

## **Monetary Policy: Support Builds for ILSS Solution**

8 October 2007

The delegation representing the group that is advocating the implementation of the 'Interest Linked Savings Scheme' (ILSS) solution, to provide the New Zealand Reserve Bank with more rational instruments for the operation of monetary policy, will appear before the Finance and Expenditure Committee of parliament on Wednesday, 10 October 2007.

"The time allocated to our group has been extended to 40 minutes, which is still tight, so we have reduced our delegation to five persons, to make the most efficient use of this time" says the originator of the ILSS, Phil Verry, who is the executive chairman of EROS Capital Ltd and of Red Stag Timber Ltd, which operates Waipa Mill, New Zealand's largest sawmill and timber processing plant.

Mr Verry says the ILSS delegation will be:

Phil Verry: executive chairman, EROS Capital Ltd and Red Stag Timber Ltd;

Anthony Byett: economist; former chief economist for ASB Bank;

Bryan Gould: company director; former Vice-Chancellor, Waikato University; and former British political leader;

Michael Houlahan: CEO, Tuatara Consulting, a leading NZ forex management company;

Steven Becker: chief analyst, Tuatara Consulting.

He says the delegation will also convey letters of support, for ILSS to be seriously pursued, including from:

Alasdair Thompson: CEO, Employers & Manufactures' Association (Northern) Inc;

Peter Conway: economist, NZ Council of Trade Unions.

"The letters demonstrate how broad-based is the support for ILSS. We have many other supporters from diverse sectors of New Zealand commerce and society, who have recognised: the economic damage caused by the present OCR-based methodology used for the operation of monetary policy, and; the many benefits the ILSS methodology would bring to the New Zealand economy", says Phil Verry.

"The move by government to order the review of monetary policy followed a speech I gave on 14 October 2005 to which the Minister of Finance, the Hon Dr Michael Cullen, responded followed by interest by the Prime Minister, Helen Clark".

"Therefore, we feel a responsibility to ensure the select committee is fully briefed, including an understanding of the adverse consequences for the nation's economic future if the failed OCR-based methodology is not dumped", says Phil Verry.

***Attached: Paper by Bryan Gould, which gives a succinct précis of the 'Interest Linked Savings Scheme' (ILSS).***

### **The Interest-Linked Savings Scheme**

The constant assertion that there is no alternative to current policy and that other proposals are all fatally flawed is given the lie by the excellent and ingenious schemes that have been put forward by knowledgeable people with good practical experience of what it means to be running a business in the current context. One such instance is the Interest-Linked Savings Scheme put forward by Phil Verry, a leading figure in New Zealand's business community, and the head of New Zealand's largest sawmilling firm. The Scheme warrants some detailed consideration, both because of its intrinsic merits and because it illustrates so clearly the falsity of the contention that there are no ideas that are worthy of attention.

The starting-point for the ILSS is the observation that the constant and exclusive reliance on the Official Cash Rate in order to control inflation means that New Zealand business people, producers and investors are being asked to pay an extra-market interest rate surcharge across the board, the cost of which is lost to the New Zealand economy because it is paid in the main to overseas investors who contribute nothing to the New Zealand economy and whose gains at our expense cost us twice over by adding to our current account deficit and penalising us with an overvalued currency. The ILSS provides a way of using what are essentially fiscal measures to mimic the operation of the OCR as a counter-inflation tool without burdening the New Zealand current account with unnecessary payments to foreigners or the denial of valuable resources to investment in the New Zealand productive capacity.

The Scheme would work by replacing the Official Cash Rate with a savings surcharge applied to interest rates. The key difference between the ILSS and the OCR is that, instead of paying an interest rate premium to foreigners, the savings surcharge would be paid into either the individual savings accounts of borrowers, through a scheme such as KiwiSaver, or into a general fund which would then be used to invest in the New Zealand economy.

In the former case, the surcharge would, by lowering the spending power of consumers, reduce demand and therefore operate for counter-inflation purposes in the short term very much like a tax. It would also have, by raising the cost of borrowing, the same counter-inflation effect as a rise in the OCR. The money paid into individual savings accounts would eventually be paid back to those who paid the surcharge, perhaps – as with KiwiSaver – with the addition of whatever return had been made on investing the money. The repayment would be made at a time when inflationary pressures had diminished. It would offer on the other hand an effective way of stimulating the economy at times of threatened deflation or recession.

In the latter case, the money raised through the surcharge would be paid into what the framers of the Scheme call a New Zealand Economic Stabilisation and Growth Fund. The money raised would in this case not be returned to those who paid the surcharge but would instead be invested in infrastructure and other projects designed to improve our productive capacity. In this respect, the Fund would act in a way not unlike the Superannuation Fund, but with the key

difference that the investments would be made, not just to produce a good return to the public but also to benefit directly the performance of the New Zealand economy. Again, money would be released from the Fund and invested at times when the level of demand in the economy meant that this could be done safely.

These fundamental differences between the OCR and the ILSS mean that a large number of collateral benefits would also be obtained. We would no longer be penalising ourselves and losing national wealth by making free gifts to short-term investors of "hot money" from overseas. We would no longer be burdening ourselves with an over-valued currency, an inflated current account deficit and an exchange rate roller-coaster. Macro-economic policy, including exchange rate policy, could be allowed to fulfil its proper purpose of promoting the continued development and competitiveness of new wealth-creation.

The pain felt when the savings surcharge was raised would be offset by the realisation that the surcharge would in due course be returned to those paying it, operating like a kind of compulsory saving, or would be earmarked to invest in our productive capacity, or a combination of both. The political price to be paid for taking action to raise the surcharge would accordingly be much reduced, and the political obstacle to taking effective counter-inflationary action would be lowered.

Those who might be nervous about departing from the current orthodoxy could be reassured since the OCR would not be abandoned, but could be kept in reserve and wheeled out if for any reason the savings surcharge proved ineffective. This seems unlikely, given the advantages that the ILSS has over the OCR in both its immediate effectiveness as a counter-inflation instrument and its avoidance of the huge damage done to our economy by the OCR weapon.

The potential scope and practical operation of the ILSS strongly suggest that it would be much more effective in combating inflation than the OCR could ever be. Lenders and investors would be free to respond to normal market factors in agreeing on what interest rate would be paid in a given transaction. Foreign lenders would not be paid a premium above the market rate.

The impact of the ILSS would be both potentially much wider and more easily targeted than the OCR. It would be wider because it would apply as much to fixed interest rate arrangements as to floating interest rate deals, and it could also be extended to a range of consumer credit transactions and to mortgages other than on residential property. It would accordingly be much less easily evaded than the OCR which has seen its effectiveness substantially reduced by the preponderance of fixed interest rate mortgages. A lower evasion rate would mean that the surcharge could be lower for a given counter-inflation effect than the less reliable and more easily evaded OCR.

It would be more easily targeted because – instead of operating through the single decision to raise the Official Cash Rate paid by the banks and then relying on a problematic "trickle down" of higher interest rates throughout the economy – it could be stipulated that it would apply only to some kinds of borrowing instruments or purposes, or to particular geographical areas or industries. This would remove one of the major objections to the OCR – its broad-brush impact which means that the whole of the productive economy will be damaged by the attempt, for example, to rein back inflation in the housing market.

We should, however, re-emphasise the most important advantage of a scheme like the ILSS – the fact that our economy (and our living standards and economic prospects) would no longer be paying a huge price for a relatively ineffective counter-inflation strategy. There will no doubt be those who are content to try to pick holes in this well thought-out proposal, rather than accept its superiority over monetarist orthodoxy, but those holes – even if they do exist – are the merest pinpricks by comparison with the gaping chasm into which the current strategy has plunged our economy.

We can be confident that proposals like the ILSS give the lie to the constant assertion that there is no alternative. A strategy such as the ILSS, coupled with some of the other measures that might be taken, would not only take care of our inflation problem more effectively but would also open up a much brighter economic future for us.