THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Net debt as a fiscal anchor - balance sheet management

Date:	17 April 2009	**Report No:**	T2009/927

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Discuss at FSR meeting, Monday 20 April, 4.00pm	Monday 20 April, 4.00pm

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Mark Sowden	Manager, Macroeconomic Group	[deleted – privacy]		✓
[deleted – privacy]				

Minister of Finance's Office Actions (if required)

None.

Enclosure: No

Treasury Report: Net debt as a fiscal anchor - balance sheet management

Executive Summary

The 2009 Fiscal Strategy Report (FSR), to be published with the 2009 Budget, will set out the Government's complete fiscal strategy, as recently agreed by Cabinet. We are currently working on a draft of the FSR which will provide options across all of the elements of the fiscal story. Alongside this report you will have received an outline of the FSR. This report seeks decisions about the debt objective ahead of the other elements because of its importance as a fiscal anchor.

At Fiscal Issues on March 18 we discussed the possible shift from gross debt to net debt as the fiscal anchor. In addition, we proposed a new definition for net debt. This report seeks confirmation of these changes and a decision about the formulation.

The key reason for the shift in the fiscal anchor is that net debt more closely reflects the policy decisions of the Government and the amount of fiscal headroom available whereas gross debt is influenced by a range of operational decisions by the Reserve Bank and New Zealand Debt Management Office (NZDMO). We therefore recommend the shift to net debt as the fiscal target as part of the wider balance sheet management approach.

The financial statements currently publish two versions of net debt – both including and excluding the NZS Fund. We recommend targeting a version of net debt that excludes NZS Fund otherwise the projected growth in the NZS Fund over time would need to be reflected in the profile for the target.

In addition, we recommend the net debt indicator exclude advances. Advances, such as student loans and DHB loans, are undertaken for public policy rather than government financing reasons.

The debt objective can either be set at current tracks, or at a more ambitious level. There are many advantages to setting a low debt objective. Even as the current financial crisis begins to unwind, it would be reasonable to assume a degree of heightened vulnerability and volatility in the near term. This suggests keeping a significant debt buffer. Notwithstanding the partial prefunding provided by the NZS Fund, we still face fiscal challenges in terms of increasing costs for government funded retirement incomes and healthcare. This suggests a low debt starting point as these pressures start to hit in 2025.

However, in doing so there is a likelihood that the government would be pressed for details of how it will get below the current projected track. While some extra recognition may be gained from credit rating agencies for setting an ambitious target, questions would then arise as to the method to achieve it.

Our advice balances these factors and we recommend setting an objective that keeps net debt below 40% of GDP, and over the next 15 years see it reach 30%. Additionally, we recommend you include that ideally you would like to see it reach a lower ratio, perhaps around 20% of GDP, by the time demographic change starts to build and the NZS Fund starts to play its role. Over this period you can consider carefully how any positive revenue surprises over this period should be dealt with.

Recommended Action

We recommend that you:

a **note** we are currently preparing a draft of the Fiscal Strategy Report which will provide a range of options around the fiscal objectives, given its important role as a fiscal anchor, we are seeking decisions about the debt objective ahead of the other elements;

b **agree** to specify the Government's long-term debt objective in terms of net debt, less NZS Fund and advances;

agree / disagree

c **note** that, if there is any change to government policy regarding borrowing by state-owned enterprises or Crown entities (e.g. public-private partnerships), the use of a core-Crown debt target should be revisited to preserve the credibility of the debt objective and the Government's fiscal policy;

d **agree** to the wording for the objective of net debt to be:

"We intend to keep net debt below 40% of GDP and over the next 15 years see it reach 30%. Ideally we would like to see it reach a lower ratio, perhaps around 20% of GDP, by the time demographic change starts to build and the NZS Fund starts to play its role.";

agree / disagree

e **agree** to accompany this wording with an explanation of the degree of heightened vulnerability and volatility in the near term and the fiscal challenges in terms of increasing costs for government funded retirement incomes and healthcare. (These are further explained on page 9 of this report); and

agree / disagree

f **discuss** at our meeting on Monday 20 April at 4.00pm any wording changes you would like.

Mark Sowden
Manager
for Secretary to the Treasury

Hon Bill English
Minister of Finance

Purpose of Report

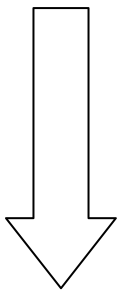
1. The purpose of this report is to get a decision on the appropriate form and level of the debt target for the 2009 Fiscal Strategy Report (FSR). Cabinet has recently made decisions regarding the fiscal strategy over the medium-term. As noted in that Cabinet paper, the FSR, to be published with the 2009 Budget, will set out the complete fiscal strategy, including an increased focus on balance sheet issues, together with the formal reporting requirements set out in the Public Finance Act 1989 (PFA) (e.g., revised long-term fiscal objectives and fiscal projections). We are currently preparing a draft of the FSR that will set out the main elements of the story. You will have received an outline of the FSR alongside this report. Given its important role as a fiscal anchor, we have separated the shift away from gross to net debt from the drafting of the FSR.

Move from Gross to Net Debt

2. This report follows our discussion at Fiscal Issues on Wednesday 18 March by seeking a decision from you on the move to a net debt anchor; the definition; and the wording of the anchor. In that discussion you mentioned that you thought net debt was a good idea, but we wanted to come back to confirm this with you. While there were also discussions on the net worth issue, this report will focus on net debt as a fiscal anchor and net worth will be considered as part of the balance sheet work programme and reported on separately. At this stage we are only expecting to include net worth as one of a suite of indicators as part of Budget 2009 due to the potential significant practical issues in translating the net worth indicator into a fiscal management tool.

There are a suite of indicators available for Budget 2009:

Wide



Specific

Debt indicator[1]	
Gross debt	
Gross debt excluding settlement cash	*Current fiscal anchor
Gross debt excluding settlement cash and Reserve Bank bills	
Net debt including NZS Fund	*
Net debt excluding NZS Fund	*
Net debt excluding NZS Fund and advances	Proposed fiscal anchor

* Currently reported

3. We suggest there is value in moving from the current gross debt anchor to a net debt anchor. The key advantages of net debt are that it more closely reflects the policy decisions of the Government and the amount of fiscal headroom available. Gross debt

[1] We also envisage that budget documentation will continue to include net worth as part of a suite of indicators. Net worth will be further explored as part of the separate balance sheet work programme.

is influenced by a range of operational decisions by the Reserve Bank and New Zealand Debt Management Office (NZDMO) that do not affect the net debt position of the Government and it does not account for financial assets. (See Appendix One for a full explanation of the advantages and disadvantages of net and gross debt as a fiscal anchor).

4. One consideration is the perception of the shift from gross to net debt given current economic circumstances. Some commentators may argue that the change is being made to make the debt situation appear to be better than it is using a gross debt definition. The response is that gross debt will continue to be published but for fiscal management net debt is a better target measure. This issue will be addressed in the FSR.

Definition of Net Debt

5. A decision needs to be made regarding the definition of net debt. The choices involve the potential inclusion or exclusion of the NZS Fund and advances.

Should the NZS Fund be included in the calculation of net debt?

6. The Budget documentation publishes an indicator of net debt that includes NZS Fund assets as it is a useful indicator of the overall progress towards prefunding future liabilities. However, we do not believe this indicator is appropriate as a target because:

- if the NZS Fund grows over time, the inclusion of it in the net debt measure would mean that the target would have to show a changing profile over time. This makes communication of the target more difficult;

- there may be increased focus on accumulating assets in the NZS Fund. This might mean a greater weight is put on the pre-funding aspect of the strategy at the expense of not taking appropriate actions in the interests of macro stability;

- significant movements in the indicator may be seen from factors that are not the direct result of fiscal policy – specifically, movements in the valuation of the Fund's assets. While valuation movements will still remain if the NZS Fund is excluded (through NZDMO and the Reserve Bank), the NZS Fund is the biggest source of these valuation movements; and

- the pre-funding aspect of the fiscal strategy can be captured through the operating balance objective (ultimately to run surpluses sufficient to meet requirements for contributions to the NZS Fund), reporting on the Fund separately and through balance sheet indicators.

Should advances be included in the net debt calculation?

- advances are made for public policy reasons rather than for purposes associated with government financing. Including them in an indicator that represents the financing position of the government is therefore neither appropriate nor of benefit to users of the indicator; and

- advances are not liquid in the short term so their inclusion in the net debt indicator may provide a misleading indicator of the government's ability to meet obligations. This is because in the New Zealand context, advances are mostly student loans and loans to DHBs, which are particularly illiquid and their valuation may differ from their actual market value. Securitisation would perhaps be possible, but is not often done in this current economic environment, making advances illiquid. However, their inclusion would allow greater international comparability as the OECD generally includes advances in its definition of net debt.

7. We suggest the arguments for excluding advances outweigh the benefit from possible international comparability so propose to use a net debt measure excluding advances.

We therefore propose moving to a net debt measure that excludes both the NZS Fund and advances.

8. You should note that net debt only takes into account core crown financial assets and liabilities. The credibility of this definitional choice depends on the Crown not using intermediaries to borrow or enter into obligations that a counterparty would not accept on normal commercial conditions. The current policies applying to Crown Entities and SOEs support the use of only core Crown for net debt but if any changes were to be made to these policies (e.g. around the use of public-private partnerships) this decision would need to be reviewed.

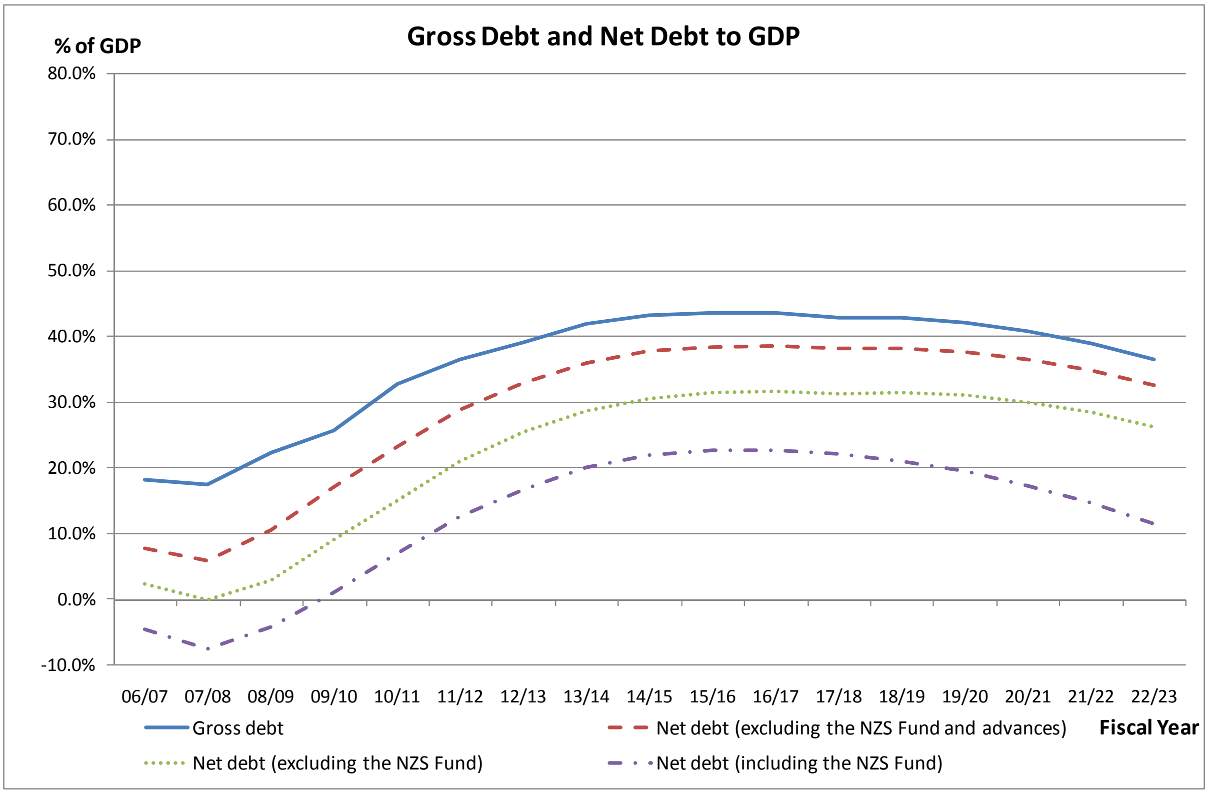
How the Current Gross Debt Anchor Translates into the Proposed Net Debt Anchor

9. The following table show the growth in both gross and net debt over time under the 2009 Fiscal Strategy package.

Gross Debt vs. Net Debt – under the 2009 Fiscal Strategy package

Fiscal Year **% of GDP**	**08/09**	**09/10**	**10/11**	**11/12**	**12/13**	**17/18**	**22/23**
Gross Debt[1]	22.4%	25.8%	32.7%	36.5%	39.1%	42.8%	36.5%
Net Debt[2]	10.7%	17.1%	23.2%	28.9%	32.9%	38.1%	32.6%
Difference	**11.7%**	**8.6%**	**9.5%**	**7.6%**	**6.1%**	**4.7%**	**3.9%**

Figure 1: Gross and net debt indicators under the 2009 Fiscal Strategy package



Where:
Gross Debt is Gross Sovereign-Issued Debt (GSID) less Reserve Bank settlement cash and bills.

10. At the end of the forecast period in 2012/13 gross debt is 39.1% of GDP while net debt (excluding NZS Fund and advances) is 32.9% of GDP. At the end of the projection period in 2022/23 gross debt is 36.5% of GDP while net debt is 32.6% of GDP.

11. The wedge between the gross debt and net debt measures above is made up of financial assets (excluding those held by the NZS Fund and advances in our recommended measure). The difference between gross debt and our recommended net debt measure narrows over time. Put simply this is because debt is rising faster than financial assets are being accumulated.

12. Most of these financial assets are held by the DMO and the Reserve Bank. The financial assets held by the DMO are generally being reduced in the forecast period (though they use some ‘smoothing’ techniques which can cause fluctuations up and down). The financial assets held by the Reserve Bank are almost constant in the forecast period. The financial assets held by both the DMO and the Reserve Bank are also held constant (from the number in the last forecast year) in the projection period. In particular the level of foreign reserves has historically been assumed constant in nominal terms (an unreasonable assumption in the long run).

Setting Objectives

13. The PFA requires that objectives are set for five indicators; debt (we recommend the net debt anchor); the operating balance; revenue; spending and net worth. We are seeking a decision about net debt and the debt objective first because of its importance as the fiscal anchor. The wording for these other secondary objectives will be reported on as part of the developing FSR.

14. The objective can either be set at current tracks, or at a more ambitious level.

Debt objective set at current tracks

15. From the above figures and chart, net debt (excluding NZS Fund and advances) is projected to be 32.6% of GDP in 2022/23. This would suggest setting a target of around 30% of GDP in the long run.

Debt objective set at a more ambitious level

16. You could choose to set your debt objective at something below current tracks to signal the Government's commitment to reducing debt. There are advantages and disadvantages to doing this.

Advantages of a lower debt objective

- it acts as a stronger "fiscal anchor" – a top down tool that can help Ministers to manage expense pressures and ensure value for money;

- it allows debt to play a shock absorber role in the face of economic shocks, which is particularly important for a small open economy, especially in the current environment with higher volatility;

- it helps to maintain if not improve New Zealand's credit ratings (through in part acting as a counterweight to New Zealand's high external indebtedness in the eyes of the credit rating agencies) with consequent benefits for the cost of capital. Here a lower debt objective is better as long as it is credible;

- it keeps debt servicing costs as low as possible, therefore keeping resources free for higher value spending or tax initiatives;

- it maximises the options available to future governments to cope with the fiscal pressures arising out of population ageing. These pressures can be expected by 2025 so this is the time you would want debt to be at its minimum. This does assume that no other action is taken to address longer term challenges;

- the overall effect of the contribution holiday from the NZS Fund means that even once contributions are resumed the value of NZS Fund never will regain previously projected levels, and there will be either less pre-funding overall or more will have to be done through lower debt to compensate; and

- it helps to preserve fiscal headroom to deal with the current economic crisis. At present, the current recession, while serious, is not an extraordinary New Zealand-specific shock. Despite being unlikely, there is a potential risk that we will still need a buffer to deal with issues such as the potential bail-out of the banking sector or a freezing up of the credit market. (Countries such as the US and the UK have already incorporated the costs of the financial crisis bailout in their worsened debt outlook).

Potential problems with a lower than projected debt objective

17. Setting a lower-than-projected debt target would raise questions among various parties. While some extra credit may be gained from credit rating agencies for setting an ambitious target, questions would then arise as to the method to achieve it. Without a full explanation of the reasons for setting a lower-than-projected target agencies may discount the more ambitious goal to some extent. Setting a lower-than-projected target would imply either you plan to carry out more fiscal consolidation in the future or that you believe Treasury's forecasts are viewed as pessimistic and you plan to bank any surpluses gained in future to then pay down debt. Either way you may come under pressure to explain any strategies for reaching your lower debt target.

Treasury's Recommendation

18. Ideally we would recommend you set a low rate, ideally around 20% to enable the economy to be well-placed to deal with costs rising with demographics in the long run and to be better placed to deal with shocks that might hit our small open economy.

19. However, recognising that the Government's view of necessary actions gets net debt to around 30% in 2022/23, we think setting a lower specific target may raise credibility issues and imply actions in addition to what the Government currently considers necessary. If you conclude that for now an appropriate long-run formal objective is a net debt of 30%, a formulation that might achieve this, while aspiring to something lower longer-term, is set out below.

Suggested wording to support the objective in the FSR

20. The Government has made decisions in this Budget that bring net debt back so that it reaches around 30% of GDP by 2023. Net debt would peak below 40% of GDP. Rising debt indicates that we are utilising the buffer provided by New Zealand's currently low levels of public debt.

21. Larger economies with lower levels of net international liabilities can arguably sustain high public debt ratios. For example, the UK has previously operated with a net public debt ratio around 40% of GDP while it's net international liabilities are around [15]% of GDP. In contrast, New Zealand is a small, open economy subject to large swings in its international terms-of-trade and with a net international investment position approaching [100]% of GDP. Even as the current financial crisis begins to unwind, it would be reasonable to assume a degree of heightened vulnerability and volatility in the near term. Our ability to use debt as a buffer in the current crisis is because we start with relatively low levels of public debt. This suggests returning to a low public debt ratio over time so as to be well placed for the next shock.

22. Notwithstanding the partial prefunding provided by the NZS Fund, we still face fiscal challenges in terms of increasing costs for government funded retirement incomes and healthcare. Treasury published its first Statement on the Long-term Fiscal Position in 2006. The statement indicated significant fiscal challenges in the future, with debt-to-GDP starting to rise from around 2025. This situation is unlikely to have materially improved.

Suggested formulation for the objective

23. These factors mean that *we intend to keep net debt below 40% of GDP and over the next 15 years see it reach 30%. Ideally we would like to see it reach a lower ratio, perhaps around 20% of GDP, by the time demographic change starts to build and the NZS Fund starts to play its role.* The suspension of capital contributions to the Fund over the period of operating deficits will mean that the Fund is smaller than otherwise when entering the period of demographic change. Note that the PFA specifies that targets must be set to a ten or greater year horizon, hence a 15 year target is of no consequence.

24. Over this period we will consider carefully how any positive revenue surprises over this period should be dealt with. This will take into consideration our overall revenue strategy [*to be included as an Annex as in the 2008 FSR.]* Faced with high levels of uncertainty, we may need to respond further if the world situation worsens and the New Zealand fiscal position deteriorates further.

Appendix One:

Advantages of net debt v gross debt

Transparency	Net debt is more transparent in terms of its role in presenting information on available "fiscal headroom". The fiscal constraint is determined not only by the level of debt but also the level of financial assets held. Net debt includes financial assets held by the New Zealand Debt Management Office (NZDMO) and therefore changes in these assets are reflected in the measure.
Consistency	Movements in net debt are more consistent with residual cash compared to gross debt. Residual cash typically initially flows through to changes in holdings of NZDMO financial assets which are included in net debt and not in gross debt.
Reflects primarily fiscal policy decisions	The debt indicator should primarily reflect fiscal policy decisions. Net debt is not impacted by decisions such as the change to banks' holdings of settlement cash. The level of settlement cash reported in financial statements is determined by Reserve Bank operational decisions and varies. This influences the level of gross debt. A net debt target would allow the Reserve Bank and other core-Crown entities to structure their balance sheets without unnecessary regard for the impact such decisions have on the Government's debt objective. Such decisions could involve wider considerations such as the overall level of risk rather than just the level of debt. In recent months, issuance of Treasury bills has increased in response to demand for relatively liquid assets from banks. This change is seen in a gross debt increase but is not reflected in net debt.
Communication	Net debt would provide the best information on the short term solvency of the Government.

Disadvantages of net debt v gross debt

Familiarity	The public is familiar with a gross debt indicator, less so with a net debt indicator.
Definitional Issues	There is no consistent international definition of net debt making it difficult to do international comparisons. Some financial assets are not liquid in the short term (e.g. student loans), thereby providing a misleading indicator of the government's ability to meet obligations.

However, we believe these definitional disadvantages can be minimised by targeting a relatively narrow definition of net debt which includes financial assets such as cash, cash equivalents and marketable securities, but excludes student loan advances and the New Zealand Super Fund.

On balance, we believe net debt would be a more appropriate debt indicator. The key advantage of the net debt indicator is that it more accurately reflects the "fiscal headroom" available to the Government.

Table 1 below sets out the differences between the current gross debt indicator, the current net debt indicator (including advances) and the proposed net debt indicator (excluding advances).

Table 1 – Components of debt indicators

As at February 2009	**Gross debt* indicator ($ million)**	**Current net debt indicator ($ million)**	**Proposed net debt indicator ($ million)**
GSID	53,332	53,332	53,332
Less RB settlement cash	(9,508)		
Add back NZDMO borrowing due to settlement cash	1,600		
Less RB bills	4,677		
GSID excl set. Cash and RB bills	**40,747**		
Less core Crown Financial assets		61,063	61,063
Net core Crown debt (incl NZS)		**(7,731)**	**(7,731)**
Add back NZS Fund		10,982	10,982
Net core Crown debt (excl NZS Fund)		**3,251**	**3,251**
Add back advances			11,356
Net core Crown debt (excl advances)			**14,607**

* Gross debt indicator is GSID less Reserve Bank settlement cash and bills
Source: February 2009 Government Financial Statements