The Treasury

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TE TAI ŌHANGA
THE TREASURY

Fiscal indicator review update

Finance priorities meeting 12 August 2021

Macroeconomic & Fiscal Policy, Fiscal Reporting, and Capital Markets Policy teams

12 August 2021

Introduction

The purpose of this meeting is to get your feedback on:

- where we are getting to with the formulation of net debt
- our wider work on fiscal indicators
- possible public engagement relating to the indicators and the plan to implement any changes

This slide pack outlines:

- our current thinking on the fiscal indicators
- the implications of any changes to the fiscal indicators for fiscal management, including the fiscal strategy, fiscal targets, and Budget process
- implementation considerations

Note that this slide pack only considers fiscal indicators, not fiscal strategy more generally. You will be receiving advice on the Budget strategy tomorrow, which will include our initial advice on fiscal policy responses to the improved economic outlook.

Main recommendations

Net debt

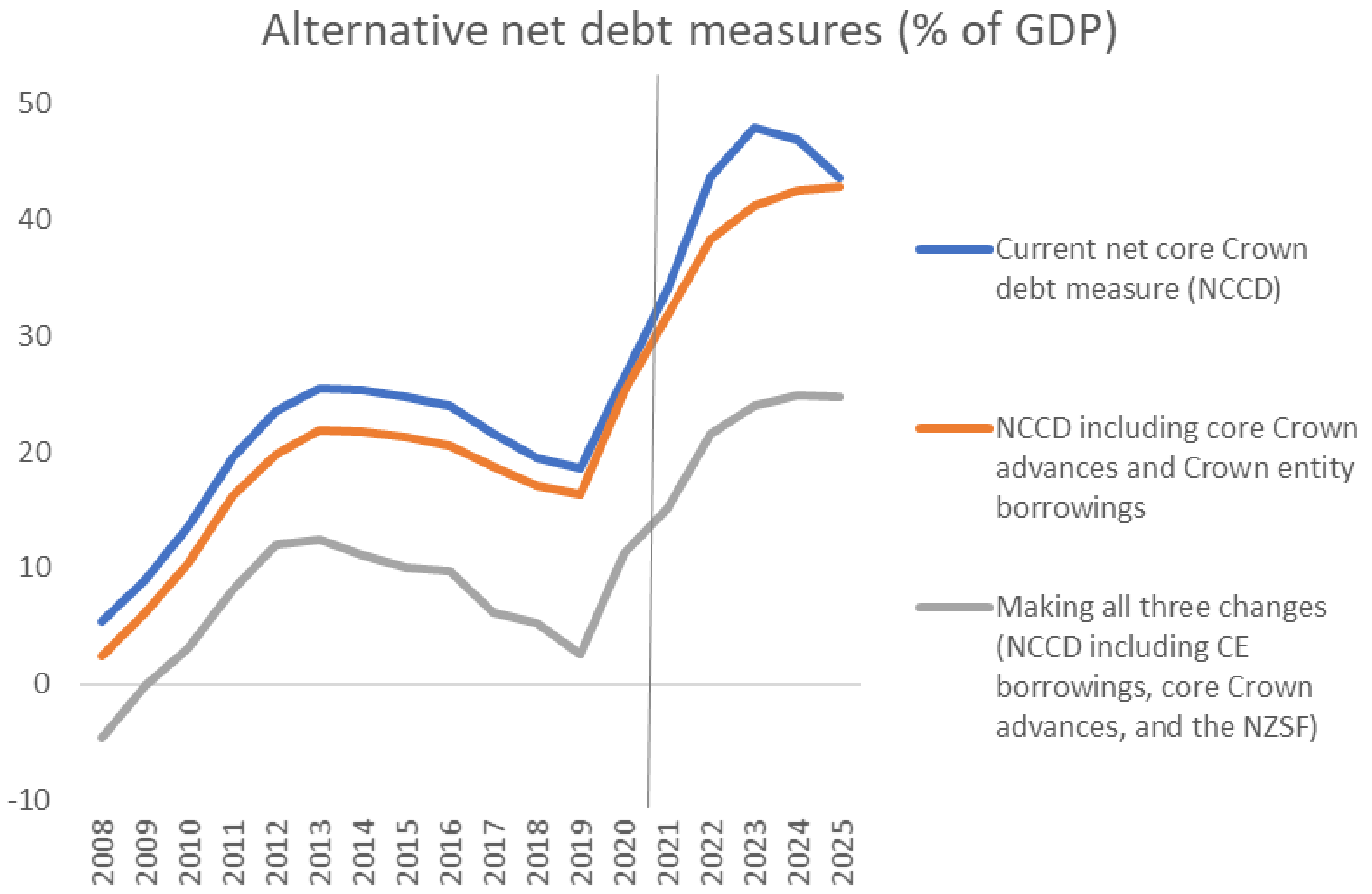
- We recommend broadening the coverage of the net debt indicator to include more financial assets and liabilities. This would:
  - present a clearer picture of New Zealand's fiscal position
  - resolve some specific issues with Crown entity borrowing and the Reserve Bank
  - better align the indicator with international norms for the most part, and with how market participants view debt levels.
- In particular, we recommend including:
  - Crown entity borrowing
  - advances
  - The New Zealand Superannuation Fund (NZSF), although we recommend also presenting a version of the indicator without the NZSF.

Other indicators

- We recommend:
  - Leaving OBEGAL unchanged
  - Working towards publishing a debt-servicing-to-GDP indicator. We will provide further advice on the definition and possible uses of it.

How the alternative indicators would look

- Over the forecast period, including Crown entity (CE) borrowings and core Crown advances initially lowers and flattens net debt. This is because the impact of including advances is slightly larger than the impact of including CE borrowings. By the end of the forecast period the measures are relatively similar, and based on current policy settings this trend is likely to continue beyond the forecast period.
- Including the NZSF signficantly reduces net debt as it brings a large amount of assets into the indicator.



Background

- Net core crown debt was adopted as a fiscal anchor in 2009 on Treasury advice, replacing gross debt (T2009/927 refers).
  - This was mainly because gross debt was being impacted by the operational decisions of the Reserve Bank and the Debt Management Office.
- Treasury started a review of the headline fiscal indicators in late 2020, focusing on whether net debt and OBEGAL were fit-for-purpose.
- We provided a slide pack to you in March summarising our analysis. Following this, you considered it would be best to defer decisions until after Budget given the complexity of the issues (especially regarding net debt).

Main issues with net debt

- The main questions are around what assets and liabilities should be included in net debt, particularly:
  - **The treatment of Crown entity borrowing**: Third party Crown entity borrowing has become significant but is not included in the net debt indicator. Crown entity borrowing from third parties is forecast to grow to around 4% of GDP by 2025, and could grow significantly further beyond that. Most of the borrowing is currently done by Kāinga Ora and Waka Kotahi.
  - **The impacts of RBNZ interventions**: The main issue relates to the Funding for Lending Programme (FLP). Net core Crown debt currently includes the liabilities created by the FLP (the settlement cash) but excludes the assets (the loans, which are advances). This increases net core Crown debt by up to 7.5% of GDP over the forecast period. Large Scale Asset Purchases (LSAPs) have also impacted net debt through repurchase price effects.
  - **Longstanding questions around the exclusion of the NZSF:** Making contributions to the NZSF builds a realisable asset for the Crown, but this is not currently recognised in net debt. The net assets of the NZSF are forecast to be around 19% of GDP by 2025.

Criteria used for evaluating changes to net debt

We have used the following criteria to consider changes to net debt:

Net debt should:

1. **Be useful as an <u>accountability</u> indicator**
   a) It should reflect the policy decisions of the government
   b) The indicator's use should not be adversely impacted by volatility or items fiscal policy should not react to
   c) There should not be significant boundary issues that encourage inefficient financial management
2. **Primarily measure <u>sustainability</u>** (including in the face of economic shocks)
   a) Our working definition of sustainability is: *"Whether the government can meet existing spending and debt obligations without drastic policy changes (including in the face of economic shocks)".*
   b) We think it should primarily reflect sustainability rather than liquidity because: 1) a government with sustainable finances would likely only face liquidity issues on a temporary basis, and 2) public discourse on debt appears to be more about sustainability than liquidity
3. **Have the <u>other desirable characteristics</u>** of a good fiscal indicator
   a) International comparability
   b) Standard measurement
   c) Easy communication
4. **Remain a <u>'debt' indicator</u>** by predominantly covering debt instruments and similar financial instruments. If we want a very wide indicator, we should use a version of net worth or net financial worth.

Key recommendations for net debt

Issue	Recommendation and rationale

RBNZ and advances	**Recommendation: Issues with the RBNZ are best managed by including all advances in net debt (rather than excluding the RBNZ).**
	• Including all advances would address the FLP issue as FLP loans would be netted off against the liability. It would also bring in other advances - the largest category of these being student loans (equal to approx. 3% of GDP).
	• This would bring New Zealand in line with the international norm. Other countries generally include advances in net debt as they are a form of fixed interest asset.
	• Advances were previously excluded from net debt as they are somewhat less liquid than other financial assets (such as bonds), but we now put less weight on liquidity.
	• An alternative would be to exclude the RBNZ from net debt, but we consider that this would be undesirable because:
	    • Movements in the RBNZ's financial position will always flow back to the Crown. It is beneficial to recognise this in the debt indicator to avoid creating an incentive to leave losses on the RBNZ's balance sheet or undercapitalise it.
	    • Excluding the RBNZ would remove LSAP repurchase price effects from net debt (in addition to removing FLP effects). While these have created volatility for net debt, they have been much smaller than the FLP issues. Furthermore, we consider that repurchase price effects represent something genuine: LSAPs swap fixed rate debt for a higher amount of floating rate debt when interest rates are low, locking in a higher level of starting debt in exchange lower expected floating interest rates over the life of the debt. Keeping the RBNZ in the indicator would recognise this impact.

Crown entity borrowings	**Recommendation: Crown entity borrowings should be included in net debt**. • Crown entity (CE) borrowing has a similar effect on the fiscal position as core Crown borrowing. There is a high level of implicit guarantee over the debt because the Crown is unlikely to let CEs fail, and most of CE revenue is payments from the core Crown. • Inclusion of CE borrowing in the indicator would enhance accountability because ministers largely determine Crown entity borrowing (e.g. through Kāinga Ora's borrowing limit). • Most countries include the equivalent of Crown entities in their debt indicators. • Including CE borrowing would bring the indicator more in line with how markets view New Zealand's debt as they view Kāinga Ora debt as being similar to core Crown debt. • When net debt was adopted in 2009, Crown entities had little debt. However, Treasury advised that if there was a change to Government policy regarding CE borrowing, the coverage of the debt indicator should be revisited to preserve its credibility (T2009/927 refers). Given CE borrowing has increased significantly, it is appropriate to revisit whether it should be included.

Key recommendations for net debt

Issue	Recommendation and rationale
Crown entity assets	**Recommendation: Crown entity assets should remain excluded from net debt.** • Most Crown entity assets are held to cover their non-debt liabilities (e.g. ACC's insurance liabilities and EQC's potential payouts). • An ideal first-principles solution would be to include CE assets other than those held for specific non-debt liabilities. However, it would be complex to separate these out from overall CE assets in the Financial Statements of the Government, and they are relatively small in practice (around 2-2.5% of GDP).
NZSF	**Recommendation: We should include the NZSF in net debt, but also publish an indicator with it excluded.** • Including the NZSF would better represent the fiscal position by recognising that we build an asset when the NZSF grows. NZSF assets also differ from ACC assets because NZSF assets are owned and accessible to the Crown, funded by taxes rather than separately determined levies, and the NZSF in practice is used as a place to store surplus Crown revenue. • Inclusion would have mixed impacts for international comparability. On the one hand, Australia includes around 70% of its superannuation fund assets in its debt indicator, so inclusion of the NZSF would improve comparability with Australia. On the other hand, most countries do not include equity assets in the debt indicator, and the NZSF is predominantly equities. • However, inclusion would introduce volatility into net debt. For example, a very large (e.g. GFC sized) shock to the NZSF would increase net debt to GDP by 5 to 10 percentage points, in addition to any other impacts the shock had. Any future net debt target including the NZSF should be far out enough in time that short term volatility can be looked through. If the government were to adopt a short term debt target, an indicator excluding the NZSF would be more appropriate. • The considerations with the NZSF are relatively complex and are summarised in more detail in the annex.

Other indicators

Regarding other indicators, we recommend:

- **Leaving OBEGAL unchanged.** On balance we consider it to be fit-for-purpose:
  - **An accrual-based headline flow indicator (such as OBEGAL) is preferred** over cash-based measures as they are more transparent and reflect transactions when the activity occurs.
  - The headline flow indicator should **continue to exclude capital items**. This provides a better measure of year-on-year fiscal performance as ‘lumpy’ capital items are excluded.
  - **It is best to keep SOEs included in OBEGAL.** If we adopt a core Crown+CE debt metric, there could be merit in narrowing OBEGAL to the same segment coverage by excluding SOEs. This would support stock-flow consistency. On the other hand, including SOE income in OBEGAL will encourage sound financial management of SOEs (there is a clearer case to exclude SOE debt from the debt indicator as there is a high level of risk transfer to bond holders). On balance we consider the financial management considerations favouring inclusion of SOEs are more important than the advantages of aligning sector coverage generated by exclusion.
  - A headline flow indicator should continue to **look through market movements** (such as revaluations) so it reflects the fiscal choices of governments over short to medium term horizons. The operating balance provides a comprehensive measure of the fiscal performance of the Crown over longer time frames.
- **Working towards publishing a debt-servicing indicator in the HYEFU**
  - Debt servicing is an important aspect of the fiscal position.
  - We will provide further advice on the construction of an enduring debt servicing indicator (e.g. real vs nominal, instrument coverage), key considerations for how it would best be used as an indicator, and where in the HYEFU it should be published.

Implications of changes to net debt definition

Fiscal targets

- We will be providing you with advice on your fiscal strategy ahead of Budget 2022. As part of this advice, we will discuss what these changes to net debt mean for your fiscal targets and consider options to place greater emphasis on the operating balance and debt servicing costs.
- While including the NZSF into our net debt measure gives a better picture of fiscal sustainability and avoids penalizing payments into the NZSF, it has the potential to introduce significant volatility in to the indicator (up to 5-10 percentage points of GDP each year depending on market movements). This makes this debt metric less suited to being a binding fiscal target, especially a short-term target (e.g. less than 10 years). We would still publish a net debt indicator excluding the NZSF as an alternative.

Approach to Budget management

- [33]

Implementation

Suggested approach to implementing new fiscal indicators

- Introduce the new net debt and debt servicing indicators in a box at HYEFU, but do not use them as a main indicator described in the fiscal chapter of the HYEFU or in the Budget Policy Statement.
- Continue to publish the current net core Crown debt indicator alongside the new indicators for a while to support transparency.
- Targeted engagement/consultation between HYEFU 2021 and BEFU 2022:
  - Discussions with Credit Rating agencies
  - Speech from the Secretary to the Treasury
- Describe the indicators and the fiscal position more fully in the investment statement (planned for January/February).
- Use the indicators as the focus of the fiscal chapter in the BEFU and the Fiscal Strategy Report in May 2022.

Links to fiscal strategy and targets

- You are receiving initial Budget strategy and high-level fiscal strategy advice tomorrow ahead of a meeting with officials on Monday 16 August. The Budget strategy cabinet paper will then be agreed in the coming weeks.
- We expect that formulating a fiscal strategy in terms of specific indicators will not need to be done at HYEFU 2021, which allows time to decide on and introduce new indicators prior to introducing any more specific fiscal targets at BEFU. In particular:
  - Following preliminary HYEFU forecasts, you will receive more detailed fiscal strategy advice in October/November, covering:
    - Implications of updated economic and fiscal conditions for allowances at Budget 2022 and future budgets.
    - Implications for the Budget Policy Statement, including your short-term intentions for fiscal policy.
  - Following preliminary BEFU forecasts, you will receive further fiscal strategy advice around February/March next year, covering:
    - Implications of updated economic and fiscal conditions for allowances at Budget 2022 and future budgets, and the projection period.
    - Advice on new short-term intentions and long-term objectives for fiscal policy to include in the Fiscal Strategy Report, using the new indicators where applicable.
  - For BEFU onwards, the Fiscal Strategy model and projections would be based on the new net debt indicator.

Do you agree with this approach to implementation, external engagement, and integration with fiscal strategy advice?

Annexes

Summary of the pros and cons of including the NZSF in net debt

Factor	How much weight we put on the factor
Pros of including the NZSF	
1. Inclusion would incentivise better fiscal management by **recognising that we build an asset when we contribute to the NZSF**. Another angle on this is that the NZSF has been used as a place to store surpluses, and strengthening the fiscal position in this manner should be recognised.	We put **a lot** of weight on this as it would support the sustainability and accountability criteria.
2. Inclusion would **have mixed effects on international comparability**. Full inclusion would move us closer to Australia's metric (their fund is ~70% included) and the UK (which doesn't have a soveriegn wealth fund). On the other hand, the most common international framework (the IMF's GFS framework) always excludes equity assets, so countries following this framework include the fixed interest assets of their soveriegn wealth fund but not the equities. We consider that following the GFS approach is undesirable as it would create problematic incentives around for the NZSF's portfolio allocation choices.	We put **a small amount** of weight on this given that neither full inclusion nor full exclusion fully moves us in line with the international norm.
Cons of including the NZSF	
1. Inclusion would increase the **volatility** of net debt. For example, the NZSF is forecast to have financial assets of around 19% of GDP in 2025, so a +/-20% movement in the fund's value would move net debt by 4 percentage points of GDP. Movements of this magnitude or larger have occurred in 7 out of the last 18 years.	We put **a lot** of weight on this if the Government were to adopt binding short-term debt targets. The scale of volatility is large enough to materially affect fiscal strategy in these circumstances.
2. Inclusion would introduce a **trend** in net debt. Towards the later part of the forecast period, when our long run assumptions about NZSF contributions and asset returns hold, this trend would be around a 0.5 percentage point per annum decline in debt-to-GDP (reflecting that NZSF assets as a share of GDP are expected to grow slightly faster than GDP). If this downward trend in net debt is not accounted for in fiscal strategy, then any net debt target would also have to be correspondingly reduced over time, otherwise the growth in the NZSF would be offset by higher spending.	We put **a moderate amount** of weight on this given that the trend is moderate in size (perhaps 5 percentage points of GDP per decade, although with a lot of uncertainty). In these circumstances, it may be feasible to revisit the level of any debt target periodically to account for it (eg. once a decade).
3. Including NZSF in net debt would **complicate the stock-flow reconciliation** as OBEGAL and a debt servicing indicator would be unlikely to include NZSF gains and losses.	We put **a small amount** of weight on this. It is complex to reconcile net debt and OBEGAL already, so we are not losing a lot by further complicating it.
4. Inclusion would **incentivise borrowing to invest in the NZSF over borrowing to invest for non-financial assets**	We put **little** weight on this. Unless we are going to adopt a comprehensive measure (eg. net worth or net financial worth), a line needs to be drawn somewhere, and it is arguable to have this line either include or exclude the NZSF.
5. Including **NZSF assets without including the unrecorded future liability** would overstate the strength of fiscal sustainability.	We put **little** weight on this. The NZ Super liability will exist regardless of how many assets are in the NZSF, and a government has the option to change settings or taxes to manage the NZ Super liability.
6. NZSF financial assets are predominantly equities, so may **sell for a significant discount if liquidated in a crisis.** This means inclusion in normal times could overstate the strength of the fiscal position.	We put **little** weight on this. While NZSF assets may drop sharply in value at times (e.g by around 50% in a repeat of the global financial crisis), inclusion is likely to better represent sustainabiltiy in general, and much of the NZSF is invested offshore, protecting its value from NZ-specific shocks.
7. It might be difficult to draw a **boundary** around which Crown Financial Institutions (such as ACC) or other non-debt instruments are included	We put **a small amount** weight on this. There are some differences between Crown Financial Institutions (CFIs) that could justify including the NZSF but not the other CFIs. However, including large non-debt items in net debt does move it fundamentally away from being a debt indicator.

Where core Crown net debt sits in the spectrum of possible entity and instrument coverage: