# The Treasury

## Budget 2022 Information Release

## August 2022

This document has been proactively released and is available on:

- The **Budget website** from August 2022 to May 2023 only at: **https://budget.govt.nz/information-release/2022**, and on
- the **Treasury website** from later in 2022 at: **https://treasury.govt.nz/publications/information-release/budget-2022-information-release**.

### Information Withheld

Some parts of this information release would not be appropriate to release and, if requested, would be withheld under the Official Information Act 1982 (the Act).

Where this is the case, the relevant sections of the Act that would apply have been identified.

Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

Key to sections of the Act under which information has been withheld:

[1] 6(a) - to avoid prejudice to the security or defence of New Zealand or the international relations of the government

[23] 9(2)(a) - to protect the privacy of natural persons, including deceased people

[25] 9(2)(b)(ii) - to protect the commercial position of the person who supplied the information or who is the subject of the information

[27] 9(2)(ba)(ii) - to protect information which is subject to an obligation of confidence or which any person has been or could be compelled to provide under the authority of any enactment, where the making available of the information would be likely otherwise to damage the public interest

[33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[34] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions

[35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment;

[36] 9(2)(h) - to maintain legal professional privilege

[37] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice

[38] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice

[39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

[40] Out of Scope

[41] 18(c)(i) - that the making available of the information requested would be contrary to the provisions of a specified enactment

[42] 18(d) - information is already publicly available or will be publicly available soon

Where information has been withheld, a numbered reference to the applicable section of the Act has been made, as listed above. For example, a [1] appearing where information has been withheld in a release document refers to section 6(a).

## Copyright and Licensing



## Accessibility

The Treasury can provide an alternate HTML version of this material if requested. Please cite this document's title or PDF file name when you email a request to information@treasury.govt.nz.

TE TAI ŌHANGA
**THE TREASURY**

# **Treasury Report:** Specification of the debt servicing indicator

| | | | |
|---|---|---|---|
| **Date:** | 22 April 2022 | **Report No:** | T2022/830 |
| | | **File Number:** | MC-1-5-4 |

## Action sought

| | Action sought | Deadline |
|---|---|---|
| Hon Grant Robertson<br>**Minister of Finance** | **Note** the contents of this report.<br>**Indicate** if you have any feedback on our proposed approach. | Monday 2 May 2022 |

## Contact for telephone discussion (if required)

| Name | Position | Telephone | | 1st Contact |
|---|---|---|---|---|
| Matthew Galt | Senior Analyst, Macroeconomic and Fiscal Policy | [39] | [35] | ✓ |
| Katy Simpson | Team Leader, Macroeconomic and Fiscal Policy | | N/A<br>(mob) | |

## Minister's Office actions (if required)

| |
|---|
| **Return** the signed report to Treasury. |

| | |
|---|---|
| Note any feedback on the quality of the report | |

**Enclosure**: No

## **Treasury Report:** Specification of the debt servicing indicator

## Executive Summary


In October 2021 you agreed to our recommendation to create a new debt servicing indicator aligned with the new net debt indicator. Following confirmation of your new fiscal rules, we have further considered our previous recommendation. While we still think that debt servicing is a useful indicator to help tell the fiscal story, we note that the inclusion of New Zealand Super Fund equities in the new net debt indicator means that net debt and a debt servicing indicator aligned with it may not tell a consistent story. Instead, **we propose using core Crown finance costs** (an existing published measure) as a simple way of analysing trends in debt servicing.

In our previous advice we also recommended using a nominal debt servicing indicator as the primary measure, rather than a real measure [T2021/2416 refers]. Having further analysed this, **we consider that a nominal indicator still fits best** in the Treasury's Economic and Fiscal Updates, but that a real indicator could be used in your discussion of fiscal strategy on an as-needed basis.

To support the use of both nominal and real debt servicing indicators in the future, **we propose including a box on debt servicing measures** in the Budget Economic and Fiscal Update (BEFU) 2022. A draft of this box is included in Annex 1.


## Recommended Action

We recommend that you:

a **note** the contents of this report

b **indicate** if you have any feedback on our approach to the debt servicing indicator proposed in this report.

Katy Simpson
**Team Leader**

Hon Grant Robertson
**Minister of Finance**

# **Treasury Report:** Specification of the debt servicing indicator

## Purpose of Report

1. This report outlines our proposed approach to the specification of the debt servicing fiscal indicator for use from Budget 2022 onwards.

## Background

2. Choices about the fiscal indicators that are not defined by Generally Accepted Accounting Practice (including net debt, OBEGAL and debt servicing metrics) are a matter for the Government of the Day and the Treasury, depending on their uses. The Government can use the indicators it prefers to articulate its fiscal strategy. The Treasury can then choose how fiscal indicators are used to describe the fiscal outlook in the Economic and Fiscal Updates (EFUs), taking into account how their use in the Government's fiscal strategy affects the fiscal outlook.

3. The Treasury commenced a review of the fiscal indicators in late 2020. Through this review so far you have:

   a agreed to modify the headline net debt indicator to include Crown entity borrowings and core Crown advances [T2021/2416 refers] and the New Zealand Super Fund (NZSF), and to use this modified indicator for your new debt rule [T2022/306 refers].

   b agreed to include debt servicing as a fiscal indicator, with coverage aligned to the new net debt indicator, and requested further consideration about whether the debt servicing indicator should be real or nominal [T2021/2416 refers].

4. We recommended including debt servicing as a fiscal indicator because lower interest rates have made debt more affordable in recent years, and this is an important consideration when judging prudent debt levels. This was consistent with commentary in the 2021 Fiscal Strategy Report (FSR) about debt servicing (refer to page 40 of the Wellbeing Budget 2021 document).

5. The Treasury also included analysis of issues with the current suite of fiscal indicators and potential modifications to address them in the latest *Investment Statement*, published in March 2022.[1] The Statement noted that the Treasury had identified benefits in creating a debt servicing indicator.

## Coverage of the debt servicing indicator

6. In our previous advice in October 2021, we recommended aligning the debt servicing indicator with the new net debt indicator [T2021/2416]. The aim of this was to have net debt and debt servicing tell a consistent story.

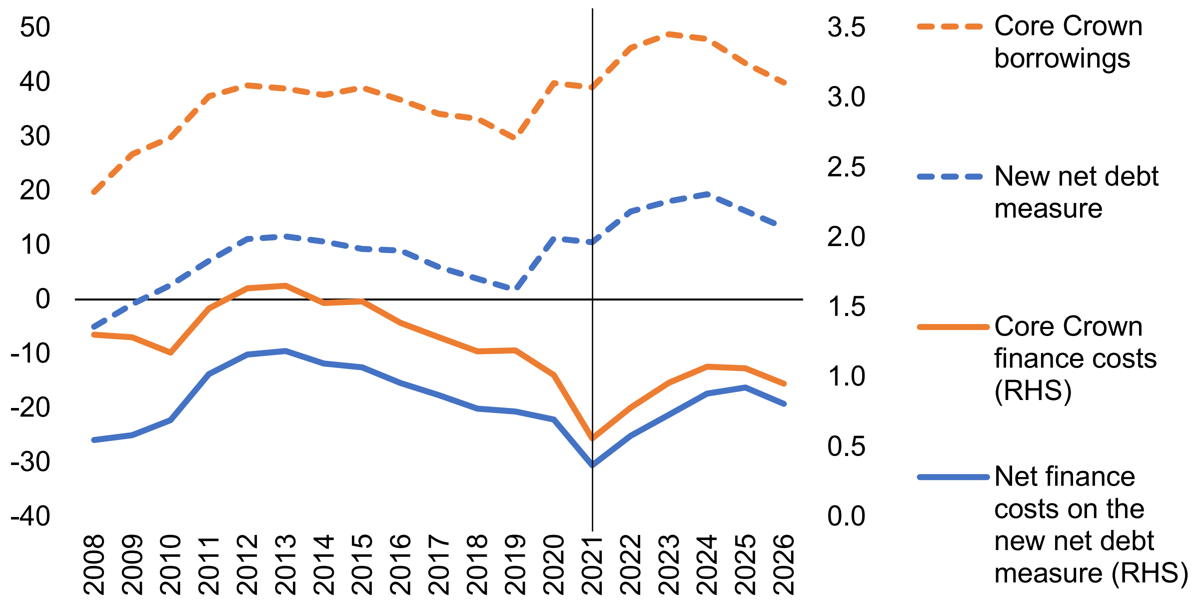
7. Since then, you have chosen the net debt indicator including the NZSF as the primary net debt indicator, and have set new fiscal rules [T2022/37 and T2022/343 refer]. Debt servicing does not have a specific role in the fiscal rules.

[1] He Puna Hao Pātiki: 2022 Investment Statement - Section 3.3 Fiscal indicators (pages 60-64). https://www.treasury.govt.nz/publications/investment-statement/he-puna-hao-patiki-2022-investment-statement

8. After considering the final form of the new primary net debt indicator and analysing the corresponding potential debt servicing indicators, **we no longer think there is a compelling case to regularly publish a new debt servicing indicator with coverage aligned with the new net debt indicator** in the Treasury EFUs.[2]

9. Instead, we recommend using the nominal core Crown finance costs indicator (an existing published measure) for analysis of trends in debt servicing. Core Crown finance costs measures debt servicing costs on core Crown borrowings (a measure of core Crown debt which has no assets netted off). Figure 1 shows how the measures compare (based on 2022 BEFU preliminary fiscal and economic forecasts). Core Crown finance costs, and another very similar measure (debt servicing costs on Gross Sovereign Issued Debt), were the indicators used in the 2021 FSR.

***Figure 1: Debt and debt servicing measures (% of GDP, BEFU preliminary forecasts)***




10. The reasons for our revised recommendation are:

    a. The inclusion of the NZSF means that the new net debt measure and a debt servicing indicator aligned with it may not always tell a consistent story over history and through the forecasts and projections. This is because growth in the NZSF's equity holdings will lower net debt, but will not reduce net interest costs.

    b. Core Crown finance costs is a standard measure that will be published regardless, and adding a second, new indicator to the EFUs would risk creating confusion for limited gain. Core Crown finance costs follow a broadly similar path to debt servicing on the new net debt measure, so could be used to tell the fiscal story around debt servicing and debt levels.

    c. We have an existing time series of core Crown finance costs back to 1972. We have a time series for a debt servicing metric aligned with the new net debt measure back to 2008, but going back further would be resource intensive and require simplifying assumptions as the historical data is difficult to collate.

[2] An indicator aligned with the new net debt measure would be calculated as interest paid on gross core Crown borrowings and Crown entity borrowings, less core Crown interest revenue.

## A nominal or a real debt servicing measure

11. Nominal debt servicing represents nominal interest expenses on debt. Real debt servicing represents real (ie, inflation-adjusted) interest payments on debt. Both measures can be expressed as a share of GDP. In our previous advice we recommended using a nominal measure, although you requested further consideration of this.

12. We have further analysed options to publish a real measure in the Treasury's EFUs. A real measure could provide a better illustration of the economic cost of debt servicing, and could help provide continuity with previous commentary. It could also be useful for telling the fiscal story by taking into account the interaction between debt, interest rates and inflation.

13. However, on balance we continue to think that, for the Treasury's EFUs, a nominal indicator would be most suitable. The advantages of having a nominal indicator as the primary, regularly-published indicator in the EFUs are:

    a **there are significant judgements required** in choosing the method of adjusting for inflation in the real indicator,

    b **volatility in inflation could create significant volatility in the real indicator**, which may not represent the underlying trend in real debt servicing costs,

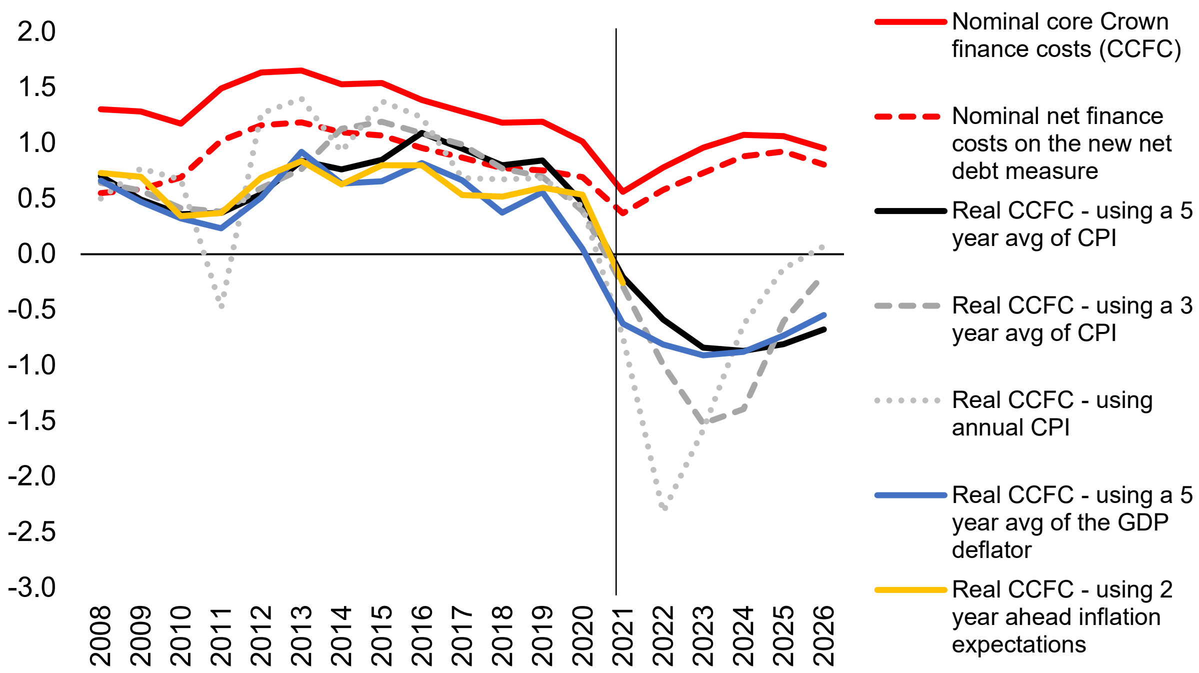
    c **a nominal indicator could be easier for users to understand**,

    d **all other fiscal indicators are reported in nominal terms**, and

    e **a real measure would not have a natural home** in either the fiscal chapter of the EFUs (all nominal indicators) or the economic chapter (all economic indicators). It would likely need to go in a box if included in the EFUs, potentially giving it greater prominence than may always be necessary.

14. We consider that the choice of how to adjust for inflation is a significant challenge at the moment. The previous real indicator used in the 2021 FSR – debt servicing adjusted using a 5-year average of past inflation – is now low and forecast to remain low over the forecast period, due to the effect of averaging inflation over a long period (see Figure 2). However, a measure using annual inflation (ie, not averaged) is forecast to rebound from this year onwards, telling a different story. Given the heightened level of inflation currently, and following discussion with your office, we have included a nominal debt servicing metric in the draft 2022 FSR.

***Figure 2: Nominal and real debt servicing metrics (based on core Crown finance costs, % of GDP, BEFU preliminary forecasts)***




15. Nevertheless, given real debt servicing can be a useful indicator at times, we suggest calculating and presenting it on an as-needed basis (such as for FSRs). An appropriate inflation-adjustment method can be used at the time taking into account the intended use of the indicator. For example, using smoothed measures of inflation could better approximate the concept of inflation expectations, and less smoothed measures could show real debt servicing costs that actually eventuated each year in the past.

## Box on debt servicing indicators in the 2022 BEFU

16. We propose including a box on debt servicing indicators in the 2022 BEFU to support the use of alternative debt servicing indicators on an ad-hoc basis in the future, and to close out this part of the fiscal indicators review. A draft box is included in Annex 1.

## Next Steps

17. Please indicate if you have any feedback on our proposed approach to the debt servicing indicator. Depending on any feedback you have, we intend to include the box drafted in Annex 1 in the 2022 BEFU.

## Annex 1: Draft proposed box on debt servicing indicators to be included in the 2022 Budget Economic and Fiscal Update

As discussed in He Puna Hao Pātiki: The Treasury's 2022 Investment Statement, lower interest rates have made debt more affordable in recent years, and this is an important consideration when judging prudent debt levels. At present, the New Zealand Government's debt servicing costs are historically low, despite higher levels of public debt, particularly when considered in real terms. This may reflect long-term global structural changes that have led to a decline in the neutral interest rate, as well as more transitory developments in inflation. Given these trends, it is worthwhile to consider indicators of debt servicing costs alongside traditional measures of the stock of debt.

The Treasury's primary debt servicing indicator is core Crown finance costs (CFFC). This measures nominal interest expenses on core Crown borrowings (a measure of core Crown debt which has no assets netted off). This indicator is regularly published in Economic and Fiscal Updates (EFUs) as it is a simple and established measure.

Like with net debt, there are choices about how to best measure debt servicing costs, and some alternatives are shown in Figure A. Net debt servicing costs on all of the instruments captured in the new net debt indicator are slightly lower than core Crown finance costs. This is because the additional interest revenues on assets included in the net debt measure outweigh the additional interest expenses on the additional liabilities included the net measure. However, the two measures follow broadly similar trends and have moved closer over time.

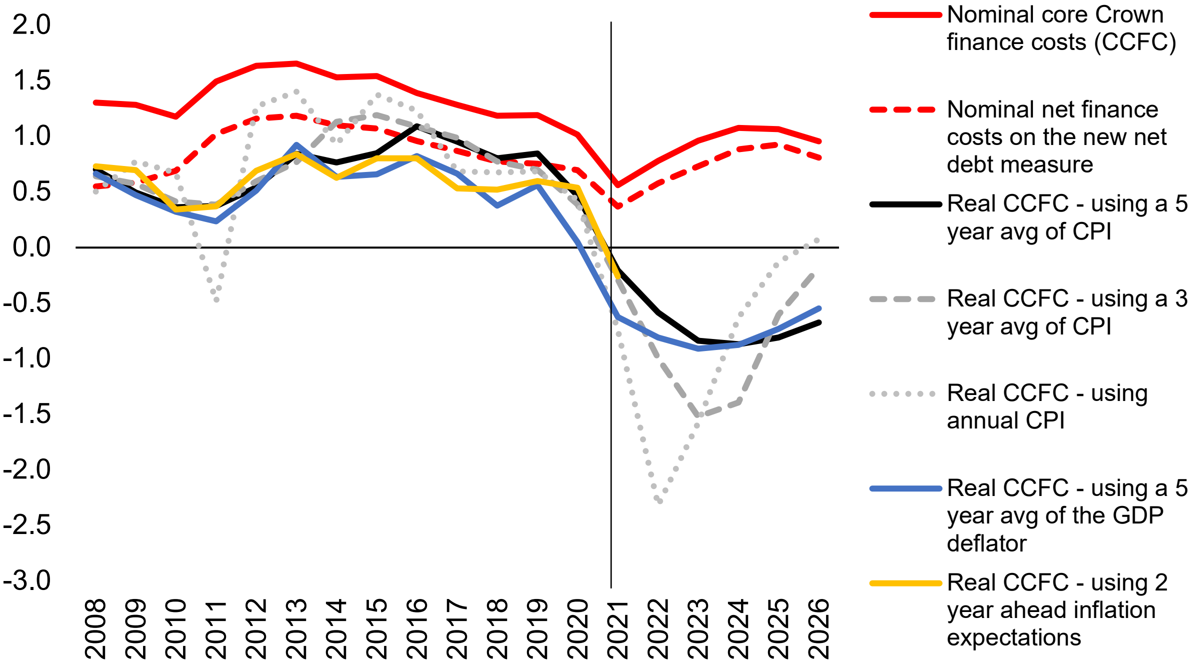
Real debt servicing costs apply a real (ie, inflation-adjusted) interest rate to debt. This can provide a better illustration of the economic costs of debt servicing. Judgement is needed as to the best way to adjust nominal debt servicing costs for inflation. The trend in the GDP deflator may provide the best metric in the context of the New Zealand Government as it accounts for changes in the terms of trade and most closely corresponds to tax revenue growth. However, consumer price index inflation or measures of inflation expectations are more widely known, and are not subject to the statistical revisions that the GDP deflator is.[3] Smoothing of actual inflation can better capture trends in inflation, or provide an approximate measure of inflation expectations given these are not widely forecast. Less smoothed measures could better show real debt servicing costs that actually eventuated each year in the past. However, the recent volatility in inflation has made the choice of inflation measure used in real measures more significant, as shown in Figure A.

The Treasury intends to continue publishing core Crown finance costs (in nominal terms) in its EFUs, and in the historical fiscal indicators covering 1972 onwards.[4] From this, real debt servicing metrics can be calculated using a chosen inflation-adjustment methodology.

[3] Furman and Summers (2020) use five-year average of inflation to calculate real debt servicing costs in their paper: 'A Reconsideration of Fiscal Policy in the Era of Low Interest Rates'.

[4] These can be found on the Treasury website: https://www.treasury.govt.nz/publications/information-release/data-fiscal-time-series-historical-fiscal-indicators

**Figure A: Alternative debt servicing measures (% of GDP, BEFU prelim forecasts)**




*Note: No forecast is shown for the measures using inflation expectations due to data limitations.*