The Treasury

Budget 2022 Information Release

August 2022

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

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[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

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Fiscal indicators review

Date:	14 October 2021	**Report No:**	T2021/2416
		File Number:	MC-1-5-4

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**Consider** the recommendations in this report and discuss with officials at the weekly agency meeting on **Monday 18 October.**	18 October 2021

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			

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: Fiscal indicators review

Executive Summary

We have reviewed the suite of fiscal indicators given several trends relevant to the fiscal position, namely higher government debt levels and lower interest rates globally, the advent of alternative monetary policy tools in New Zealand, and growing Crown entity borrowings.

We propose that you adopt the following suite of indicators to describe the fiscal position: **the operating balance before gains and losses (OBEGAL), net debt, debt servicing and indicators of the types and outcomes of spending** (such as physical capital investment, net worth and topical wellbeing indicators).

For the net debt and debt servicing indicators, we recommend:

- broadening the definition of net debt to include Crown Entity borrowings and core Crown advances, and continuing to publish versions both with and without the New Zealand Superannuation Fund (NZSF), and
- adopting a nominal debt servicing cost indicator aligned with the headline net debt metric. A nominal measure is aligned with our approach to other fiscal indicators and makes it easy to compare the cost of debt servicing with other government expenditure.

We propose first using the new indicators in Budget 2022, but introducing and explaining the proposed changes to the indicators in the Treasury Investment Statement, which will be published by the end of March 2022. This will help build the credibility of the changes and allow sufficient time to implement the changes.

Following our advice on the first draft of the 2022 Budget Policy Statement (BPS), you agreed to keep the fiscal targets (the short-term intentions and long-term objectives) broadly unchanged in the BPS, and to use the BPS to signal your intention to set new fiscal targets in the Budget 2022 Fiscal Strategy Report [T2021/2485 refers]. Our preliminary thinking is that new fiscal targets could be focused on OBEGAL as an effective fiscal anchor to guide operating decisions without constraining space to borrow for capital investment. As part of this we are exploring an approach involving setting a new net debt target, although this could be set in a manner that allows flexibility around a capital investment programme, such as by having a long-term focus or being expressed as a ceiling or a range.

At this point, we have concerns about using binding targets for other variables such as debt servicing, net worth or capital investment. Debt servicing costs are very sensitive to movements in interest rates. These tend to be unpredictable and outside of the control of the government. In addition, using debt servicing costs as a target could create pressure to use risky strategies to reduce debt servicing costs, such as issuing a lot of short-term debt. Net worth is influenced by volatile revaluations, such as those driven by asset price inflation, which makes it more challenging to use as a target. We will provide further advice on fiscal targets in the coming months.

[33]

Recommended Action

We recommend that you:

a **Agree** to modify the net debt indicator so it includes Crown entity borrowings and core Crown advances, and to continue publishing versions of the net debt indicator including and excluding the NZSF.

Agree/disagree.

b **Agree** to include debt servicing as a fiscal indicator, with coverage aligned with the net debt indicator.

Agree/disagree.

c **Indicate** which debt servicing measure you wish to adopt as a standard indicator for describing the fiscal position:

a) nominal debt servicing costs as a share of GDP (recommended).

Yes/No.

b) real debt servicing costs as a share of GDP.

Yes/No.

d **Note** that we will be meeting with you at the Weekly Agency Meeting on Monday 18 October to discuss this report. We are particularly interested in your feedback on:

- The proposed suite of headline fiscal indicators. The proposed suite is the operating balance before gains and losses (OBEGAL), net debt, debt servicing, and indicators of the types and outcomes of spending (such as physical capital investment, net worth and topical wellbeing indicators).
- The proposed approach to announcing and implementing changes to net debt and the debt servicing indicators, should you agree to make the changes. We propose using the new indicators in the fiscal forecasts from Budget 2022 onwards, but introducing and explaining them earlier in the Treasury's Investment Statement to support their credibility.
- Our preliminary thinking on fiscal targets for the 2022 Fiscal Strategy Report. We are exploring an approach whereby fiscal targets could be based on a shorter-term OBEGAL anchor and a debt anchor. The debt anchor could have a long-term focus.
- The possible fiscal narrative presented in Annex 1. This fiscal narrative shows how the fiscal indicators can be used to explain the fiscal position.

Katy Simpson
Team Leader, Macroeconomic and Fiscal Policy

Hon Grant Robertson
Minister of Finance

Treasury Report: Fiscal indicators review

Purpose of Report

1. This report provides advice on an enduring suite of fiscal indicators suitable for describing the current and future fiscal position. It also provides our preliminary thinking on the approach and options for setting new fiscal targets ahead of the Fiscal Strategy Report (FSR) in Budget 2022.

Background

2. Several structural changes in the economic and fiscal landscape in recent years are relevant to our understanding of the fiscal position. These changes include the persistence of low interest rates since the global financial crisis, higher levels of public debt internationally as a result of COVID-19, the advent of alternative monetary policy tools in New Zealand, and increased Crown entity (CE) borrowings.

3. Given this changing context, we have reviewed whether the headline fiscal indicators are still fit for purpose. We publicly stated that this review was underway in both the 2020 Half Year Economic and Fiscal Update (HYEFU) and 2021 Budget Economic and Fiscal Update (BEFU).

4. We met with you at the 12 August Finance Priorities Meeting to discuss our analysis. We recommended broadening the net debt indicator and working toward publishing a debt-servicing-to-GDP indicator. You signalled you were broadly comfortable with the direction of the work and requested further advice on:

   i. the bigger picture of the fiscal position, and which mix of fiscal indicators could be used to guide and explain the fiscal strategy; and

   ii. the impact that including the New Zealand Super Fund (NZSF) in the net debt indicator would have on the volatility of the indicator.

5. We provided advice to you last week on the fiscal strategy sections of the 2022 Budget Policy Statement (BPS). You agreed to keep the short-term intentions and long-term objectives (referred to in this report as 'fiscal targets') broadly unchanged in the BPS given the ongoing uncertainty about the economic and fiscal outlook. You also agreed to use the BPS to signal your intention to set new fiscal targets in the Budget 2022 FSR [T2021/2485 refers].

6. In response to your requests, this report provides further advice on the indicators as well as a possible fiscal narrative in Annex 1. It also includes our preliminary thinking on options for setting new fiscal targets for your feedback.

7. You will be receiving further advice on the near-term fiscal strategy next week. This will cover fiscal headroom, major spending pressures, the macroeconomic stance and options for allowances to communicate at the BPS.

Indicators to describe the fiscal position

8. We recommend you adopt the following as enduring indicators to describe the fiscal position: Operating Balance before Gains and Losses (**OBEGAL)**, **net debt**, **debt**

servicing, and indicators that show the types and outcomes of spending** (such as physical capital investment, net worth and topical wellbeing indicators).

9. Below is a summary of each indicator and our recommendations on their construction.

<u>OBEGAL</u>

10. **We recommend that you continue using OBEGAL as a headline fiscal indicator.** OBEGAL is an indicator of whether operating spending and revenue are broadly balanced. We consider that the current OBEGAL measure is fit for purpose. It is a simple and well-known indicator and is generally suitable as a short-term target (e.g. for a surplus target within a few years). Alternative indicators would include the cyclically adjusted balance (CAB), structural balance and operating balance. However, the CAB and structural balance rely on assumptions (such as the output gap) and the operating balance is volatile in the short term due to the influence of gains and losses.

<u>Net debt</u>

11. The current net debt indicator (net core Crown debt) has been used as the main headline debt measure since 2009. It is currently defined as gross sovereign issued debt less some financial assets (specifically, core Crown financial assets excluding advances and the assets of the NZSF).

12. Two issues have arisen with the coverage of the current net debt indicator:

    i. Crown entity (CE) borrowings have been growing but are not captured in the indicator. When the current net debt indicator was adopted as a fiscal target in 2009, the Treasury advised that the exclusion of CE borrowings would not be a problem as long as all substantial borrowing was done by the core Crown (T2009/927 refers). CE borrowings have since grown significantly and is expected to grow further (figure 1). Most CE borrowings are undertaken by Kāinga Ora and Waka Kotahi.

    ii. The Reserve Bank's alternative monetary policy interventions have impacted the current indicator (figure 2). The Reserve Bank's Funding for Lending Programme (FLP) in particular has increased reported net debt. This is because settlement cash, which funds the programme, counts towards the debt indicator, while the advances made under the programme do not - despite the advances having a relatively short maturity and very low risk. The Large-Scale Asset Purchase programme (LSAP) has increased net debt due to the higher cost of swapping fixed interest rate instruments (government bonds) with a floating rate instrument (settlement cash).

Figure 1: Crown entity borrowings as a share of GDP (excluding Crown borrowings)

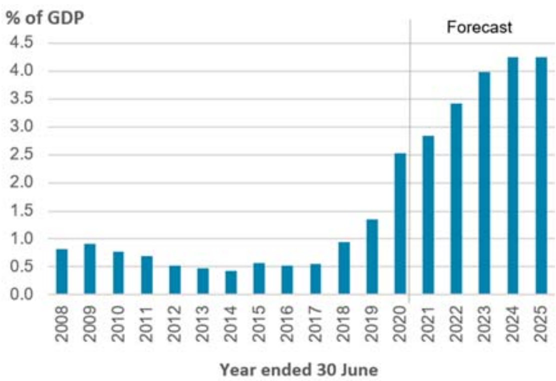
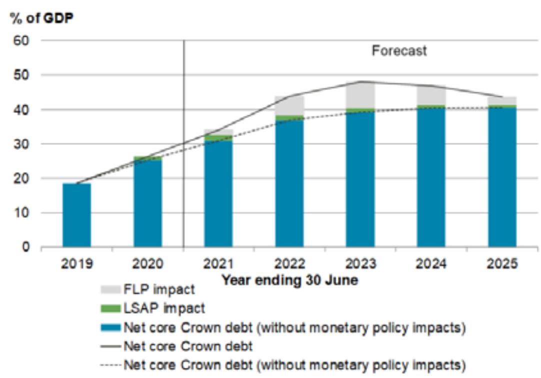


Figure 2: Impact of FLP and LSAP on net core Crown debt

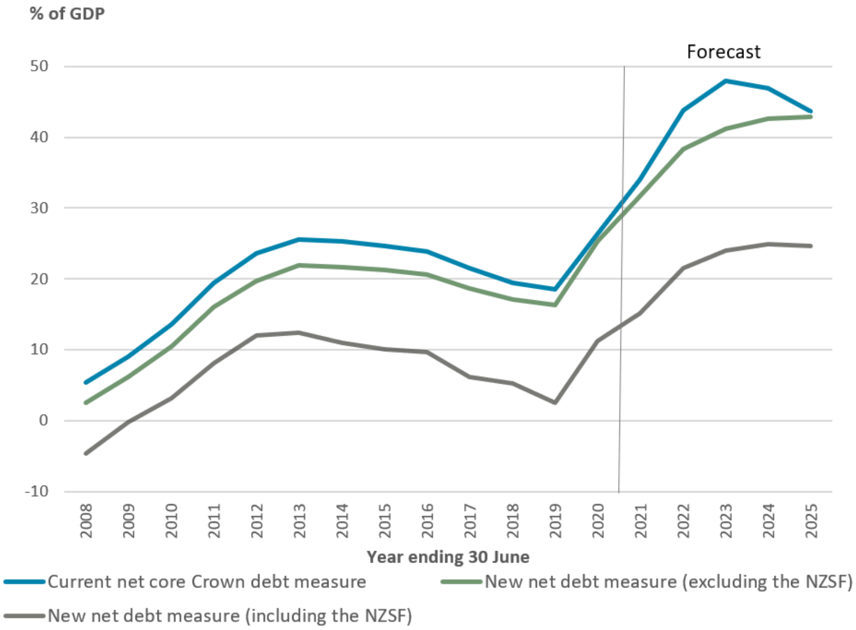


Source: Budget 2021 forecasts

13. **We recommend broadening the definition of the net debt indicator to include CE borrowings and core Crown advances, while continuing to publish versions with and without the NZSF**.

14. Figure 3 uses Budget 2021 figures to illustrate the impact our recommendation would have on the net debt indicator. Over the forecast period, including CE borrowings and core Crown advances initially lowers and flattens net debt under the broadened definition because the impact of including advances is slightly larger than the impact of including CE borrowings. The two measures that exclude the NZSF are similar at the end of the forecast period, and based on current policy settings this trend is likely to continue beyond the forecast period. The version including the NZSF is significantly lower than the version without the NZSF because the NZSF brings a large amount of assets into the indicator.

Figure 3: Current net debt metric and proposed changes



Note: The new net debt measures are net core Crown debt including CE borrowings and core Crown advances.

15. **We recommend including CE borrowings in the net debt indicator because they have become significant, they have a similar impact on the fiscal position to core Crown borrowings and doing so would align New Zealand with international norms.**

16. We consider that CE debt should be treated like core Crown debt. CE debt has a high level of implicit government guarantee as the Crown is unlikely to let CEs fail, and most CE revenue comes from the core Crown. In addition, Ministers have a high degree of control over CE borrowings as Ministerial authorisation is required for it.

17. Most countries include the equivalent of Crown entities in their debt indicators, including countries following the IMF's Government Finance Statistics (GFS) framework.[1] Including CE borrowings in the indicator is also more consistent with how credit ratings agencies and capital markets view New Zealand's sovereign debt. Should CE borrowings continue growing, leaving them out of the headline debt indicator could weaken New Zealand's fiscal credibility. Credit ratings agencies place significant weight on institutional factors including consistent commitment to any fiscal targets or limits. Finally, including CE borrowings means that the most appropriate form of core

[1] The IMF's GFS is an internationally recognized statistical reporting framework for public finance. New Zealand does not follow GFS, and instead follows Generally Accepted Accounting Practice.

Crown or CE funding can be used for a given circumstance without the choice impacting the net debt indicator.

18. We do not recommend including CE financial assets in new net debt indicator. Most CE financial assets are held to cover non-debt liabilities, such as Accident Compensation Corporation's (ACC's) insurance liabilities and the Earthquake Commission's potential payouts. CE financial assets (both liquid and non-liquid) are sizable, at around 15% of GDP. Using a measure that includes these assets but not the liabilities would present an unbalanced picture of the fiscal position. While an ideal first-principles approach would be to include CE liquid financial assets other than those held for specific non-debt liabilities, we do not consider this to be operationally practical. It would be complex to separate these out from overall CE assets, and they are relatively small in practice at around 2-2.5% of GDP.

19. **We recommend including advances in a new net debt indicator.** Including advances in the definition of net debt would mean the Reserve Bank's FLP loans (peaking at around 7.5% of GDP) and student loans (~3% of GDP), along with some smaller advances, will be included as financial assets and netted off against debt. Only the fair value amount would be netted off (ie, amounts expected to be recovered). There are three reasons for this recommendation:

    i. Including advances addresses the mismatch generated by the FLP, as both the settlement cash liability and the fair value of the asset would be included, with only any differences between the two impacting net debt.

    ii. Inclusion brings New Zealand in line with the international norm, such as countries following the IMF's GFS standards. Other countries include advances because they are a fixed interest asset that will eventually be repaid to the Crown.

    iii. Advances were excluded from net core Crown debt when it was adopted in 2009 because they are less liquid than other financial assets (such as bonds) and are not held for the purposes of government financing. However, we now put less weight on net debt measuring liquidity and more weight on it measuring sustainability. Including advances moves net debt closer to a sustainability indicator.

20. An alternative way of addressing the effect of the FLP would be to exclude the Reserve Bank from net debt, which we do not recommend. Excluding the Reserve Bank would also be consistent with the international norm. However, movements in the Reserve Bank's financial position will always eventually flow back to the Crown. It is beneficial to recognise this in the net debt indicator to avoid creating an incentive to leave losses on the Reserve Bank's balance sheet or to undercapitalise it. Excluding the Reserve Bank would also exclude LSAP impacts, yet while these created volatility for net debt, we consider they represent the LSAP programme's genuine impact on the Crown balance sheet.[2]

21. **We recommend continuing the current practice of publishing the net debt indicator both with and without the NZSF, but potentially placing greater focus on the indicator with the NZSF**. The key advantage of including the NZSF is recognising the NZSF's contribution to fiscal sustainability. The key disadvantage is it introduces significant volatility into the indicator. Our initial view is the indicator with the NZSF could be more suitable as a long-term indicator or target (10 years or more in the future) as this would allow enough time to smooth out the volatility. The version not including the NZSF may be more suitable as a short-term indicator or target. We will provide further advice on which indicator to place greater focus on as part of fiscal

[2] 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.

targets advice. Annex 2 outlines the key considerations about including versus excluding the NZSF in more detail and provides further analysis on the volatility the NZSF may add.

Debt servicing cost

22. **We recommend adopting a debt servicing cost indicator as one of the standard indicators used to explain the fiscal position. The indicator would show the cost of debt servicing as a share of GDP.**

23. Adopting a debt servicing cost indicator reflects that the affordability of debt is important for determining whether a given level of debt is sustainable. At present, debt servicing costs are at their lowest level in recent decades despite higher levels of public debt. This reflects long-term structural changes which have led to a decline in the neutral interest rate[3]. This suggest that solely looking at the debt stock cannot provide a full picture of sustainability. The trend of falling interest rates has also resulted in favourable debt dynamics where economic growth rates exceed interest rates.

24. However, debt servicing costs have some limitations as a fiscal sustainability indicator. There is high uncertainty over future interest rates which means there is a risk of the favourable debt dynamics reversing. This would require significant changes in the operating balance to stabilise debt. This risk is particularly pronounced with a large debt stock, where a change in debt dynamics can have significant impacts on sustainability.

25. Therefore, we propose that a debt servicing cost indicator should be part of a wider suite of fiscal indicators which jointly provide a holistic picture of sustainability and prudent debt levels.

26. **We propose using a nominal measure for the standard debt servicing metric but recognise there are finely balanced arguments for using either nominal or real interest rates.**

27. The Budget 2021 FSR included both a nominal and a real measure for debt servicing costs. We recommend adopting a nominal measure as one of the standard fiscal indicators but retaining the option of also publishing a real measure from time to time if useful to describe the fiscal position.

28. A nominal debt servicing cost measure is preferred to a real measure because:

    i. It is consistent with the other fiscal indicators as these are also reported in nominal terms.

    ii. It is easier to communicate as most people are familiar with nominal indicators.

    iii. It enables easier comparison with other government spending which are reported in nominal terms. For example, it is easier to show what proportion of government spending is allocated to debt servicing costs versus other expenditure such as health and education.

    iv. It is more aligned with international norms as debt servicing costs are normally presented in nominal terms, although the US is now focusing on a real interest cost measure.[4]

29. The real interest cost measure published in the Budget 2021 FSR depicts the inflation-adjusted cost of servicing debt as a share of GDP. Adjusting for inflation may provide a

[3] The decline in the neutral interest rate reflects long-term structural challenges such as an ageing population, low productivity growth and rising inequity, which influence global rates of saving and investment.
[4] There is significant variation in the coverage of debt servicing costs (e.g. whether the reported measure includes federal, state or local government debt servicing costs) which make international comparisons challenging.

better illustration of the actual cost of borrowing when making investment decisions. For example, it can help communicate that the inflation-adjusted cost of borrowing is currently negative. However, this measure is not directly observable and requires significant assumptions such as the choice of inflation measure used[5]. Inflation rates are also subject to significant volatility which could lead to large movements in the metric.

30. On balance, we propose adopting the nominal metric as one of the standard indicators for the fiscal position. It broadly shows the same trend as the real measure, with significantly lower debt servicing costs as a share of GDP and enables better comparison with other government spending. Further, inflation's impact on the affordability of debt can be communicated as part of the wider fiscal narrative without being directly incorporated in the debt servicing metric.

31. For the construction of the metric, we recommend:

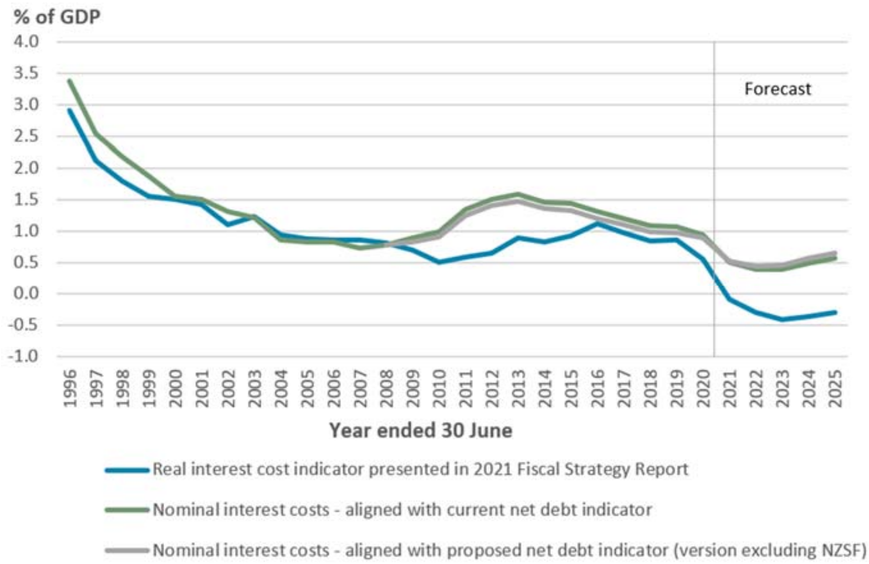
    i. **Aligning the debt servicing metric with the proposed net debt indicator.** This will ensure that the net debt and debt servicing indicators tell a consistent story and provide a holistic picture of the government debt position, which will consider both core Crown borrowings and financial assets.

    ii. **Aligning the debt servicing metric with the higher profile of the two net debt indicators (with and without the NZSF)**, rather than publishing two indicators. At this stage it is unclear which of the two net debt metrics will be higher profile, although we expect this will become clearer as work on fiscal targets progresses.

    iii. **Using net core Crown finance costs for calculating the debt servicing cost** in order to reflect the same instruments as the net debt metric. This is a change from the debt servicing measures published in the Budget 2021 FSR which used gross core Crown finance cost to calculate debt servicing costs, and therefore did not incorporate interest revenues from financial assets.

32. **Figure 4 below shows the real interest cost metric published in Budget 2021 and the proposed nominal metric.** Note this chart is indicative based on Budget 2021 figures.

Figure 4: Options for debt servicing indicators (% of GDP)



[5] We consider that the GDP deflator is the most relevant measure of inflation for the purposes of analysing real debt servicing costs given that it is more closely linked to tax revenue than the Consumer Price Index (CPI). However, it is subject to much more volatility than the CPI due to movements in the terms of trade. The real debt servicing indicator in the 2021 FSR used a five-year average of CPI inflation.

__Note:__ The grey line (nominal interest costs aligned with the proposed net debt indicator) only goes back to 2008 as there are data limitations for the prior years which will require further work. However, it is likely that the two nominal debt servicing lines would be closely aligned over history.

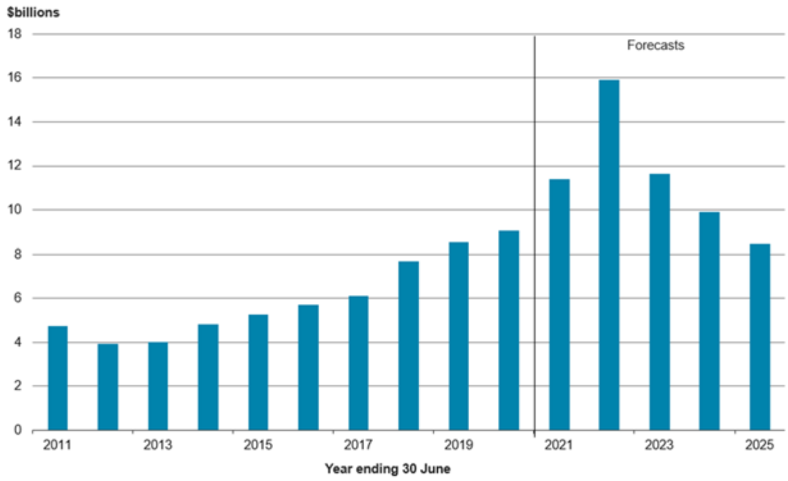
<u>Measuring the types and outcomes of spending</u>

33. We recommend introducing indicators that measure the types and outcomes of spending. This reflects that fiscal sustainability is not just about the total level of debt, but also what the money is spent on (for example, whether spending is welfare-enhancing).

34. In practice, it is easier to measure the types of spending (what the money is being spent on) than the outcomes of the spending (the wellbeing benefits that arise as a consequence). Below we discuss some key metrics and other supplementary types of metrics. We welcome your feedback on whether you find the recommended indicators useful and whether there are other metrics we should consider, noting we will continue refining these metrics over time as we collect more data on wellbeing outcomes.

35. **We recommend primarily using the net capital spending on physical capital indicator to outline trends in investment**. This has been used in recent publications (figure 5).

Figure 5: Net capital spending on physical investment



36. We think this is currently the most reliable indicator for measuring the Government's medium-term investment programme as it is relatively simple to understand and is directly controlled by the Government. One limitation is that it does not capture non-physical investments in areas such as health and education, which would be captured in the operating balance. It is also important to be mindful that capital investment can create subsequent operating expenditure (for example, building a hospital will create ongoing expenditure to run it once it is complete). However, we consider that overall capital investment is still the most useful proxy for measuring the overall scale of a government's capital investment, which will likely have positive outcomes on wellbeing and sustainability as capital investment can boost productivity and therefore the size of the economy and tax revenues.

37. **We propose adopting net worth as a useful complementary indicator of how the government is managing both its assets and liabilities.** The Crown's financial health (including its ability to borrow) depends on its overall balance sheet position, not just net debt. Net worth also tells a broader story than net debt, as for many forms of capital it tends to capture both sides of an investment. For example, borrowing undertaken to finance financial and physical assets, plus potentially some intangibles, would change both assets and liabilities. Net worth also provides some incentives for good balance sheet management. For example, it incentivises maintaining physical

assets, growing the value of financial or commercial assets, and reducing non-debt liabilities. However, it also has some limitations as a fiscal target (this is discussed in the next section).

38. It is more challenging to identify enduring measures of the outcomes of spending, such as living standards or wellbeing indicators. These measures tend to be more niche, lagged, and it can be difficult to be confident in the causality from spending to outcomes. However, we expect that topical wellbeing and living standards indicators could be used from time to time to demonstrate the outcomes of spending. These could be linked to the Budget Wellbeing Objectives, such as by using measures of child poverty, health, and climate change responses. A range of other reports will provide analysis of the outcomes of spending that could be cross referenced or drawn on, including the Budget Wellbeing Outlook, Budget Child Poverty Reports, and the Treasury Wellbeing Report under development.

39. **See Annex 1 for an example of how the suite of fiscal indicators can be used to explain the fiscal position.** Depending on your feedback, this could be adapted for use in the 2022 BPS and as a basis for developing fiscal targets in the future, building on our preliminary thinking on fiscal targets described in the next section.

Exploring new fiscal targets post-COVID-19

40. Following advice on the first draft for the BPS 2022, you agreed to keep the fiscal targets broadly unchanged in the BPS but to signal your intention to set new fiscal targets in the Budget 2022 FSR. As uncertainty from COVID-19 diminishes, we consider that more definitive fiscal targets should be adopted to enable transparent and robust fiscal management.

41. Our initial thinking is that fiscal targets could be focused on OBEGAL. This could provide an effective fiscal anchor to guide operating decisions while not constraining space to borrow for capital investment. There are choices about how you manage capital spending, and we are exploring an approach involving setting out a new net debt target. This could be a longer-term target, a ceiling or a range if you wish to have flexibility around capital investment and responding to shocks.

42. This approach would move New Zealand’s fiscal strategy more explicitly towards a ‘golden rule’, where the government borrows to invest in long-lived assets but does not borrow to fund current spending. A golden rule arrangement should be supported by careful value for money assessments of capital investment given the greater level of flexibility it allows.

43. Although we consider debt servicing costs to be a useful indicator, we have concerns about using it as a binding fiscal target:

    i. Debt servicing costs are very sensitive to unpredictable movements in global long-term interest rates, and therefore the government only has limited control over the path of the indicator. Forecasters internationally have a poor track record of predicting movements in long-term interest rates, such as the large fall in interest rates since the global financial crisis. Should interest rates unexpectedly increase, the Government would need to make large adjustments to the stock of debt to offset the impact on debt servicing costs to meet a binding fiscal target.

    ii. The indicator would be sensitive to the structure of debt, which could create pressure to use risky strategies to reduce debt servicing costs. For example, it could incentivise the government to issue a lot of short-term debt.

iii. Having a binding fiscal target that is highly sensitive to interest rates could create pressure on the Reserve Bank to keep interest rates inappropriately low.

44. Similarly, we have reservations about using net worth as a fiscal target. Net worth has some features that require careful communication, which make it challenging to use as a target. The relationship between net worth and living standards is not always direct for two key reasons. First, some forms of investment are not captured in net worth and some are not. For example, investment in physical/financial capital is captured but not investment in human capital. Second, assets can be subject to volatile revaluations that are beyond the control of decision makers and that do not necessarily reflect any change in the provision of government services. An example would be recent increases in the value of property, plant, and equipment. These mean it is difficult to set a target level of net worth. International comparability is also limited because many other countries do not have balance sheets measured based on the Generally Accepted Accounting Practice method used in New Zealand.

45. We will provide further advice on fiscal targets in the coming months.

Implementation

46. We recommend first using the new indicators in the forecasts at Budget 2022, but introducing and explaining the proposed changes to the indicators in an earlier Treasury document. Having the Treasury discuss the indicators in one or more of its documents will help build the credibility of the indicators. This will be important as the recommended changes to net debt currently result in the reported level of net debt being lower.

47. Our preference is to use the Investment Statement to introduce and explain the proposed changes to the indicators. The Investment Statement is a document Treasury must produce at least every four years describing the Crown's assets and liabilities and how these are changing over time. The next Investment Statement will be published by the end of March 2022 and we will provide advice on the scope of it in November 2021.

48. The indicators would subsequently be used in Budget 2022. Once fully implemented, we expect the headline indicators (eg, OBEGAL, net debt and debt servicing) would be published in most or all key documents from Budget 2022 onwards. This would include the Treasury's Economic and Fiscal Updates, the Financial Statements of Government, and key Budget documents.

49. Alternatives to introducing the indicators at the Investment Statement would be to either introduce the changes in a box in the HYEFU (to be published in December) or introducing them at the same time as they are first used in the forecasts at the Budget in May 2022. However, using the HYEFU would allow less space to explain the changes and less time to prepare communications. Introducing them at Budget 2022 would not allow as much time to build the credibility of the indicators before they are used. It would also make operational implementation of the changes more challenging.

50. We recommend continuing to publish the current net core Crown debt measure for a while to assist transparency during the transition to a new debt indicator, although we expect it would no longer need to be published once the new indicator becomes more established.

[33]

[33]

53. We will consider the impacts on other agencies (such as Kāinga Ora, the Guardian's of the NZSF and agencies responsible for student loans) as we develop the advice on fiscal targets. Given the sensitivities involved, we have not yet discussed our proposed changes to the indicator with these other agencies. You may also wish to discuss potential changes with your Ministerial colleagues responsible for the impacted agencies ahead of implementing changes.

Next Steps

54. We will discuss this advice with you at the weekly agency meeting on 18 October. Advice on the near-term fiscal strategy will be provided to you next week, followed by more detailed advice on fiscal targets in the coming months.

Annex 1: Possible fiscal narrative *(not Government policy)*

The government borrowed to support the economy in response to COVID-19, helping to prevent long-term scarring.

- The Government responded to the COVID-19 pandemic with significant fiscal stimulus. This led to **higher net debt** and a period of **OBEGAL** deficits.
- But this fiscal response has helped prevent a deeper and longer lasting recession, which could have had long-term impacts on New Zealand's wellbeing and living standards.
- Prior to the current outbreak, the economy had recovered to the pre-COVID trajectory with strong levels of demand.

We will invest to boost wellbeing, living standards and the capacity of the economy.

- We will continue to borrow to invest in the wellbeing of future generations. Capital investments can boost productivity and therefore also long-term fiscal sustainability.
- Our level of investment can be shown through our **net physical capital investment,** but also specific bespoke indicators that show the scale of our investments in climate change, for example.
- We will use robust value for money assessment to make sure we are only funding good quality investment, which will support a long-term trend of increasing **net worth**, as well as other **wellbeing and living standards indicators.**

We will ensure debt is prudent by considering not just the level of debt, but also the cost of servicing it.

- While **net debt** has increased, **debt servicing costs** have fallen. This is because interest rates have been falling in recent decades – based on structural, long-term factors – making this investment more affordable. And though interest rates are likely to rise from here, they are likely to remain lower than previously.
- Current debt levels are unlikely to limit our ability to borrow further if required and remain low relative to our peers. In part this is due to favourable debt dynamics where interest rates are lower than the economic growth rate.
- This means we can borrow to make good quality investments to boost intergenerational wellbeing, while maintaining prudent debt.

There are long-term fiscal challenges.

- We know there are going to be growing costs from an aging population in the future, so we will stabilise **net debt** by [X date] at [Y level/range].
- We will also monitor the **cost of servicing debt** and the trajectory of debt in the medium-term - to make sure we remain on a prudent pathway.

We will focus on returning to surplus as the economy recovers.

- As we did in response to COVID-19, governments should run operating deficits in response to economic shocks and surpluses in the good times.
- Because the fiscal response to COVID-19 is largely temporary, deficits will shrink as temporary support measures end. We aim to get **OBEGAL** back to a range of [X to Y] by [X year].
- We will ensure intergenerational wellbeing by balancing ongoing spending and revenues over time so today's day-to-day spending is paid for by today's taxes.

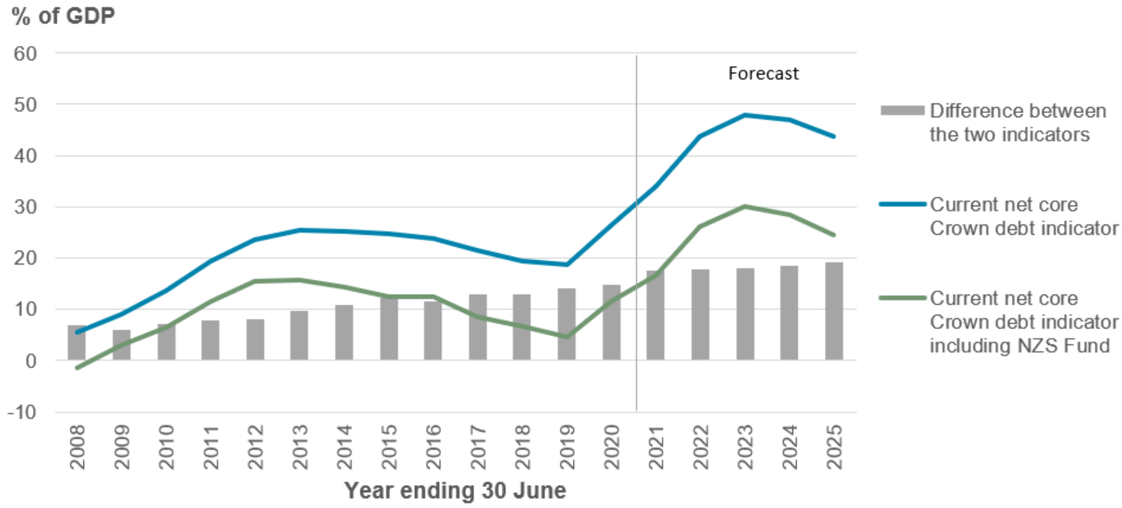
55. **The main advantage of including the NZSF in net debt is that it would better represent New Zealand's fiscal sustainability by recognising that we build an asset when the NZSF grows.**[6] The purpose of the NZSF is to support fiscal sustainability as the population ages. Therefore, it is beneficial to recognise its contribution to sustainability in the fiscal indicators. The NZSF has also in practice been used as a place to store surplus revenue, so inclusion allows decisions to be made about making contributions to the NZSF (versus paying down debt for example) without the impact on headline net debt having undue weight in the decision.

56. **The main disadvantage of including the NZSF is that it would introduce volatility into net debt as the value of its assets fluctuates. This potential for volatility will grow as the fund grows.** Having the NZSF in net debt would not have introduced major volatility in the past due to the relatively small size of the fund (figure 6). However, the NZSF is expected to be nearly 20% of GDP by the end of the forecast period, which is approximately 3 times larger as a share of GDP than before the global financial crisis (GFC). The Guardians of the NZSF estimate that a GFC sized shock would approximately halve the value of the NZSF now. With a fund size of 20% of GDP, this would impact net debt by 10 percentage points of GDP.

57. Including the NZSF would also introduce a downward trend in net debt (reflecting that NZSF assets as a share of GDP are expected to grow slightly faster than GDP). This downward trend in net debt should be accounted for in the fiscal strategy, as otherwise there is a risk that growth in the NZSF would be offset by higher spending. This trend would be around a 0.5 percentage point per annum decline in debt-to-GDP towards the end of the forecast period.

58. Including the NZSF would have mixed impacts for international comparability. Inclusion of the NZSF would improve comparability with Australia because it includes around 70% of its superannuation fund assets in its debt indicator. On the other hand, most countries do not include equity assets in the debt indicator, and the NZSF is predominantly equities.[7]

Figure 6. NZSF impact on the current net core Crown debt indicator



[6] NZSF assets also differ from ACC assets (which we do not recommend including in net debt) because NZSF assets are owned and accessible to the Crown, are not linked to a specific contractual liability, and are funded by taxes rather than separately determined levies.

[7] Under the IMF's GFS framework, fixed interest assets held by superannuation funds would be included in net debt but not any equities. Australia follows their own framework and include their superannuation funds fixed interest assets (~25% of its assets) and collective investment vehicles (~45% of its assets) in net debt. They do not include directly held equities in net debt. Collective investment vehicles are pooled investments and their superannuation fund holds the pool rather than the underlying securities. We do not recommend including only some categories of the NZSF's assets as this could result in the NZSF's portfolio allocation choices having a significant impact on net debt.

Annex 3: Possible changes to the Fiscal management approach if the coverage of net debt changes

[33]