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When is rapid growth in a central bank's balance sheet not cause for concern?

The unprecedented growth in the Federal Reserve's balance sheet during the past year has generated considerable debate about potential problems for the economy down the road (see for example, here, here, and here). But a big change in the size of a central bank's balance sheet in a relatively short space of time is not necessarily a precondition for problems down the road. A case in point is New Zealand circa 2006.

In July 2006, the Reserve Bank of New Zealand (RBNZ) changed the monetary policy operating system from a channel or corridor system (like that used in Australia and Canada) to a floor system (see Neild 2006 for a description of this transition). Under this floor system, the RBNZ stopped offering free collateralized daylight credit to banks for settlement purposes. In other words, they removed the distinction between daylight and overnight reserves. Also under this new system, reserves were remunerated at the official cash rate (OCR), the RBNZ's target interest rate. Banks have access to RBNZ credit if needed as well, but at a rate 50 basis points above the OCR.

By the end of 2006 the target supply of bank reserves had increased sufficiently to allow for the smooth operation of the New Zealand payment system. The new level fluctuated around NZD 8 billion and represented an increase of 400 times the level under the previous regime. Todd Keister, Antonie Martin, and James McAndrews from the New York Fed have an interesting article describing the economics of a floor system. In that paper the authors stress that a floor system severs the link between the quantity of reserves and the target interest rate. A central bank could increase the supply of reserves—either for settlement or liquidity purposes—without changing the stance of monetary policy (the target interest rate).

Well, that's the theory. What about in practice? Did New Zealand's economy collapse under the weight of an inflationary spiral created by an explosion in the central bank money? In short, the answer is no. Because these newly created reserves were staying within the banking system there was no upward pressure on the broader money supply. For instance, M1 (currency plus checkable deposits) was NZD $22.9 billion in July 2006, and a year later it stood at $22.2 billion—a change that would not scare even the most hardcore monetarist.

Could a floor system work in the United States? Possibly. For one thing, with total reserve balances at the Fed about 18 times as large as they were a year ago there has been a sharp decline in demand for daylight overdrafts. Average daylight overdrafts for funds were $52 billion in the first quarter of 2008, but a year later that level had fallen to around $8.9 billion. With so many reserves in the system, the need for intraday borrowing from the Fed has decreased sharply. Of course, there are some big differences between the financial systems of New Zealand and the United States, including the fact that not all institutions depositing funds with the Fed are eligible to earn interest on reserves. But I do think the floor system provides some interesting food for thought—kiwifruit, perhaps.

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