The Treasury

Budget 2024 Information Release

September 2024

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Further advice on the debt objective for your fiscal strategy

Date:	Monday 11 March 2024	**Report No:**	T2024/604
		File Number:	MC-1-5-2-2024

Action sought

	Action sought	Deadline
Hon Nicola Willis **Minister of Finance**	**Agree** to the preferred indicator of net debt for your fiscal strategy.	Wednesday 13 March 2024

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Ash Dunstan	Principal Advisor, Macroeconomic and Fiscal Policy	[39]	[35]	✓
Ben Gaukrodger	Manager, 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: Further advice on the debt objective for your fiscal strategy

Executive Summary

The Treasury has recently provided you with advice on the short-term intentions and long-term objectives for your fiscal strategy to be announced at the Budget Policy Statement 2024. This report provides further advice on the debt objective within your fiscal strategy, following feedback from your office that you are considering changing the debt indicator to net core Crown debt, and setting a long-term objective to return to and maintain debt between 20 and 40 % of GDP based on that measure (which is a more binding target than recommended by the Treasury). These changes would result in greater certainty that the government will have sufficient balance sheet capacity to increase debt in response to significant economic shocks.

Your choice of debt indicator should balance principles of international comparability, accuracy in reflecting fiscal sustainability trends, suitability for use in fiscal management, and ease of communication. The Treasury recommends that the chosen measure should include Crown Entity borrowing and net off advances. This would more accurately reflect the liabilities of the Crown, better align with international practice, avoid creating incentives for Crown Entities to seek Ministerial permission to borrow against their own balance sheet, and avoid criticism that the change in indicator is overstating the forecast improvement in the fiscal position. The growth in government financial assets has also strengthened arguments in favour of reflecting a comprehensive measure of these assets in the net debt indicator.

A more binding debt objective will be more likely to constrain your future fiscal decisions. The Treasury's indicative forecast update shows that net Core Crown debt may not return to within the 20-40 % of GDP range until well after the forecast period. The proposed objective could therefore create additional pressure to offset capital investment with future forecast operating surpluses. Moreover, the increased emphasis on the debt objective may result in sharper trade-offs between your fiscal strategy and your objective of increasing the stability of the capital investment pipeline. In the event that operating deficits increase in response to an economic shock, there would be stronger incentives to reduce investment to meet the debt objective (assuming that it is not suspended).

Recommended Action

We recommend that you:

a **Note** the Treasury provided advice on your short-term intentions and long-term objectives including the debt indicator and objective (T2024/312 refers),

b **Note** the Treasury recommends fiscal metrics that are comprehensive, internationally comparable and consistent through time,

c **Note** the Treasury recommends that the net debt measure includes Crown entities and nets off the carrying value of advances,

d **Note** that changing the treatment of advances would result in an approximate decline in net debt of 3.5% of GDP prior to 2025/26 due to the Reserve Bank's Funding for Lending Programme, which provides an inaccurate representation of the trend in fiscal sustainability, e **Indicate** which indicator you would like to use in your fiscal strategy:

i. Net debt including New Zealand Super Fund, OR

Agree/disagree.

ii. Net debt excluding New Zealand Super Fund, OR

Agree/disagree.

iii. Net core Crown debt,

Agree/disagree.

i. **Note** that a 20 – 40% debt range based on net core Crown debt would be a more binding debt objective than recommended by the Treasury, and is more likely to create a tension between the fiscal strategy and a stable pipeline for capital investment,

j. **Note** the Treasury proposes to adjust its reporting of the monthly Financial Statements, along with commentary provided in the Fiscal Strategy Report, to reflect your decision on the debt indicator,

k. **Agree** to discuss this report with Budget Ministers at the meeting on Tuesday 12 March 2024.

Agree/disagree.

Ben Gaukrodger
Manager, Macroeconomic and Fiscal Policy

Hon Nicola Willis
Minister of Finance

_____/_____/_______

Treasury Report: Further advice on the debt objective for your fiscal strategy

Purpose

1. This report provides further advice on the debt measure used to guide your fiscal strategy to be announced at the Budget Policy Statement 2024. It responds to feedback from your office that you are considering changing the debt indicator to net core Crown debt, and introducing a range of 20 – 40% of GDP for the long-term debt objective.

Background

2. The Public Finance Act 1989 (PFA) requires you to set out your short-term intentions (STI) and long-term objectives (LTO), including your fiscal objectives relating to the balance between revenue and expenses and debt. The Treasury recently recommended you agree to a net debt LTO of a ceiling of 30% of GDP (or 50% if New Zealand Super Fund is excluded from the net debt definition) (T2024/312 refers). Treasury recommended this should be accompanied by an STI that says the Government intends to put net debt on a downward trajectory.

3. In 2022, the Treasury recommended changing the headline debt indicator from net core Crown debt to a broader net debt indicator. The new net debt indicator included all the assets and liabilities in net core Crown debt and:

    a. added Crown Entity (CE) borrowings (excluding Kiwibank) – mainly borrowings of Kāinga Ora (KO) and New Zealand Transport Agency;

    b. netted off the carrying value of advances – mainly Reserve Bank Funding for Lending (FLP) loans and student loans; and

    c. netted off the value of the New Zealand Superannuation Fund (NZSF) financial instruments.

    The International Monetary Fund (IMF) and rating agencies supported the new measure when it was introduced.

4. Feedback from your office suggests you intend to return to the previous debt measure of net core Crown debt to guide your fiscal strategy, and to set a LTO to return to and maintain net debt between 20% and 40% of GDP. We understand that the possible change to the debt indicator reflects concerns about the valuation of NZSF assets increasing the volatility of the current measure, and the clarity would be lost by having to periodically amend the debt objective to account for rises (and falls) in the value of the NZSF Fund. The proposed change also reflects a desire to have a consistent measure over time that provides clarity about how the current size of debt, and the Government's objectives, fits into a historical perspective.

5. Net core Crown debt is defined as gross sovereign issued debt[1] less some financial assets (specifically, core Crown financial assets excluding advances and the assets of the NZSF).

[1] Represents debt issued by the sovereign (the core Crown).

Principles to guide your choice of debt indicator

6. The debt indicator used for your fiscal strategy should provide an accurate picture of trends in the Crown's fiscal sustainability, particularly the parts of the balance sheet under the direct control of the Government of the day. A good indicator reflects a balance of:

   a **International comparability**: Alignment with international standards and methodologies, including proximity to the IMF's Government Finance Statistics (GFS) net debt figure (i.e. how similar the level of net debt would be compared to the actual IMF's GFS net debt figure for New Zealand).

   b **Effectiveness in reflecting fiscal sustainability:** How well the measure represents New Zealand's fiscal sustainability including assets and liabilities.

   c **Fiscal management:** The indicator's suitability for use in fiscal management, particularly the extent to which its trajectory is within the control of the Government of the day.

   d **Ease of communication:** Fiscal rules should be readily understood by policymakers and the public to support government accountability. A key factor in this is continuity over time and across Governments.

   An assessment of the options discussed in this paper against these criteria is contained in Annex 1.

Treatment of Crown Entity borrowings

7. The Treasury considers that there are significant benefits and no material downside in maintaining CE borrowings in the debt indicator. Including these liabilities provides a more accurate reflection of the liabilities of the Crown, given that CEs are ultimately owned by the Government and decisions to allow CEs to borrow sit with Ministers. Inclusion of CE borrowings also avoids the incentive to engage in more expensive borrowing on Crown entity balance sheets that would fall outside the net debt indicator but does not realistically shift risk away from the core Crown.

8. As an illustration of the risks of including CE borrowing in the debt indicator, there was significant growth in KO borrowings prior to the adoption of the new indicator in 2022. As KO debt is issued at a premium to Government bonds, this led to an unnecessary increase in the cost of Government debt. Moreover, the direct issuance of debt by KO reduced government oversight of KO financial decisions by giving them a mechanism to fund activities without going through the Budget process.

9. Although we understand from your office that you do not intend to allow CEs to increase borrowing on their own balance sheet, the exclusion of CE borrowings would increase pressure on your Government to do so over successive Budgets, and future Governments may take a different approach. The inclusion of CE borrowings is consistent with the advice leading to the adoption of net core Crown debt in 2009, which noted that CE borrowings should be included if they increase materially (T2009/927 refers). CE borrowings have increased from 1% of GDP to 5% of GDP since that advice was provided.

10. If you decide to exclude CE borrowings from the debt indicator, the Treasury can advise you on options to mitigate the risks associated with this approach.

Whether to net off advances

11. The Treasury recommends that the debt indicator continues to net off the fair value of advances.

    - Excluding advances means that the metric is open to criticism that it is overstating the forecast improvement in the fiscal position. In particular, there is a 3.5% of GDP improvement in net Core Crown debt over the forecast period. This reflects the repayment of government debt that is funding the loans made under the Reserve Bank's Funding for Lending Programme (FLP), as the loans made under the scheme mature between now and 2025/26. Including the government debt that finances that FLP while excluding the loans made under the FLP will distort the fiscal forecasts and present a less accurate reflection of the sustainability of the fiscal position.

    - Including advances bring the net debt measure into better alignment with international norms – for example, as reflected in the guidelines IMF's Government Finance Statistics. Other countries include advances because they are a fixed interest asset that will eventually be repaid to the Crown.

12. On the other hand, there is an argument that advances – such as student loans – are less liquid than other financial assets and are not held for the purpose of government financing. However, the primary purpose of the net debt indicator for fiscal strategy is to measure fiscal sustainability.

13. Another option for your debt indicator is to only net off advances related to the FLP. This approach would help ensure that the forecasts present an accurate picture of the fiscal impacts of the FLP, but otherwise treat advances in the same way as under the net Core crown debt measure.

Treatment of the Super Fund

14. Our previous advice (T2024/312 refers) covered the pros and cons relating to the treatment of the New Zealand Super Fund in the debt indicator:

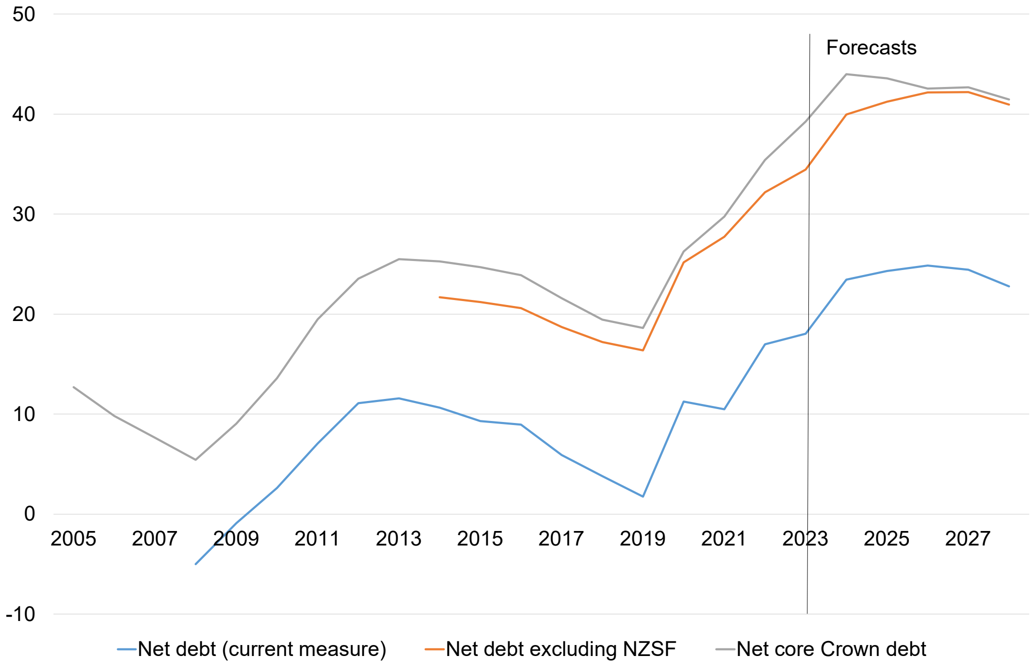
    a Including the NZSF better represents New Zealand's long-term fiscal sustainability. Excluding these assets can create perverse incentives to not build financial assets that could support fiscal sustainability and intergenerational equity. It is also more consistent with international practice – for example, the net debt series as part of the IMF GFS includes interest bearing instruments of pension funds. These arguments have become stronger over time as the financial assets of the Government have grown significantly. For these reasons, the Treasury supported the inclusion of the NZSF in the current debt indicator.

    b On the other hand, including the NZSF increased volatility of the fiscal indicator, and creates a need for periodic amendment to reduce the debt ceiling so the growth of the NZSF is not spent through increased room for net debt. The NZSF is also earmarked for future use, and so does not represent an asset that should be leveraged to increase borrowing. Moreover, the inclusion of NZSF assets would be most suitable for a non-binding debt target, such as a ceiling calibrated above projected debt levels. The inclusion of NZSF assets combined with a binding target could lead to pro-cyclical policy following declines in the value of NZSF assets.

Implications for the fiscal outlook

15. The various measures of net debt have a different profile over history and into the forecast period. Net core Crown debt declines by approximately 2.5% of GDP between 2023/24 and 2027/28in the Treasury's indicative forecast update. Net debt (excluding the NZSF) increases by approximately 1% of GDP. This means that as a result of excluding advances and CE debt, net core Crown debt shows a reduction in net debt of 3.5% of GDP more than the measure that includes advances and CE debt. As noted above, almost all of this additional reduction in net debt is a result of the $18.1 billion of FLP loans being repaid by 2025/26. By only treating FLP as a liability, without counting the financial asset as part of net debt, net core Crown debt overstates how much the fiscal position is improving.

Figure 1: Treasury indicative update to forecasts for measures of net debt (% of GDP)



16. For transparency reasons, if you choose to move back to net Core Crown debt, the Treasury proposes to continue to publish net debt information both including and excluding NZSF in the Fiscal Strategy Report and, publish narrative information that illustrates how Crown entities and advances are affecting the Crown balance sheet. This approach will mitigate the downsides if you choose to move back to net core Crown debt as the primary debt indicator, by ensuring that a range of information is available to the market to assess debt sustainability.

Risks

17. As set out in T2024/312, the Treasury considers that a ceiling for net debt of 50% (based on a debt measure that excludes the NZSF) is consistent with the PFA requirements to maintain prudent debt levels. Your office has indicated that you are considering adopting a LTO to return and maintain net debt within a 20 – 40% of GDP alongside changing the indicator to net core Crown debt. This would be a more binding long-term objective for debt, which would have a more central role in your fiscal strategy relative to the current formulation (where the debt ceiling acts as a backstop for the operating balance rule).

18. We understand from your office that the possible change to the debt objective reflects a concern that debt could ratchet up beyond the Treasury's recommended debt ceiling as future Governments fail to bring down debt down fast enough. We acknowledge that the Treasury's recommended debt ceiling calibration would require large operating surpluses to bring debt back below the ceiling following significant economic shocks, albeit that the Treasury's modelling makes conservative assumptions about the post-shock trajectory for interest rates and economic growth. Your alternative approach would have the benefit of providing greater certainty that the Government will have sufficient balance sheet capacity to increase debt in response to significant economic shocks, such as a financial crisis or following natural disasters related to climate change.

19. The implication of a more binding debt rule is that it will be more likely to constrain your future fiscal decisions, potentially including your ability to borrow to finance future capital investment. The Treasury's indicative forecast for net core Crown debt is broadly stable and is unlikely to return to below 40% of GDP until well after the forecast period. Moreover, Treasury analysis suggests that forecasts for annual government revenue four years ahead – the current horizon for 2027/28 – are highly uncertain. For example, past experience suggests there is a 50% chance that that revenue is $15.7 billion per annum higher or lower than the central forecast at this horizon. Lower revenue could require significant adjustments to forecast and projected expenditure to meet the debt rule.

20. We understand that you would like to ensure that any debt objective does not cut off opportunities for high-quality public investment, given that additional capital investment and making better use of existing asset may help boost long-term productivity growth. The Treasury's early analysis suggests that a 20 – 40% debt range could create additional pressure to offset capital investment with increased forecast operating surpluses. We can provide more advice on the trade-offs between your debt objective and capital investment when the medium-term fiscal projections are produced. A more binding debt ceiling may also make it more difficult to maintain a stable investment pipeline, with pressures to reduce capital investment increasing if OBEGAL deficits rise in response to economic shocks (assuming that the debt objective is not suspended).

21. The introduction of a more binding debt range also increases the risks described above relating to the incentive for CEs to borrow on their own balance sheet to avoid the need to seek funding through the Budget process.

22. There is a risk that the change to a new debt measure, following recent changes made in 2022, creates market confusion about the best metric to assess fiscal sustainability. However, we acknowledge that the debt indicator has been changed multiple times in the past without undermining the credibility of the fiscal strategy.

Next Steps

23. We recommend that you discuss this report with Budget Ministers at the meeting on Tuesday 12 March 2024. We will work with your office to incorporate your final decisions on the appropriate indicator and range for your LTO for debt. This will enable us to provide you with a near-final draft of the BPS by Wednesday 20 March 2024.

24. The Treasury will continue to work with your office on the indicative update to the economic and fiscal outlook to be published alongside the BPS. This will include updating the text to reflect your decisions on the debt objective, and agreeing wording to explain any deviations between the forecasts and your STIs and LTOs.

25. In terms of reporting, we will need to reflect any changes to the debt indicator into the monthly financial statements for February 2024. If you choose to move back to net Core Crown debt, we also propose to increase the explanation of advances and total borrowings to support the market in interpreting changes to the underlying sustainability of the balance sheet, as noted above.

Annex 1: Assessment of debt indicator options against principles

Criteria		Current net debt indicator	Net debt excl. NZSF	Net core Crown Debt
International comparability	Alignment with international standards and the concept of net debt	Reasonably well aligned, but not in every respect (e.g. it doesn't net off all the NZSF and ACC fixed interest assets that the IMF's Government Finance Statistics (GFS) would typically allow).	GFS standards and most countries explicitly exclude equities from net debt. Australia is an outlier in including a sizable amount of them.	Not well aligned with GFS and international practice regarding fixed interest assets and Crown entity borrowings..
	Proximity to the IMF's GFS net debt figure	Broadly results in the same level of net debt as the IMF's GFS and average peer economy headline indicators.	Arguably overstates NZ debt by ~10-20 ppt of GDP relative to IMF and average peer economy indicators (estimate as at 2022).	Arguably overstates debt by ~10-20 ppt of GDP relative to IMF and average peer economy indicators (estimate as at 2022).
Effectiveness in reflecting fiscal sustainability		Best reflects NZ's fiscal sustainability.	Doesn't capture that growing the NZSF supports fiscal sustainability.	Doesn't include NZSF, advances or Crown Entities, which are relevant to fiscal sustainability.
Fiscal management	Volatility	Inclusion of NZSF equities introduces significant pro-cyclical volatility (up to 10ppt of GDP in a repeat of the GFC).	Removes volatility associated with the valuation of NZSF assets.	Removes volatility associated with the valuation of NZSF assets, but indicator is currently distorted by the Reserve Bank's Funding for Lending programme.
	Other fiscal management considerations	Risk of spending growth in NZSF if debt ceiling not lowered periodically (approx. 5ppt per decade).	Some potential boundary issues (e.g. may incentivise not contributing to the NZSF funds in order to suppress reported net debt).	Some significant potential boundary issues as it excludes Crown entities which may encourage future Governments to engage in more expensive borrowing on Crown entity balance sheets. It may incentivise not contributing to the NZSF in order to suppress reported net debt.
Communication		Risks appearing as though the government intends to borrow against the NZSF, effectively spending them, which is not the government's intention.	Easy to communicate as a simple change compared to the current net debt measure but is also comparable to the previous measure (net core Crown measure).	Relatively easy change to communicate as returning to the previous measure, although may be difficult to explain the rationale for excluding Crown entity borrowings and FLP advances.