credit, and fairly substantial remittances of capital from the country.

51. This situation was met, not by the contraction of credit, but by the introduction of comprehensive import and exchange controls. No goods could be imported into the country without a licence or a special exemption from the necessity to obtain a licence. The Reserve Bank was released from its obligation to convert its notes into sterling; all exports were made subject to licence, and licences were issued only on condition that the exchange proceeds were paid to a New Zealand bank; a permit was required before any overseas payments could be made; and the Reserve Bank was given power to require the trading banks to sell their overseas exchange to it. In 1940 the Reserve Bank was also given authority to compel the sale to it of all foreign moneys and securities held by New Zealand residents. Thus, for many years after 1938, a system of direct control over imports and other exchange transactions was used to keep overseas payments in check, irrespective of the level of bank lending in New Zealand.

52. The traditional necessity to limit the expansion of the volume of money in New Zealand in order to preserve an adequate level of exchange reserves was obscured for over a decade after 1938 by the maintenance of these import and exchange controls, and by other factors peculiar to the period. Shortages of imported goods during the war and early post-war years, the imposition of comprehensive direct controls over the level of income and spending in New Zealand, the selective advance control policy, and the Government's policy on bank purchases of securities, all tended to hold down the demand for bank credit. In addition, a combination of relatively low imports and continually rising export receipts enabled substantial reserves of foreign exchange to be accumulated, despite large repayments of overseas debt.

53. However, from 1947 onwards, imports became more readily available, and the controls over domestic incomes and spending were gradually relaxed. After the wool boom in 1950–51, import control was removed from a wide range of goods. The volume of money rose from £187 million in March 1947 to £291 million in March 1951 mainly as a result of an expansion of Reserve Bank and trading-bank credit. The collapse of the boom in wool prices in the subsequent year, which coincided with a substantial upsurge in imports, led to a large deficit in the balance of payments. The country's reserves of overseas exchange were then being reduced at such a rate that it was again felt necessary to introduce direct controls over imports, this time in the form of allocations of exchange by the Reserve Bank.

54. It was once more apparent that if people are to be allowed to spend relatively freely on imported goods, the level of spending in New Zealand, and therefore the volume of bank money which is an important element in making it possible for people to spend, must not be exececessively expanded. The substantial deficit in the balance of payments in 1954–55, after exchange allocation had been removed and the volume of bank credit had again been permitted to rise substantially, reiterated this important lesson.

(f) *Factors Governing the Supply of Bank Money Today*

55. To sum up, in New Zealand at present the supply of bank money is generally increased if the Reserve Bank or trading banks buy more overseas exchange than they sell or if they increase their lending or purchases of other assets. Conversely, the supply of bank money is generally reduced if the Reserve Bank or trading banks sell more overseas exchange than they buy or reduce their lending or purchases of other assets.

56. The extent to which the trading banks can lend or buy assets and increase the supply of money depends on several factors:

(i) The amount of cash (i.e., notes, coin, and balances at the Reserve Bank) and overseas exchange which they can obtain, for they must keep a prudent proportion 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.)

(ii) The proportions of their customers' deposits which they are required under the reserve ratio system to maintain as balances at the Reserve Bank and the rate of interest which they are required to pay to borrow money from the Reserve Bank.

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

(iv) 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.

57. As far as creation of bank money by the Reserve Bank is concerned, before 1950 there was a specific legal limit on its power to expand its lending or purchases of assets. This limitation took the form of an obligation to maintain reserves of gold or sterling exchange equal to at least 25 per cent of its notes and other demand liabilities. Now the Reserve Bank is bound merely to keep such reserves of gold, sterling, or other exchange as the Board thinks provide "a reasonable margin for contingencies". But the interest of the Reserve Bank does not lie in expanding its lending in order to make profits. It is charged with the duty of doing "all such things within the limits of its powers as it deems necessary or desirable to promote and safeguard a stable national price level and the highest degree of production, trade, and employment that can be achieved by monetary action", and of giving "effect as far as may be to the monetary policy of the Government, as communicated to it from time to time by the Minister of Finance". Unfortunately, as we point out in Section Two of our report, these objectives are not at all times completely consistent with one another. But the Reserve Bank's primary function is so to regulate its own creation of bank money and that of the trading banks as to contribute to their achievement as far as possible. We consider in Section Seven of our report how successful it has been in the exercise of this function.

(g) *Some Misconceptions About the Creation and Destruction of Bank Money*

58. It is desirable to clear up certain misconceptions about the provision of money by the trading banks which seemed to be common to several of the witnesses appearing before us.

(i) *Are the Banks Alone Responsible for Expansion and Contraction of Bank Credit?*

59. Many witnesses appeared to believe that the trading banks contracted or expanded credit with the deliberate purpose of bringing about a certain course of economic events. The witnesses did not appear to appreciate that the basic cause of variations in the volume of trading-bank credit is the action of customers of the banks. In granting overdrafts, banks are responding to the requirements of their customers. In times of prosperity the demands on the banks for accommodation are greatly increased, and it is not surprising that, if the Reserve Bank permits the trading banks to hold excess reserves of cash, their advances rise. On the other hand certain witnesses alleged that the banks deliberately contract their lending in times of depression. It is true that in times of economic stress the banks pay particular attention to advances made to customers who, through a change in economic circumstances generally, appear to be leaning too heavily on bank credit, but the critics put far too little emphasis on the natural and necessary tendency of business men to reduce stocks and their general financial requirements in times of a recession in trade. The automatic effect of this tendency is to reduce the demand for bank credit and in this way to contract the volume of lending by the banks.

(ii) *Are Trading Banks Peculiar in Not Lending the Deposits of Their Customers?*

60. Some witnesses attached great importance to the fact that a trading bank does not lend the deposits which are left with it by its customers. They pointed out that when a trading bank grants an overdraft and the borrower draws a cheque against it, which the recipient deposits in his own bank, a new deposit is created without any reduction in the deposits standing to the credit of other customers of the banks. This is true, but it is not peculiar to the operations of the trading banks. For instance, when deposits in a savings bank increase more rapidly than withdrawals, a savings bank is in a position to increase its lending or to buy more securities. In this way it transfers to the borrower or to the seller of the securities some of the extra notes or bank deposits which it has acquired. But the depositors at the savings bank who have made available the money which has been lent out do not give up their rights to withdraw their deposits on demand.

61. The vital distinction between the operations of the trading banks and the operations of the savings banks rests in the fact that, when trading banks increase their lending, the supply of bank money (which is used by most people to meet their day-to-day expenses) is increased. The savings banks merely transfer part of the existing supply of money from one person or institution to another. In the process, the total of savings-bank deposits may increase, but these are not normally used to meet day-to-day expenses. They are normally left in the savings bank for some time and later withdrawn in cash for some special purpose.

A given amount of trading-bank deposits therefore finances a much greater volume of spending during a year than the same amount of savings-banks deposits, and this is why the operations of the trading banks must be more closely controlled.

(iii) *Can Trading Banks Create the Money They Lend Without Needing to Borrow from the Public and Without Cost to Themselves?*

62. Several witnesses claimed that, unlike other financial institutions which have to borrow money already in existence before they can lend anything at all, the trading banks create the money they lend without cost to themselves. This is a gross exaggeration of the power of the trading banks.

63. We have already stressed that, in fact, a trading bank can lend only to the extent that its reserves of bankers' cash allow. They must be adequate to meet any conceivable demands by its customers for notes, coin, or foreign exchange, to preserve customers' confidence in its ability to meet their requirements immediately, and to meet the minimum statutory balance which it is currently required to keep at the Reserve Bank. The bank can maintain this cash reserve only if people are willing to leave deposits with it. If a much larger number of its depositors than usual suddenly decided to convert their deposits into notes, coin, or foreign exchange, or transfer them to customers of other banks, the bank would be forced to sell some of its investments and call up some of its advances to enable it to meet their demands. Thus a trading bank's ability to lend depends on its ability to induce people to leave deposits with it, and these are clearly debts of the bank to its customers. The trading bank, like other financial institutions, must therefore borrow in order to lend.

64. Some witnesses drew attention to the fact that a trading bank pays interest on only a small proportion of its total deposits, while a savings bank pays interest on all deposits, despite the fact that they can be withdrawn at call. They implied that the trading bank had an unfair advantage in this respect and should have to borrow on terms similar to those offered by other financial institutions. But it must be remembered that, although a trading bank pays interest only on fixed deposits, it provides for depositors having funds on current account the facility of being able to transfer these funds to other people by cheque, this service being rendered at a charge which by no means covers the direct costs involved. Without inducements of this nature, people would be unlikely to leave money on deposit with the trading banks if they could obtain interest elsewhere.

65. The Associated Banks have estimated that about three-quarters of the total staff of the banks, involving approximately two-thirds of the total salaries bill, are employed in the conduct of the current account system (i.e., in cashing cheques; posting cheques, bills, and credits to individual customers' accounts; the provision of statements to customers; the issue of cheque books; and the handling of cheques drawn on other branches). That means that 5,000 men and women, earning salaries totalling about £3 million annually, are engaged in providing chequing services. Add to this the annual cost of the stationery involved (which the banks say reaches between £200,000 and £300,000) and the equipment used, and it will be seen that the attraction and maintenance of the deposits, without which the trading banks would be unable to lend, is by no means costless.

(iv) *Can Trading Banks Lend Out any More than the Extra Cash They Receive from Time to Time?*

66. One or two witnesses doubted whether trading banks really had the power to create money at all; in practice, they argued, they merely lent out sums equivalent to any bankers' cash which they might have in excess of the minimum reserves which they were bound, whether by prudence or by law, to maintain. Others argued that the banks, if unrestrained by the Government or Reserve Bank, could create bank money to a value several times in excess of any additions to their cash reserves. Strangely enough, there is a large element of truth in both views. The first is broadly correct if we look at the operations of an individual bank competing with several others; the second is correct if we look at the operations of the banking system as a whole.

67. Let us look, first of all, at the position of an individual trading bank which does, say, one-fifth of the trading business of the country. Assume: (i) that the minimum ratio which it feels bound for reasons of prudence to keep between its reserves and its customers' demand deposits is 20 per cent; (ii) that it has reserves £1 million greater than its minimum requirements, but that the other banks have no excess reserves; (iii) that it has a manager who believes that he can immediately grant extra overdrafts to a value of five times the amount of reserves he has in excess of his minimum requirements; and (iv) that he finds people who are willing to borrow £5 million and who spend it all within the country. When these people draw cheques against this sum to pay for goods and services rendered, the recipients deposit the cheques in their banks. But since the bank which granted the overdrafts does only one-fifth of the banking business, it will probably receive cheques worth only £1 million; the other £4 million will be lodged with its competitors. They, in turn, will present the cheques to the bank upon which they are drawn for payment and this bank will have to transfer to them £4 million of its balance at the Reserve Bank. Thus it loses not only the £1 million which it originally had in excess of its needs at the Reserve Bank but £3 million more. As its customers' deposits have now risen by £1 million, and its reserves have fallen by £4 million, it is obviously no longer meeting its minimum reserve requirements. It may eventually get back some of the cash which it has lost, if the other banks increase their lending on the basis of their increased cash reserves, but it cannot rely on this happening rapidly, and, in any case, it will never receive enough from its competitors to make up for the cash which it originally lost.

68. Of course, the position would have been different if the bank with the excess reserves had had no competitors. If it were the only bank in the country, it could reasonably expect that, if the overdrafts it had granted were spent within the country, the great bulk of the cheques drawn against them would be deposited with it, because those with the overdrafts would be paying other customers of the bank. In these circumstances, none of the bank's cash need be transferred at all. The lodgment of cheques to the value of £5 million against the new overdrafts granted would raise the bank's deposits by £5 million. Since it retained the extra £1 million of cash, which is 20 per cent of the addition to its deposits, it could still satisfy its minimum reserve requirements. Thus a bank with a monopoly of the banking business of the country could immediately expand its lending by several times any addition to its excess

reserves of cash. But an individual bank in competition with several others cannot safely lend any more than an amount equivalent to the bankers' cash it has in excess of its minimum requirements, unless it knows other banks also have excess reserves and are likely to increase their lending in step with it. It is not surprising, in the light of this, that many bankers in the past have denied that they have the power to create money.

69. But even in a competitive banking system, what cannot be done by an individual bank can be done as a result of the operation of the system as a whole. Let us start again with an individual bank, just meeting its prudent minimum reserve ratio of 20 per cent and having excess reserves of £1 million. This time, the manager increases overdrafts by only £1 million, knowing then that, even if all the cheques drawn by the borrowers were paid to customers of other banks, he would still satisfy his minimum reserve requirements. But the process does not end there. The banks which receive the cheques obtain an addition both to their deposit liabilities and to their cash reserves of £1 million. (Some may, of course, be lodged with our original bank.) Therefore, the banks receiving the cheques now have cash reserves in excess of their minimum requirements. They, in turn, after setting aside as a reserve 20 per cent of their new deposits, or a total of £200,000, can increase their lending by a total of £800,000 if credit-worthy borrowers want overdrafts. Again, if this were spent within the country, the deposits and cash reserves of the banks receiving the cheques would be increased by £800,000, against which they could increase their lending by £640,000. Already, therefore, deposits have increased by £1 million plus £800,000 plus £640,000 and advances by £1 million plus £800,000 plus £640,000 on the basis of the initial excess cash reserve of £1 million, although no one bank after the first has ever lent out more than four-fifths of any addition to its excess cash reserves. The process would continue until advances and deposits had increased by £5 million. Then the banking system as a whole would have no further excess reserves of cash – the excess £1 million with which it started would all be required as the 20 per cent reserve against its increased deposits of £5 million.

70. This example is, of course, over-simplified. In practice, for instance, the banking system could not expand its lending as far as this, because some of the additional cash would probably be withdrawn by the public, wanting to hold more notes in circulation, and some might have to be used to buy overseas exchange from the Reserve Bank to satisfy an increased demand for imports. But it illustrates the proposition that, while no individual bank, by itself, can engage in a multiple expansion of credit, the banking system as a whole can do so through the process of transferring excess reserves of bankers' cash from one bank to another.

71. It should be noted that the converse also applies. If the cash reserves of the banks are reduced, and they were previously lending to the maximum, their deposits will have to be reduced, in the absence of intervention by the Reserve Bank or Government, by a multiple of the reduction in their cash reserves, as they attempt to regain the required ratio between bankers' cash and deposits.

72. Since the deposits are money, it is clear that this process of creation and destruction of bank deposits must be closely controlled in the public interest.

(v) *Have the Trading Banks Usurped the Community's Credit?*

73. Miss King, in her submissions for the New Zealand Social Credit Association, and several other witnesses complained that the trading banks had usurped the community's credit. Miss King correctly pointed out that the possession of money gave power-of-demand over goods and services; and she urged that the amount issued should be a faithful reflection of the "*known capacity*" of the community "*to produce and deliver goods and services*". She complained, however, that the trading banks issued money in the form of loans, and thus apparently presumed that the money was their own property; in fact, it was the property of the community as a whole – "*the reflection or monetisation of the Real Credit or Productive Capacity of the Nation*". The "*claim* (of the banking system) *to own the credit it deals in*" was, she felt, "*the usurpation of the most important and powerful social asset the community possesses*". What was needed in her view was the issue of free money, to avoid increasing burdens of debt; but this was impossible "*unless the beneficial ownership of financial credit*" was "*vested in the community*".

74. We have seen that, to lend on any scale, the banks must induce a large number of depositors to leave money with them. When a depositor leaves money with a bank, the funds he pays in become the property of the bank; and the bank is, in our view, as entitled as any other owner of money to charge interest on any loans which are made on the basis of those funds. In return for the use of the funds, the banker undertakes certain obligations to the depositor. First, he is under an obligation to pay the depositor or his nominee notes and coin either on demand, or, in respect of a fixed deposit, after a stipulated period. His ability to honour this obligation would be gravely endangered if he gave money away instead of lending it (and, incidentally, it is easy to imagine his difficulties in choosing among the applicants for the money). Secondly, to those with sums on fixed deposit he must pay interest and to those with current account deposits he must provide relatively costly chequing facilities and other bank services. To pay this interest and provide these services, he must get income from somewhere. Today he gets most of it by charging interest on loans to people who want to borrow and are prepared to pay the interest for the use of the money. He could perhaps charge depositors more for the chequing services he provides and lend at lower rates of interest; but then he would probably have less to lend, because some people and firms would stop using the bank as a repository, keep more cash in hand, and make their payments in notes and coin instead of by cheque. The provision of bank money would, in any case, cost the community just as much as before, unless the banks' profits were reduced. The only difference would be that it would be the depositors, not the borrowers, who bore the main burden of the cost.

75. In fact, the only cost of providing bank money which the community could avoid by taking over the "*beneficial ownership of financial credit*" would be some part of the profits made by the private banks. But it was clear that most witnesses who spoke in this vein did not want to see the trading banks nationalised; nor did they envisage the abolition of interest on the provision of loans by the trading banks. This appears to us to show the weakness of their argument about the usurpation of the community's credit.

76. Several witnesses advocated the provision of substantial amounts of interest-free, non-repayable advances to the Government. This could be done today through the Reserve Bank, if it were thought to be desirable. Of course, the contribution of the Reserve Bank to the Consolidated Fund would then fall and, perhaps, some of its expenses would have to be met by the Government in other ways. Whether issues of "debt-free money" of this kind are desirable is considered in our analysis of the Social Credit submissions.

77. In fact, as we have indicated above, the Government today has a wide range of weapons to enable it to control the issue of money in the interest of the community. The community, through its elected representatives, therefore, already has power to ensure that sufficient money and no more than sufficient money is issued to enable the best use to be made of the country's labour and material resources. Whether this power has been exercised wisely in recent years is examined in Section Seven of our report.

Section Two: The Monetary and Banking System

I. INTRODUCTION

78. As the following table shows, the volume of money in New Zealand, 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 total rose from £77 million in 1939 to £417 million in 1955.

Volume of Money 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 def.)	46·2	52·7	132·5	149·4	207·2	277·4	258·0	312·3	317·0
Unexercised overdraft authorities	(1)	24·0	36·2	38·8	58·7	76·4	68·8	111·7	100·1
Total (including unexercised overdraft authorities)	(1)	76·7	168·7	188·2	265·9	353·8	326·8	424·0	417·1

(1) Not available.

79. The most important part of the supply of money is that held by customers of the trading banks in their current accounts. In addition, customers of the banks have available for spending substantial amounts in the form of unexercised authorities to overdraw their accounts. We suggest in Section Four of our report that these should be taken into account in future in statistics showing changes in the volume of money. However, to avoid confusion and to make the analysis in this report comparable with earlier publications, we have adhered to the Reserve Bank definition of money in the following discussion.

II. CAUSES OF CHANGES IN THE VOLUME OF MONEY: GENERAL

80. The main causes of changes in the volume of money during the periods we have selected are shown in the following table:

Causes of Change in the Volume of Money

(£ million)

Years ended June	Total Change	Overseas Trans-actions	Government Borrowing from Banks	Trading-bank Advances and Discounts	Shifts in Wool Retention Accounts	Other
1935–39 ..	+ 6·5	−36·5	+17·0	+ 9·9	..	+16·1
1939–43 ..	+ 79·8	+33·8	+56·2	− 13·1	..	+ 2·8
1943–45 ..	+ 16·9	+39·3	−24·8	+ 10·6	..	− 8·1
1939–45 ..	+ 96·7	+73·1	+31·4	− 2·5	..	− 5·3
1945–49 ..	+ 57·8	+16·8	+ 6·7	+ 27·5	..	+ 6·8
1949–51 ..	+ 70·2	+43·3	−14·5	+ 52·7	−20·9	+ 9·6
1951–52 ..	− 19·3	−48·7	− 6·0	+ 40·3	− 7·8	+ 2·9
1952–54 ..	+ 54·3	+64·6	− 7·6	− 23·6	+12·0	+ 8·9
1954–55 ..	+ 4·6	−35·5	− 7·5	+ 34·8	+ 5·8	+ 7·0
1949–55 ..	+109·8	+23·6	−35·6	+104·2	−10·9	+28·4
1934–55 ..	+270·8	+77·0	+19·5	+139·1	−10·9	+46·0

81. It is convenient to discuss these changes in the volume of money and their causes in four main periods.

1935 to 1939

82. During this period the volume of money increased relatively slowly (by only £6·5 million). As the country emerged from the depression, and the value and volume of production and trade increased, more trading-bank credit was required. By the middle of 1939, despite the fact that the Reserve Bank took over the finance of the marketing of dairy produce and of certain other primary products handled by the new Marketing Department, trading-bank advances and discounts had risen to nearly £10 million above the June 1935 figure. The Reserve Bank's advances for marketing purposes increased to over £6 million by the middle of 1939, partly because it was at first necessary to pay out to farmers under the guaranteed price scheme for dairy produce more than was received from the sale of the produce overseas. The Government also borrowed from the banking system. Up till the middle of 1938, it had increased its borrowing by only about £2½ million, but in 1938–39 its indebtedness to the banks rose by nearly £15 million. The effect of this expansion of bank credit on the volume of money was largely offset by a gradually increasing deficit in the balance of payments, as traders began to spend more freely on imports and others remitted some of their capital from the country.

1939 to 1945

83. By the middle of 1943, the volume of money was nearly two and a half times as great as it had been in June 1939. The major cause was a heavy increase (£56 million) in borrowing by the Government from the banking system. In addition, rising export receipts and shortage of imports produced annual surpluses in the balance of payments, adding about £34 million to the volume of money by June 1943. On the other hand, trading-bank advances declined by £13 million with the curtailment due to the war of many activities which the banks had customarily financed.

84. From mid-1943 to mid-1945, the Government reduced its indebtedness to the banking system by £25 million. Despite this, the volume of money increased by £17 million during these two years, primarily due to surpluses totalling £39 million in the balance of payments. But the rate of increase had declined considerably from that prevailing in the early years of the war, and this must have contributed markedly to the success of the Government's stabilisation policy.

1945 to 1949

85. Over this period the volume of money increased by £58 million. £27 million of this increase occurred in the June year 1945–46, mainly due to a surplus of £20 million in the balance of payments. Between June 1946 and June 1948, as the economy began to return to its peacetime shape, advances and discounts rose by £32 million; the effect on the volume of money of this increase was offset to some extent by the Government reducing its indebtedness to the banking system by about £10 million, and by a deficit of £3 million in the balance of payments in the same period. However, in 1948–49, after the appreciation of the exchange rate, conditions in the money market tightened, and the annual accretion to the farm stabilisation accounts was substantially reduced, so that the Government received less than before from these accounts and from the savings banks to finance its works programme. It met the situation by increasing its borrowing from the Reserve Bank by £11 million. This was the major cause of the rise of £13 million in the volume of money in that year.

1949 to 1955

86. Between 1949 and 1951, the volume of money rose by £70 million. The wool boom brought a large surplus in the balance of payments (£43 million), and this was accompanied by a steep increase in bank advances (£53 million). Buoyant tax receipts, on the other hand, enabled the Government to implement its declared policy of reducing its debt to the banking system, which it did by £15 million, and up to June 1951, £21 million was withdrawn from circulation temporarily by the wool retention scheme. But overall there was a sharp increase in the purchasing power available to the people.

87. In 1951–52 there was a spectacular increase in the value of imports, as traders attempted to cater for the greatly increased demand of the public. This led to a deficit of £49 million in the balance of payments for the year as compared with a surplus of £36 million in the previous year. The effect of this deficit on the volume of money was to a large extent offset by an associated rise of £40 million in the total of advances.

But a further reduction of £6 million in the Government's debt to the banking system, and the freezing of a further £8 million under the wool retention scheme, contributed to a total reduction in the supply of money of £19 million – the first reduction in a June year since 1937–38.

88. However, the supply of money rose sharply again (by £54 million) in the two following years. Exchange allocations had been introduced and many traders found they had overestimated the extent of the immediate market for their goods. As a result, imports fell from the unusually high level they had reached in 1951–52. With buoyant export receipts, a surplus of £65 million was achieved in the balance of payments for the period of two years ended June 1954. The wool growers also began to make withdrawals from their wool retention accounts and received £12 million in the two years. On the other hand, bank advances fell during this period by £24 million. They were reduced by £45 million in 1952–53 and rose by £21 million in the subsequent year. An increase of £16 million in the Government's borrowing from the banking system in 1952–53 was more than offset by a decrease of £23 million in 1953–54. But overall, the supply of money had been expanded by £54 million in the two years.

89. With this expansion accompanying the relaxation and later removal of exchange allocation the country again experienced a large deficit in its balance of payments in 1954–55 (£36 million). The Government also reduced its debt to the banking system by £7½ million. But despite these factors, the volume of money still increased by £5 million in the year; bank advances continued to increase sharply (by £35 million); wool growers withdrew a further £6 million from their retention accounts; and marketing advances by the Reserve Bank increased substantially owing to the return to free marketing and some delay in the disposal of dairy produce.

Summary, 1935 to 1955

90. Just over one-half of the increase of £271 million in the volume of money between June 1935 and June 1955 was ascribed to increases of £139 million in trading-bank advances and discounts. The second most important factor was the surplus in overseas transactions during the period, which 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, as they have been particularly since 1950, the passing of one year may make a considerable difference to the picture. For instance, if we exclude the year 1954–55, and examine 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, some of the items mentioned as separate causes of the changes in the volume of money are inter-related. For example, a rise in the level of advances may be partly an effect of a rise in the level of imports, to finance which traders require extra bank accommodation. The rise in imports in turn gives rise to a deficit in the balance of payments. We must, therefore, look more closely at the reasons for the changes in the major items which have influenced the volume of money during the period.