[Extracted from] Address to the Anika Foundation by Philip Lowe, Governor, Reserve Bank of Australia
Online – 21 July 2020

[How Australia's central bank – the RBA – funding of the economy might be repaid/ recouped]

Governor Lowe said…

"I would now like to address one idea for the use of the central bank's balance sheet that I sometimes hear – that is, we should use it to create money to finance the government. A variant on this idea is that the central bank should just deposit money in every bank account in the country – this is sometimes known as 'helicopter money' because, before we had an electronic payments system the idea was that banknotes could simply be dropped by helicopter.

For some, this idea is seen as a way of avoiding financing constraints – it is seen as holding out the offer of a free lunch of sorts. The central bank, unlike any other institution, is able to create money and the resource cost of creating that money is negligible. So the argument goes, if the government needs money to stimulate the economy, the central bank should simply create it in the public interest.

The reality, though, is there is no free lunch. The tab always has to be paid and it is paid out of taxes and government revenues in one form or another. I would like to explain why.

I will start with some central bank accounting. When a central bank creates money to finance government spending it does so by crediting the government's deposit account with it. These extra deposits represent a liability of the central bank. And on the asset side of the balance sheet, the central bank might have an IOU from the government to be paid in the future.

Now suppose that the additional government spending is successful in stimulating the economy and this starts to push inflation up. At some point, interest rates would need to be increased to avoid inflation rising too far. If this lift in interest rates did not occur, inflation would rise, perhaps to a very high level. In this case, it would be through the inflation tax that the community pays for the extra government spending. So there is no free lunch – the spending is just paid for in a different way.

Now instead suppose that interest rates are increased to avoid high inflation successfully. Even then, there is still no free lunch. How the tab is paid though depends on the nature of the arrangements that are in place.

One possibility would be for the government to pay back the IOU along with any accumulated interest at some point down the track. This repayment would need to be funded by future taxes.

If instead the IOU was not interest-bearing and was not repaid, the central bank would start accumulating losses as the interest rate it paid on its deposit liabilities increased and there was no offsetting income. This would lead to a decline in dividends to the government and possibly a future recapitalisation of the central bank. Both have to be funded through tax revenue.

Another possibility would be to increase the general level of interest rates to deal with inflation, but to maintain the low interest rate on deposit balances held at the central bank. This approach would limit losses at the central bank even if the IOU was not interest bearing. But it would effectively amount to a tax on the banking system, as it is the banks that would hold these low-interest balances once the government has spent the money. In this case, it is this tax that would help finance the extra spending.

The message here is that somebody always pays. It certainly is possible for the central bank to change when and how the spending is paid for, but it is not possible to put aside the government's budget constraint permanently. Where countries have, in the past, sought to put aside this constraint the result has been high inflation."

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