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# Interest Linked Savings Scheme

A Policy Framework for Economic Growth and Development

Derived from re-engineered monetary policy methodology, tailored to the specific characteristics & needs of the New Zealand economy

## SUBMISSION

To

Finance & Expenditure Select Committee of Parliament

By

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July 2007

# Preamble

If New Zealand is to regain the level of relative economic performance and prosperity it generally experienced and expected in the post-war years up to the early 1980's all policymakers need to embrace one key recognition: it is irrational to expect such a turnaround by persisting with macro-economic policies that have predictably failed, while continually hoping for different and better results.

Present monetary policy methodology fails to meet every success goal that could be reasonably expected of it, due to recognisable deficiencies that can be addressed. Continuation of it is bound to accentuate the accumulated economic damage.

The new economic concepts presented in this submission had their genesis in the mid-1990's, when as a Wool Board director I recognised that Reserve Bank monetary policy approaches, as are still currently used, could have only two results: the increasing impotence of the Official Cash Rate (OCR) instrument; and the New Zealand economy would continue to lose ground relative to other once comparable economies. That has been and is our experience over the intervening period of twelve years, as it will continue to be in the future unless there is sensible policy change. Without such change, further deterioration to New Zealand's relative economic position is absolutely certain.

These recognitions led to my consideration of a wide array of possible responses from which, over several thousand professional hours, was distilled the one solution that is capable of addressing all of the policy deficiencies that have rendered and are rendering the New Zealand economy uncompetitive with once-comparable economies, such as Australia and the OECD average. The 'Interest Linked Savings Scheme' (ILSS), as is outlined in this submission, when fully understood, is a suite of new instruments for the operation of monetary policy that are tailored to the needs of the New Zealand economy. But it is far more than that, too. It is a benign and easy way to sustainably re-energise New Zealand's productive economy, to attain future rates of economic growth, with low inflation, that are quite impossible to achieve under the failed OCR-based methodology that is currently used by the Reserve Bank for the operation of monetary policy.

The ILSS solution has never been credibly faulted. It is a matter of personal disappointment and concern that a 1999 review of it by Reserve Bank officials was rendered valueless by a material feature of

ILSS being distorted for purposes of the review. Moreover, I was left unaware of the existence of the officials' paper, so was not given the opportunity to correct the distortion. In consequence, this same distortion deflected the 2000 review of monetary policy, too. I became aware of these circumstances only recently. Nevertheless, ILSS has continued to gather support amongst those who have gained a thorough grasp of it.

Essentially, it is this ILSS project that has driven the developing recognition that the OCR instrument has deteriorated from being ineffective, to now being economically destructive, because: it is fuelling the inflation it is supposed to combat; and is causing enormous 'collateral damage' to the real economy, which the Reserve Bank has admitted. This, in turn, has culminated in this review of monetary policy by the Finance & Expenditure Select Committee.

My submission to the 2000 review of monetary policy contemplated that ILSS would be taken forward by a taskforce formed for that purpose. This submission incorporates some of the further development of ILSS that I had in mind for the taskforce phase in 2000.

This review is probably the most important issue the Committee has had or will have to consider, over many years. It is certainly not an exaggeration to say that it will probably determine whether or not New Zealanders will have the economic and social futures to which they aspire and which should be their birthright.

While this is a personal submission, I have consulted widely. I acknowledge the suggestions support and encouragement to continue received from many quarters. The quotations have been included in this submission to convey the thinking of the nation.



**Phil Verry**

**Red Stag Timber Ltd  
Waipa Mill  
EROS Capital Ltd**

“...That the introduction of a suite of more sophisticated instruments for the operation of monetary policy, tailored to the characteristics of the New Zealand economy, is essential if New Zealand is to regain the relative economic prosperity and performance it had maintained up until the 1970’s and 1980’s...”

*Phil (P A) Verry*

2007

# 1. Executive Summary

1.1 The following is an executive summary of this submission. The full particulars are contained in succeeding sections, including details of the ILSS solution and its benefits.

## 1.2 Core recognitions

The foundation analysis for this work developed certain core recognitions:

- a. That the single OCR instrument is quite unsuitable as the sole means by which to operate monetary policy, especially in an economy having the characteristics of New Zealand's, with:
  - i. a small open domestic economy, dependent upon imports and exports;
  - ii. exporters' exposure to:
    - small domestic market, with declining relative incomes;
    - low New Zealand border barriers for competitors;
    - remoteness from export markets;
    - high costs to access export markets: freight, tariffs, etc ;
    - high domestic compliance costs;
    - domestic interest rates at developed world's highest levels;
    - exchange rate over-valuation and volatilities;
    - huge yield-seeking global funds.
- b. That the introduction of a suite of more sophisticated instruments for the operation of monetary policy, tailored to the characteristics of the New Zealand economy, is essential if New Zealand is to regain the relative economic prosperity and performance it had maintained up until the 1970's and 1980's.

## 1.3 Dysfunctionalities of OCR-based methodology

In formulating an alternative macro-economic management and monetary policy instrument set, as a starting point, it is useful to firstly identify the flaws in the current policy instrument.

Analysis of the Official Cash Rate (OCR) instrument identified it was ineffective as a tool to combat inflation, unworkably dysfunctional and had caused enormous economic damage which will continue and compound if it is persisted with, even to the extent of putting at risk New Zealand's economic sovereignty.

“...In formulating an alternative macro-economic management and monetary policy instrument set, as a starting point, it is useful to firstly identify the flaws in the current policy instrument...”

New Zealand's economy ranks about 50<sup>th</sup> in the world, yet our currency is the 10<sup>th</sup> most traded, far more than it should be for an economy this size.

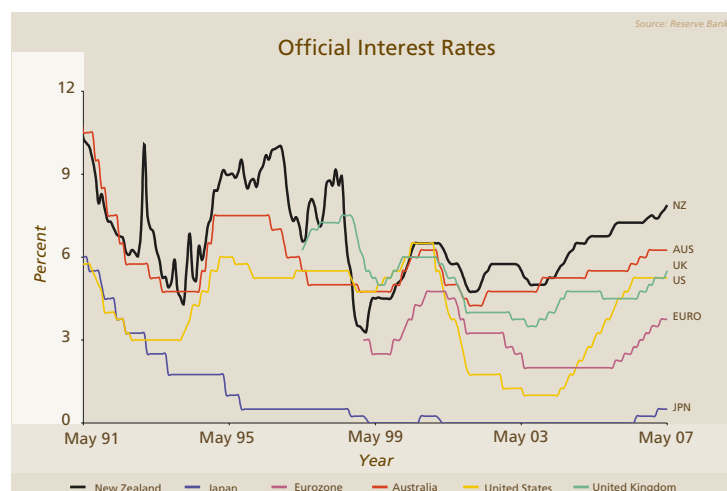
Ours is a volatile currency, not because we want it that way, but because foreign influences have a greater sway in setting the value of our dollar than we do.

The debate about losing economic sovereignty may already be over.

*Joanne Black*  
*Features Editor*  
*Listener*  
 5 May 2007

Examples of how the OCR instrument is dysfunctional are:

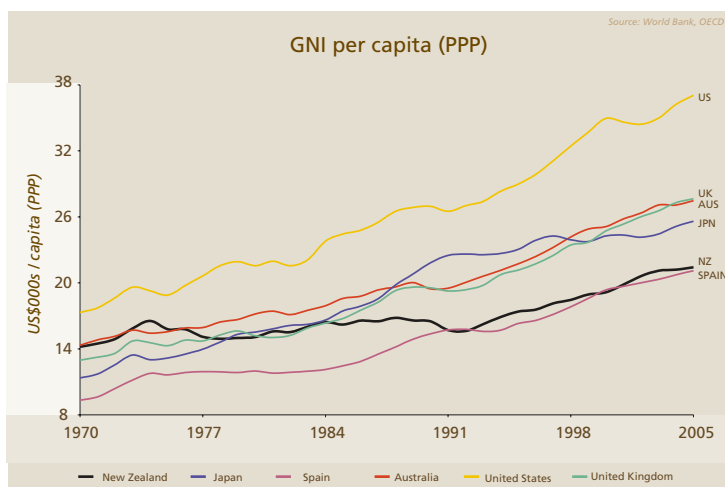
- b. Instead of contributing to economic prosperity, it is directly destroying it in two primary ways:
  - i. The effect of the OCR interventions is to impose a surcharge on interest rates, over and above the rates that would otherwise be demanded by the market. Thereby, New Zealand borrowers are forced by the Reserve Bank to in effect gift wealth to lenders, who are increasingly foreigners. They are now paying the highest interest rates in the developed world. This also puts the wealth creating tradables sector at a disadvantage with foreign competitors.
  - ii. The internationally high interest rates – which usually persist for extended periods of time due to the OCR being an ineffectively blunt instrument – attract massive inflows of foreign capital from the 'carry trade', hedge funds and speculators seeking a share of the Reserve Bank's largesse. These inflows increase the exchange rates for and volatility of the New Zealand dollar, which attacks the viability of exporters and manufacturers causing shrinkage and loss of wealth creation (output) from those sectors. The New Zealand dollar: is now the most over-valued in the world; is the currency that is most often over-valued; and is amongst the most volatile – all characteristics that are the most destructive to the tradables



sector. For a small remote exposed economy that depends upon international trade, this policy is especially destructive, both in the short and long terms.

- c. These primary dysfunctions lead to secondary economic damage, which is also considerable. Examples are:
  - i. The sheltered non-tradables sector compensates itself for higher interest rates, by increases to its prices and incomes. Thereby, it becomes the main cause of inflation, but the sector mostly avoids the costs of combating it. Remuneration settings in the government sector have been especially antagonistic to Reserve Bank monetary policy.
  - ii. Consequently, the tradables wealth creating sector – which generally consists of price takers who are not the cause of inflation – bears the greatest impact of Reserve Bank OCR interventions.

- iii. Under this pressure, businesses in the tradables sector have responded by: ceasing investment (which reduces productivity gains); consuming their capital; down-sizing; closing their businesses; or relocating offshore to more supportive economic environments.



- iv. New Zealand's economic growth has declined relative to once comparable economies, especially Australia. Since 1984, on purchasing power parity terms, average incomes per capita have fallen 30% behind those in Australia, so would need to increase by 40% to regain the relative parity they had up to 1984. This loss of income relativity is costing New Zealanders over \$50 billion per annum.
- v. To compensate for declining relative incomes, those New Zealanders who have stayed generally have:
- worked longer hours;
  - sought two incomes;
  - ceased saving;
  - borrowed to maintain spending, often on imports made cheaper by the overvalued NZ\$ (spending up to \$117 for every \$100 earned);

Yes, we were the seventh fastest growing of the 80 OECD countries from 1990 to 2004, and we grew even faster in the past five years. As a result, we have started to inch our way back up the OECD, although this great effort has got us only to 21st so far, with Spain above us and Greece below.

But we have done it by working harder, not smarter. While it is good that more people have jobs - to the point that we have the lowest unemployment rate in the OECD - there are some deeply negative aspects.

First, our work week in 1990 was 99% of the OECD average. Today, it is 113%. Only people in Iceland work longer hours. We are running harder to stand still.

The value of our work as barely budged, while the OECD's has moved ahead.

So our labour productivity has fallen from 91% of the OECD average to 79%. And labour productivity is the real driver of wealth and wages. The more value you generate for your company, the more it can afford to pay you. Extrapolate that across the whole economy - the better the living a country earns in the world economy, the more it can invest in health, education and all the other foundation stones of a developed society.

Britain, Denmark and France have achieved almost all their growth through generating more value from their work rather than working longer or employing more people.

The way the economy is being run is hurting the export sector, meaning the country "is biting the very hand that feeds it", says Fonterra chairman Henry van der Heyden.

*Stephen Ward*  
Agriculture Editor NZ Herald  
12 October 2006

The French are the champions. They have the shortest work week in the European Union, but had the biggest gain in value of their work. This will come as a surprise to many people. We consider ourselves a trading nation, shipping vast quantities of primary products to the world. Sorry, that's wrong. Over the past 20 years, exports have barely budged from about 30% of economic activity.

Other small, successful OECD countries are triple that rate, having increased exports rapidly. If our exports had tracked this growth in world trade, they would be 65% bigger today than they are.

*Rod Oram* Sunday Star Times  
20 November 2005

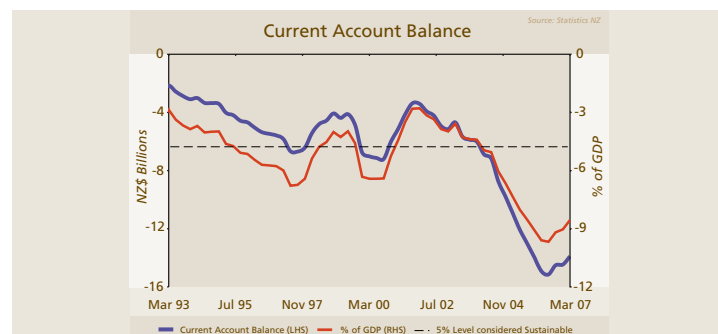
Suicides are costing New Zealand almost \$1.4 billion a year, a report released by Associate Health Minister Jim Anderton says.

There were 460 suicides in 2002 – the last year for which figures were available.

Those suicides – and the 5095 reported attempts – were calculated to cost the country \$1.381 billion.

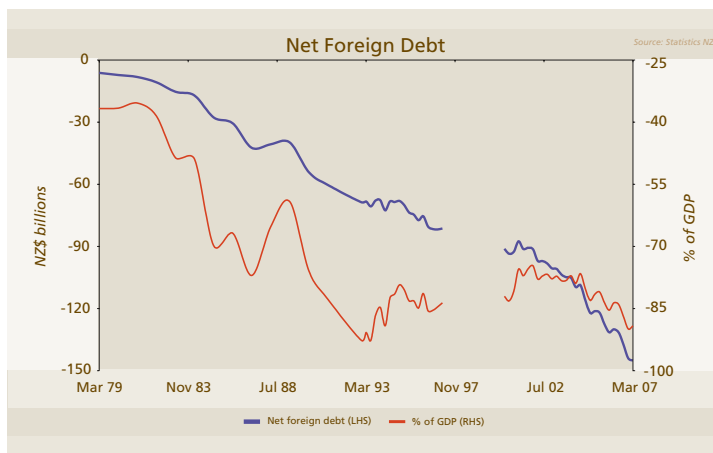
*Colin Patterson*  
13 December 2005

- sold off to foreign owners their investments in New Zealand businesses, assets, resources and future opportunities. With such loss of control, high paid jobs disappear overseas too.
- vi. Other New Zealanders emigrate, especially those with internationally mobile skills who are more aspirational. This skills flight deprives the New Zealand economy of wealth creators, potentially its best, and further deepens the economic damage caused by the OCR. The cost to the public is not only financial. Some succumb to suicide, for which New Zealand has one of the world's worst records. During a 1990's period of extreme monetary policy conditions seven farmers suicided in the Rangitikei/Manawatu region, alone, in one year.
  - vii. As a consequence of these distortions, the external current account – which is New Zealand's profit and loss account with the rest of the world – is adversely impacted by:
    - low export revenues, due to the compounding effects of the over-valued and volatile NZ\$;
    - high expenditure on imports;
    - high repatriation of profits interest and dividends to overseas investors.
  - viii. Inevitably, this creates the chronic annual external current account deficits, which have burgeoned to over \$14 billion, or over 9% of GDP, or annual losses of around \$14,000pa for a typical family of four. International expert opinion is that this deficit is two times more than is sustainable and requires the NZ\$ to drop in the currency by 25% to maintain a sustainable current account deficit of less than 5% of GDP.



- ix. These current account deficits include the surcharges on interest rates gifted to foreigners by the Reserve Bank's dysfunctional OCR instrument, and the associated destruction of wealth creation by overvaluation of the NZ\$, which the Reserve Bank calls 'collateral damage'. But the current account deficits mean we do not have the ability to fund the OCR gifts, so in effect the nation has to: borrow back from foreigners the funds that it gifts to them; and also borrow more to replace the wealth that has been destroyed.
- x. To stay solvent, New Zealand must borrow massively from foreign savers/lenders who, understandably, are more than keen to lend. Through the 'carry trade', uridashi bonds and eurobonds and speculative hedge funds, attracted by the high OCR, the financial intermediaries have practically unlimited

access to foreign funds to lend to New Zealanders, so they aggressively market that debt to Kiwi borrowers. Consequently, New Zealand is now the nation that is the most highly indebted per capita in the developed world, so Kiwis are paying the developed world's highest interest rates on the developed world's highest foreign debt per capita.



- xi. The aggressive lending by the financial intermediaries is made possible by the high OCR. So, by its own policy, the Reserve Bank has ceded control of the money supply to the trading banks. This unintended (opposite) consequence means the Reserve Bank has in effect defeated itself.
- xii. The aggressive lending by the financial intermediaries needs security, so it is targeted at house, farm and beach-side properties, often with 100% loans. This massively inflates the market values of such classes of assets, which in turn creates the 'wealth effect' whereby owners feel more prosperous than they really are. This encourages them to borrow and spend even more, incentivised by low prices for imported goods due to the overvalued NZ\$, leading to even more inflation. There is also evidence to suggest that cheaper imports from the high dollar are not being passed on to consumers, and so may not even be reducing inflation.
- xiii. Meanwhile, the wealth creating sectors find it difficult to obtain funding for business expansion because, ironically, the viability of their businesses has been eroded by the consequences of the use of the OCR: low prices and profits due to the overvalued NZ\$ exchange rates; highest interest rates, higher than their international competitors; and competition, even in their domestic markets, from imports made cheap by the high NZ\$. Therefore, the OCR severely curtails expansion of productive capacity, so the economy is deprived of the second side to a sound anti-inflation strategy: supply-side stimulus. This leaves it dependent upon demand suppression, but with only ineffectual instruments to futilely pursue inflation control.
- xiv. It is a perverse irony that, by its use of OCR surcharges, the Reserve Bank is in effect operating a compulsory savings scheme: funded by surcharges imposed on Kiwi borrowers which are, in effect, voluntarily gifted to foreign savers/lenders, to become part of their savings; which New Zealand then borrows back again, all at the developed world's highest interest rates.

The housing market remains strong, although at least one economist believes the central bank is placing too much weight on the housing boom.

There has been a "misplaced focus" on the housing market, Westpac chief economist Brendon O'Donovan said. "And every day the New Zealand dollar stays high is another day for which export earnings are compressed and an exporter contemplates shutting up shop". "The Reserve Bank does need to reassess the robustness of the economy".

**Rob Hosking**  
20 January 2006

But this laissez-faire approach may not be possible for much longer. The problems facing the country are symptomatic of a distorted and unsound economy that is reminiscent of pre-1984 New Zealand. Some sobering parallels between the two eras can be drawn: the overvalued currencies that were ruinous to exporters; unsustainable current account deficits and burgeoning overseas debt levels.

In fact, the data for the current period makes even worse reading. And the exposure of householders is now much greater, given that it is their borrowings (rather than the government's) that are driving the country's international indebtedness.

**Geff Gamlin**  
**National Business Review**  
9 February 2007

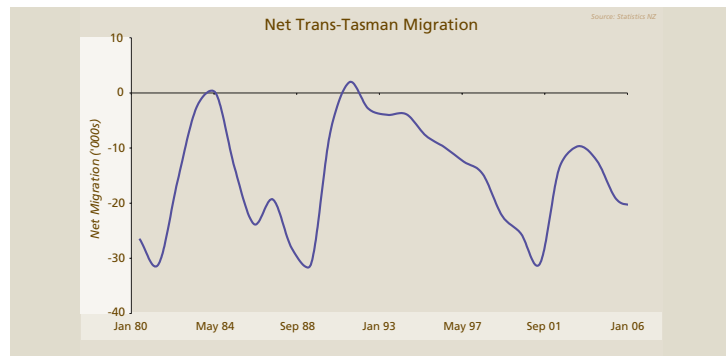
The net earnings of the four major foreign owned trading banks, ANZ National, ASB, BNZ and Westpac contributed an estimated \$2.5 billion to the 2005 current account deficit.

One of the most frustrating aspects of New Zealand's latest poor financial result is the almost total disinterest of the country's directors, our members of parliament. ... maybe our MPs are a reflection of us.

We are more interested in detail discussion on trivial issues that are quickly forgotten whereas serious economic problems, which will affect generations, are rarely mentioned.

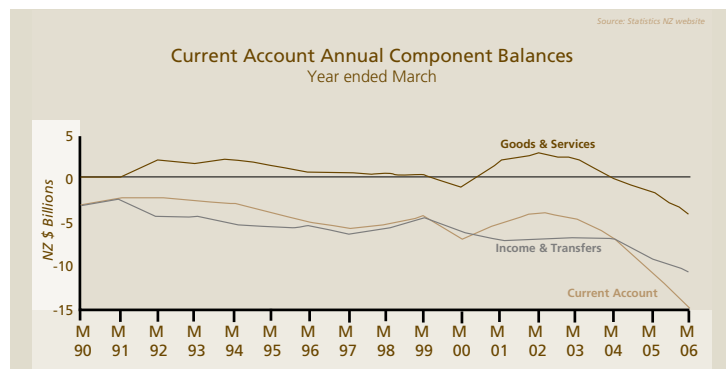
*Brian Gaynor*  
*Weekend Herald*  
 25 March 2006

- xv. There is one final, and the greatest, absurdity created by the OCR instrument. The OCR is not combating inflation at all. It has become the primary cause of inflation by the process described in the foregoing; yet another outcome that is the exact opposite of the Bank's intention.
- xvi. The only beneficiaries being served by this Reserve Bank policy are foreigners: the foreign lenders who clamour for the bank's OCR gifts; the mostly foreign owned and controlled financial intermediaries; foreign investors to whom we sell our assets, who colonise the New Zealand economy with monopolies and cartels; and foreign economies, especially Australia, to which we: gift our savings; sell our assets businesses and resources;



bestow exchange rate advantages on their exports to New Zealand, while penalising our exports to them; and educate and train a skilled workforce which we transfer to them by emigration, without compensation. Therefore, the Australian economy has the benefit of its own wealth creation and a lot of ours as well.

- xvii. To these economic consequences of the dysfunctional OCR-based monetary policy can be added social disadvantage as, due to the loss of per capita income relativities (now around \$50 billion per annum), there is consequential funding pressure for spending on health, education, welfare, policing, defence, superannuation, industry development and other government services, which further incentivises emigration of the skilled.



- xviii. A downward economic and social spiral has been created which can only worsen as the problems compound and deepen. Unless these problems are boldly and substantively addressed, those who can do so will emigrate in increasing numbers, especially when foreigners' funding of our excesses and failures is withdrawn over concern for our burgeoning foreign debt, now around \$150 billion, which makes New Zealand the most heavily indebted per capita in the world.

## 1.4 Criteria set for ILSS solution

The criteria set for the design of the ILSS solution was: to seek a technically robust long-term solution to the full range of current policy dysfunctions, without exception; to de-mystify monetary policy and to keep the solution simple, to ensure easy acceptance of the change by the electorate; to ensure ease of implementation of the ILSS instruments and transition from the OCR instrument; and to maintain confidence in financial markets. ILSS does all of those things.

Consistent with this overarching criteria, the design objectives for ILSS were and are:

- a. To equip New Zealand with the most efficient and effective set of instruments for the operation of Reserve Bank monetary policy to control inflation, tailored to the specific characteristics of the New Zealand economy and based upon savings, not interest, to: disconnect interest rates, monetary policy and exchange rates from each other; strongly increase national savings, some freely-gained by not gifting them to foreigners; and to reduce/ repay foreign debt.
- b. To equip the New Zealand economy with the powerful engine for sustainable economic growth that it currently lacks, to enable it to regain the high level of prosperity it once had.
- c. To remove any risks, economic or political, of unintended consequences.
- d. To enable New Zealand to develop a winners', not a losers', economic and social psyche.
- e. To eliminate current account deficits within ten (10) years, by doubling New Zealand's real earnings per capita from exports of merchandise trade international investment and tourism, combined.
- f. To regain parity with Australia for average income per capita within fifteen (15) years.
- g. For New Zealand to repay foreign debt, to become a net creditor (lender) nation, not a net debtor (borrower) nation, within twenty (20) years.
- h. To buy back dominant ownership of New Zealand's key businesses, assets and resources.

“...ILSS's core new instrument is to replace the failed OCR interest surcharge instrument with a savings surcharge also linked to interest rates...”

## 1.5 The 'Interest Linked Savings Scheme' solution instruments

The key recognition in developing ILSS was that, when the Reserve Bank intervenes with the OCR to increase interest rates above free-market rates, it in effect imposes a surcharge over and above the interest rates that lenders would otherwise require if the OCR intervention had not occurred. This is obviously true: otherwise Reserve Bank interventions would be ineffectual and therefore pointless; the Reserve Bank has admitted it influences interest rates; and there would not be such a flood of foreign funds available to New Zealand if our interest rates were not so excessive.

It is this surcharge that attracts the excessive inflow of foreign funds which, in turn, inflates the exchange rates for the NZ\$ and causes all of the consequential 'collateral damage' and problems from use of the OCR instrument. The problem is not the timing or degree of changes to the OCR – for which some lazy thinking commentators berate the hapless governor, always with the benefit of hindsight – it is that the OCR instrument is entirely unsuitable for the New Zealand economy and always will be.

Therefore, the identified needs were to find new more effective alternative primary instruments – to replace the OCR as the primary instrument for the operation of monetary policy – and to ensure that the new instruments disconnected NZ\$ exchange rates from their effects, while enhancing the ability to combat inflation, and that monetary policy becomes a contributor to

economic growth, not the enormous burden it has become.

The ILSS solution was researched and developed from the original thinking based upon this line of reasoning. It introduces a suite of new instruments to replace sole dependence upon the failed OCR instrument.

ILSS's core new instrument is to replace the failed OCR interest surcharge instrument with a savings surcharge also linked to interest rates.

To a degree this ILSS instrument mimics the OCR instrument, but with several key differences:

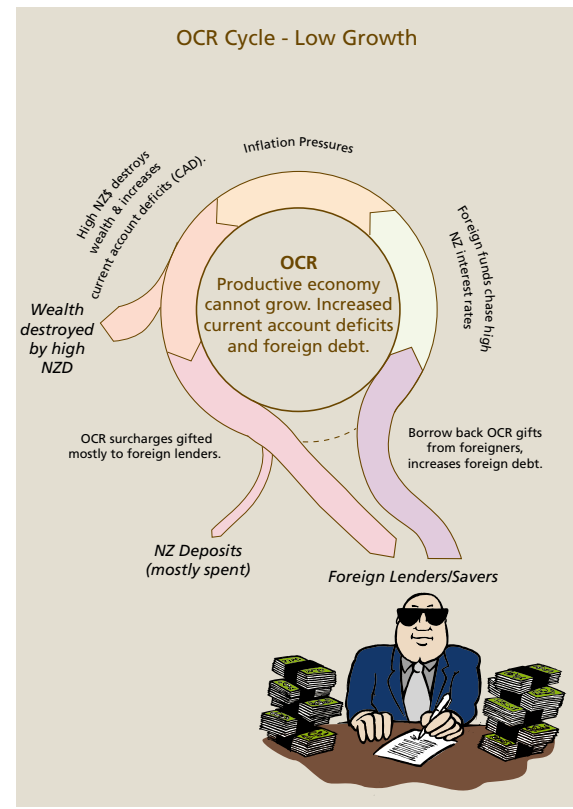
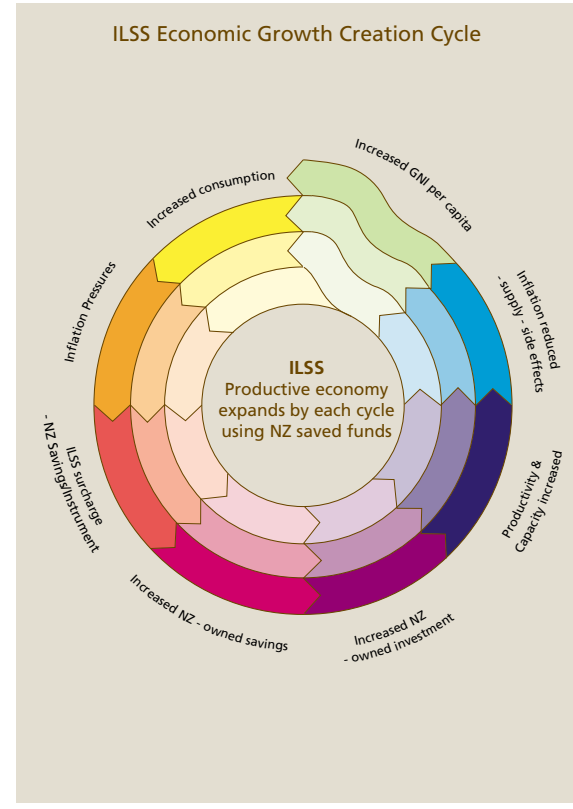
- a. The present interest-based OCR surcharge, paid mostly to foreigners, is replaced by the savings-based ILSS surcharge instrument, with

the collected new free savings funds deposited via the Reserve Bank into KiwiSaver, or into a new 'New Zealand Economic Stabilisation And Growth Fund'. The OCR is retained as a reserve instrument, to be used on rare occasions, if at all. Under ILSS, saving is the natural instrument to control inflation.

- b. Thus the enormous 'voluntary' leakage of New Zealanders' wealth, given as effectively free gifts to foreigners by OCR surcharges, is ceased.
- c. In all but the most exceptional circumstances, this removes the Reserve Bank's interventions from the financial markets, leaving lenders and borrowers to price debt without the OCR distortions. The market sets all interest rates, free of distortions caused by OCR interventions. Therefore, ILSS is less interventionist.
- d. With the removal of such interventions, the debt markets will operate freely without OCR distortions, so the foreign funds that New Zealand needs will always be available. The market will simply price interest rates on such borrowings, recognizing yield and risk differentiation, at the interest rates needed to obtain the required funds, no more. As the ILSS savings accumulate and the risk profile of New Zealand improves, market interest rates from foreign lenders will reduce, to further add to the prosperity of New Zealanders.
- e. New Zealand will then pay no more than the minimum interest rates needed to obtain the funding it requires. It will no longer be unnecessarily gifting away its wealth to foreign savers/lenders.
- f. Therefore, instead of by gifting and adding to the savings of foreigners – and then having to borrow back those gifted funds, to finance the consequently worse external current account deficits– Kiwis will retain those savings as their own new free saved wealth.
- g. The saved ILSS funds will need to be held long-term to avoid 'wealth effect' inflation and, to ensure the efficacy of ILSS as an instrument with which to combat inflation. The ILSS instrument has discretion as to the crediting of savings to either individual or nationalised accounts, to ensure its anti-inflation effectiveness.
- h. Obviously, this immediately reduces the chronic external current account deficits, too, by removing the cost of the OCR interest rate surcharges that are gifted to foreigners under present Reserve Bank methodology. Without the attraction of the OCR surcharge, 'carry trades' will not over-inflate the currency and, in time, the currency's return to market value will

allow export industries to revive and the current account deficit to reverse.

- i. The OCR is retained as a reserve instrument, but in practice is unlikely to be used.
- j. Both interest and exchange rates will float within free markets. The distortions created by the Reserve Bank interventions, both direct and indirect, will be removed.



## 1.6 ILSS allows range of instruments

The Reserve Bank will be given discretion as to its targeting of ILSS surcharges – by type of borrowing and by region – and will be required to seek economically effective targeting, with precision, to minimize the ‘collateral damage’ to non-culpable sectors of the economy that occurs under the OCR. As a general rule, the Reserve Bank would have the discretion to choose between three levels of stringency for the application of ILSS, with the OCR in reserve:

- Direct crediting of ILSS surcharges to the personal KiwiSaver accounts of the payers, as new and free savings of those payers.
- Deferred decision as to whether or not to credit personal accounts, to await evidence that such crediting would not dilute the anti-inflation compliance response that is sought. (Such deferral will remove an assumption by borrowers that ‘their’ ILSS surcharges will always be credited to their personal KiwiSaver account, to thereby ensure the ILSS instrument is effective for the purposes of combating inflationary pressures).
- Crediting of ILSS surcharges to a non-personalized general account, titled ‘New Zealand Economic Stabilization and Growth Fund’. (This form of ILSS surcharge is not dissimilar to the intention of the OCR, except: Kiwi ownership of the surcharges is retained, not gifted to foreigners; and it does not destroy its efficacy by contradictory increases to spending on consumption, by attracting inflows of foreign debt, as the OCR instrument does, to thereby fuel the inflation it is supposed to combat). In practice, if instruments a. and b. are used competently and judiciously, option c.

will probably never be needed, in which case its value will derive from the market’s knowledge of its availability to the Reserve Bank, if needed.

- The OCR would remain, only as a reserve instrument due to its economic destructiveness, but I cannot envisage a circumstance where it would be needed.

### Change from OCR to ILSS Indicative comparison

		OCR % pa	ILSS % pa
Market wholesale interest rates – say		5.0	5.0
Financiers’ margin – say		1.5	1.5
Market retail interest rates, assuming no RBNZ intervention		6.5	6.5
RBNZ intervention	OCR interest surcharge	3.0	-
	ILSS savings surcharge	-	3.0
Borrowers’ cash outlay is same		9.5	9.5
Borrowers’ effective cost is not the same		9.5	6.5
Borrowers’ gain from ILSS - savings		-	3.0

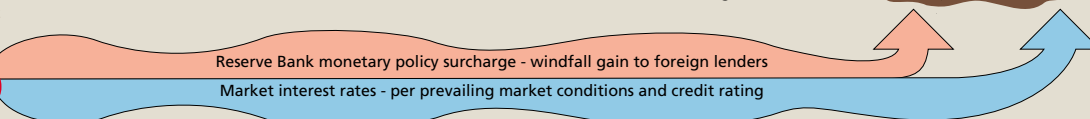
#### NOTES:

- As ILSS savings accumulate, credit ratings will improve to reduce market interest rates.
- Now OCR increases foreign debt, credit ratings will down-grade, to increase market interest rates.
- Over time, the advantages of ILSS over the OCR will increase beyond the above indicative comparison.

### Present Monetary Policy - when dampening inflation

Interest rates paid by New Zealand borrowers have two components, as shown. Overseas lenders receive their market priced portion of our high interest rates, determined by market conditions and credit ratings, plus they receive the windfall gain from Reserve Bank’s monetary policy surcharges. Both are at variable rates.

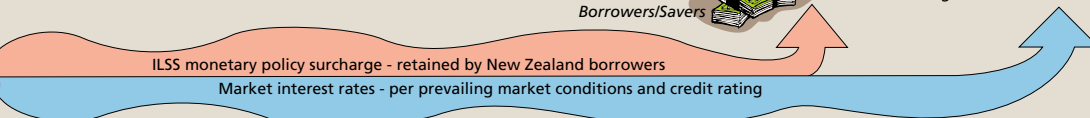
Interest Rates  
%



### ILSS Monetary Policy - when dampening inflation

Overseas lenders receive only a fair minimum interest rate, determined by market conditions and credit ratings. New Zealand borrowers are credited with ILSS-based monetary policy surcharges, as long-term savings held for them through KiwiSaver and/or a national account.

Interest Rates  
%



## 1.7 ILSS targets wider basket of borrowings

A further superior feature of ILSS over the OCR is that, whereas the OCR is applicable only to floating short-term interest rates with delayed and muted effect on fixed-term interest rates, ILSS would be targeted at a wider basket of kinds of borrowing and would have instant and more efficient effect. This combination will mean ILSS will be far more effective and efficient for combating inflation, than the inflation-causing OCR. Examples of discretionary application of ILSS are:

- a. ILSS surcharges will be applied directly to fixed rate as well as floating rate house, farm and other property mortgages. ILSS surcharges will replace implicit OCR surcharges on fixed interest rates, so such borrowers will not suffer unfair impact upon their cashflows. Actually, they too will directly benefit from ILSS. Refer para 10.11.

In any case, I am not persuaded that, on grounds of equity, those who seek certainty by fixing their interest rates deserve exemption from monetary policy. The growing prevalence of fixed rate borrowing, to avoid the OCR, is simply imposing inequity and often severe economic damage upon others, especially floating rate borrowers and exporters, for example. Moreover, by widening the basket to gain the efficiency of ILSS, the rate of an ILSS surcharge could be set at a lower level than would an OCR surcharge have been set under present policies for equivalent economic and inflationary conditions. In addition, as the ILSS surcharge will apply to fixed mortgage borrowing rolled over or taken out after the introduction of ILSS, such borrowing will not be immune from monetary policy changes, as is the case with the OCR. The economy will therefore be more responsive to ILSS changes, so the level of the ILSS surcharge will need less frequent adjustment. ILSS will avoid the over and under-shooting that results from using the OCR.

- b. The ILSS surcharge would also be applied to other forms of consumer borrowing, such as hire purchase or similar consumer borrowing, to again directly contain inflationary spending on consumption. The proviso will always be where it can be collected and administered cost effectively (see section 10.7). As a savings surcharge, there will be little motivation to avoid it. If such an ILSS surcharge is applied it would be administratively simple if applied as a single surcharge on new borrowing agreements

or re-advances under existing agreements. In effect, this is similar to a requirement for larger saved deposits for such purchases.

- c. The Reserve Bank would have the further discretion to apply the ILSS surcharge to business and other forms of borrowing, if it considers that is needed to combat inflationary pressures caused by such borrowing. The proviso will always be where it can be collected and administered cost effectively (see section 10.7). As a savings surcharge, there will be little motivation to avoid it. Moreover the Reserve Bank would have the discretion to differentiate between personalised accounts, or non-personalised, including by differentiation between New Zealand-owned and foreign-owned businesses, eg by ordering that all ILSS surcharges collected from foreign-owned business would be credited to the new 'New Zealand Economic Stabilisation and Growth Fund'. This would be equitable: as quid pro quo for foreigners having access to New Zealand's open border economy; and as recognition that foreign-owned businesses often have scale and other advantages over New Zealand-owned businesses.
- d. The Reserve Bank would also have the discretion to regionalize its application of the ILSS surcharge/s, to recognize circumstances where inflationary pressures vary between regions. The rationale here should be to avoid unnecessary collateral damage. (There is no point in adding to the misery of drought-hit farmers on the East Coast, who have already locked-up their cheque-books, if the inflationary pressures are generating from non-tradeables sectors including government in, for example, Auckland and Wellington).
- e. Special discretions would apply to allow for withdrawals of ILSS deposits in KiwiSaver by businesses. For example, businesses may withdraw deposits to combat climatic hardship or for investment in expansion or productivity improvement.
- f. ILSS deposits by trusts and partnerships would be credited directly to the KiwiSaver accounts of beneficiaries, by annual trustees'/partners' determination;
- g. Unless used manipulatively by a debtor, personal individual ILSS account balances in KiwiSaver would not be available to creditors, to avoid them being pledged as defacto security and to thereby avoid the taxpayers having to bear the burden of retirement incomes. Company/business accounts would be available to creditors.

"... ILSS surcharges will replace implicit OCR surcharges on fixed interest rates, so such borrowers will not suffer unfair impact upon their cashflows...."

## 1.8 ILSS stimulates growth, avoids OCR economic destruction

The rationale by which the Reserve Bank should be mandated to operate the ILSS-based monetary policy should be directed at three objectives: first, to pursue efficacy in combating inflation; second, to minimize collateral damage to undeserving sectors of the economy; and, third, to grow the economy and achieve the specific targets as stated in para 1.4. Used astutely and competently, the foregoing broadened array of instruments and discretions introduced by the ILSS allow for such effective ‘smart bombing’ of inflationary pressures, to avoid the ineffective counterproductive and wholly destructive ‘nuking’ outcomes of the failed single OCR-based instrument. (Even the simple fact that less exporting, primary sector, and manufacturing businesses will go under or under-perform once ILSS is introduced will in itself promote economic growth).

This change, alone, will allow the economy to maintain a higher trajectory of low inflation economic growth than is possible with the OCR instrument, even before the supply-side stimulus advantages that ILSS will also introduce, as additional instruments, to which I now refer in the next section.

## 1.9 Additional ILSS instruments to stimulate growth

ILSS will introduce three further new instruments, designed to maintain economic growth rates:

- a. When there is a need to stimulate the economy, the Reserve Bank will have the power to order refunds to depositors from the ILSS savings held in individual accounts in KiwiSaver. This instrument is important to maintain a high growth trajectory for the New Zealand economy at the level needed to regain parity with Australia for average incomes per capita. Entitlement would be on a FIFO basis, with latitude to the Reserve Bank, at its discretion, to prioritise the clearing of small balances. This ability to stimulate the economy is an additional new ILSS instrument for management of monetary policy.
- b. The ILSS savings funds credited to KiwiSaver accounts would be managed on a unit trust basis with profits/gains, after taxation, credited proportionally to beneficial owners using current KiwiSaver fund investment managers. The Reserve Bank would be involved with directing the prudent investment of the funds, but only to the extent of ordering division between investments to be made either in New Zealand (but not to conflict with the objectives of monetary policy), or overseas. Such allocation decisions would primarily aim to exert influence for a stable exporter-friendly exchange rate at all times, in accordance with predetermined criteria and to provide the finance needed by the domestic economy to maintain the growth cycle referred to earlier. At this time and allowing for the ILSS targets for economic growth rates, I recommend that the target equilibrium values for the NZ\$ be: 55-60 US cents; and 65-75 Australian cents. This is a further new ILSS instrument for management of monetary policy.
- c. The ILSS funds retained for investment in the domestic economy would be specifically targeted at funding faster economic growth to provide supply-side stimulus to the New Zealand economy, to complement the other ILSS instruments which will also assist this stimulus. New funding agencies may need to be established for his purpose, to ensure fast efficient and prudent recycling of ILSS savings into investment in productivity gains and increases to capacity. This supply side stimulus is a further new ILSS instrument

Since the float, increasing integration with world capital markets has likely raised the importance of the exchange rate channel of monetary policy to a point where, in recent times, it may dominate the interest rate channel.

• • •

This configuration of interest rate/exchange rate is less well suited to constraining a housing boom, as the interest rate channel (which might have been effective in an interest-sensitive mortgage market) is muted, and the exchange rate channel squeezes the tradables sector, when the driving cause of the boom is the rapid increase in house prices and the associated wealth effects.

• • •

One commentator [at the forum] described the process as: “Sacking the All Blacks’ coach when the New Zealand cricket team loses a match.”

• • •

In two of the last three cycles the housing sector has been an important element of the shock, and to respond to this by squeezing the tradables sector seems to apply the instrument of policy to an area well removed from the source of the problem.

• • •

If we consider the impact on the cycle, we might be more inclined to look for alternative or supplementary instruments, particularly in the case of domestic shocks such as a housing boom.

The central point is that interest rates are not doing the “heavy lifting.” The main driver is the exchange rate...

*Stephen Grenville*

*Lowry Institute and former deputy governor of the Reserve Bank of Australia.*

*Excerpts from: RBNZ/Treasury Forum: Testing stabilisation policy limits in a small open economy*

June 2006

for the operation of monetary policy.

## 1.10 Summary of benefits from ILSS

A list of the many benefits that will derive from ILSS is given in Section 9 of this submission. The following is a summary of the principal categories of benefit.

### Monetary Policy

The Reserve Bank's dependence upon the destructive and failed OCR instrument will cease. The OCR will be retained as a reserve instrument, but is unlikely to be used.

ILSS will introduce a suite of new easily usable instruments, based upon a savings surcharge on interest rates, retained as mostly free national savings to support the New Zealand economy, to replace the OCR surcharges on interest rates that are in effect given away as free gifts to foreign lenders, to support foreign economies. Thereby, monetary policy will not be so interventionist. Interest and exchange rate markets will operate freely, without the distortions and destruction caused by the OCR.

The ILSS suite of new instruments, including supply-side stimulus, will enable the targets for the operation of monetary policy to be widened, to include:

- CPI inflation at an average of 1-3% pa over the medium term.
- External current account deficits to be eliminated within ten (10) years, by doubling real export revenues per capita.
- Regain parity with Australia for average income per capita within fifteen (15) years.
- New Zealand to repay foreign debt, to be a net creator (lender) nation, not a net debtor (borrower) nation, within twenty (20) years.
- Enabling the attainment of the foregoing targets by a number of means introduced by ILSS, including targeting exchange rate stability for the NZ\$ at 55-60 US cents and 65-75 Australian cents, with future appreciation of value of the NZ\$ to reflect real gains to the strength of the New Zealand economy, relative to comparable economies, to thereby equitably share within the New Zealand community the

increased wealth created by ILSS.

- Avoidance of the 'collateral damage' caused by the OCR's nuking of the productive economy, by using ILSS to surgically smart bomb inflation risks.

### National savings

ILSS will substantially and rapidly increase national savings, by:

- Capturing as free savings the ILSS surcharges on interest rates imposed by the Reserve Bank above the rates the markets would otherwise expect, so that the surcharges that are currently gifted to foreign lenders, to grow their economies, are retained as free national savings owned by Kiwis, used to grow the New Zealand economy.
- Increasing the economic growth rate and capturing as savings part of that additional growth to fund economic growth with Kiwi funds, not by borrowing back the funds we have gifted to foreigners by the OCR.
- Compounding of returns on the vastly increased national savings supplemented by ILSS.
- Greatly expands KiwiSaver and the depth of New Zealand's capital markets.

### Fiscal impact

Government's fiscal position will be greatly improved by:

- Taxation of ILSS earnings.
- Increased taxation revenues from expanded economy.
- Lower negative expenditures (prisons, etc).
- Greater ability to fund positive expenditures on: education, health, welfare, police, defence, superannuation, infrastructure, etc.
- Ability to give tax cuts without the Reserve Bank reacting to inflation fears with OCR interest rate increases, to in effect gift the tax cuts to foreigners.
- New Zealand will regain its economic sovereignty by removing the risk of dependence upon access to foreign funders

There is no doubt our dollar is overvalued and is being held up by New Zealand offering the highest interest rates in the developed world. The current account deficit of 9 per cent of gross domestic product is a reflection of the lack of international competitiveness of the tradables sector at the current level of the exchange rate.

To achieve a corresponding improvement of the trade balance through stronger export and slower import growth, the dollar would have to fall by about 20 per cent from its present level. Consistent with past estimates, that puts it in the 55-60c range against the US dollar.

*Ulf Schoefisch*  
*Independent economic*  
*consultant*

and by regaining and maintaining greater ownership of its businesses and assets.

## Economic development

ILSS will provide strong impetus to export, regional and national development, by:

- Export led growth.
- Productivity gains and expansion of industrial capacity.
- Stimulus to investment in value adding to primary products.
- Funding for and supportive economic policies to encourage general economic expansion, including new business start-ups.
- Stemming the loss of businesses relocating to foreign countries.
- Encouragement of foreign businesses to establish in New Zealand.
- Stemming and reversing skills flight, by emigration, to improve the skills level of the New Zealand workforce.
- Improved national credit ratings to reduce sovereign risk premiums on interest rates.
- New Zealand capital provided from New Zealand savings will fund economic expansion, so that the New Zealand economy derives the maximum benefit of its production.

## Social development and equity

ILSS will introduce social and equity benefits, too:

- Higher personal incomes will improve the social well-being of the community, especially the lower paid.
- Better education, health and welfare services.
- Improved retirement incomes.
- Accelerated repayment of student debt, to allow the well educated to have families too, and incentivise those with skills to remain in New Zealand.
- Greater social equity, because monetary policy will not fall so heavily upon the most vulnerable: young families struggling with student loans and mortgage debt.
- Domestic savers will receive interest rates set by the market. They will also have access to deeper capital and investment markets; and will benefit from better control of inflation. Their need to assist their decedents into house purchases, by contributions of funding, will reduce.

## Conclusion

By use of a savings instrument, we will re-engineer monetary policy to operate conventionally, in the way it was originally intended.

“...ILSS will introduce social and equity benefits, too...  
Greater social equity, because monetary policy will not fall so heavily upon the most vulnerable: young families struggling with student loans and mortgage debt.

Conclusion  
By use of a savings instrument, we will re-engineer monetary policy to operate conventionally, in the way it was originally intended...”