NZ Insight: New fiscal rules

3 May 2022

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Confused by acronyms or jargon? See a glossary here.

A brave new (fiscal) world

Summary

- In the lead up to Budget 2022, the Government has announced new fiscal rules, including a new measure for net debt.
- The Government intends to keep operating balance before gains and losses (OBEGAL) surpluses within a band of 0-2% of GDP over time, and will introduce a debt ceiling of 30% of GDP (50% of GDP under the old measure).
- The debt ceiling is not a target, and provides plenty of wiggle room for new capital spending should economic conditions warrant (or the Government feels they can justify it). That makes the operating balance (OBEGAL) target the key binding constraint against excessive (eg pro-cyclical) fiscal expansion.
- This increases the risk of pro-cyclical capex over time, as capex isn't captured in the operating balance other than via depreciation. However, there are very good structural reasons for the Government to keep its foot on the capex accelerator through the business cycle.
- Insofar as sovereign credit rating agencies are concerned, these developments will have very little *direct* impact. That's because ratings agencies use their own (typically GFS) fiscal indicators to assess the sustainability of NZ's fiscal position.
- Given the above, the question then becomes "will these developments change the Government's incentive to tax and spend?" The answer to that appears to be "yes" – that's the point, as the Government looks for flexibility to address NZ's decades-long infrastructure deficit.
- Relative to the pre-pandemic fiscal strategy, today's developments appear consistent with a slightly looser fiscal stance on average and higher-than-otherwise debt. But that will be a story for beyond Budget 2022. As with any new fiscal rule book, it'll take a while to gauge its success.
- Overall, the new fiscal rules appear both prudent and binding enough to ensure that fiscal buffers are rebuilt over time (ensuring there is ammunition to respond to the next inevitable crisis). But it might be at a slower pace than under the pre-pandemic debt-target era.

Introduction

Fiscal indicators and the Government's fiscal strategy are relatively fluid in New Zealand. The Public Finance Act requires the Government to have both, but with the ability to choose the specific definition of key indicators, such as debt (eg what assets and liabilities to include/exclude), and what targets are appropriate to aim for over time.

As the goliath fiscal response to COVID-19 comes to an end, and in accordance with the Public Finance Act, the Government is now reintroducing updated fiscal rules (and a new definition for net debt) that will shape fiscal policy decisions over the coming years.

New debt measure

There is no perfect single indicator for Government debt, which is why it's important to keep an eye on multiple definitions (gross, net, total Crown, core Crown etc). But most people can't be bothered with that, and Governments need something relatively simple but widely encompassing to guide and communicate their fiscal strategy. The New Zealand Treasury take these (and many other) considerations into account when advising the Government of the day on appropriate fiscal indicators (and fiscal strategy).

The latest advice (which the Government has adopted) is to tweak net core Crown debt to include more assets and liabilities. As the Treasury notes, the new net debt indicator includes the same liabilities and assets as the old measure, but broadens the definition to include:

- Crown entity borrowings (mainly Kāinga Ora and Waka Kotahi borrowings).
- Advances (mainly Reserve Bank Funding for Lending loans and student loans) which will now be netted off.
- The New Zealand Super Fund (NZSF) which will also now be netted off.

Overall, it's a more holistic measure. It is also more consistent with how other countries do it. But as noted below, changes to the Government's fiscal strategy (fiscal rules) are likely to take some of the focus away from net debt as a key fiscal target. Indeed, net debt is no longer a target; it is a ceiling. That puts the emphasis on achieving operating surpluses on average over time.

Page 60 in the Treasury's Investment Statement provides more details on the motivation behind these tweaks.

At the Half-Year Update in December, the Treasury forecast net core Crown debt to peak at just over 40% of GDP in the year to June 2023. Under the new measure that will be closer to 20% of GDP. That of course sounds a lot better, but it's the change and trajectory of these indicators that really matter.

New Fiscal Strategy

The Minister of Finance announced new fiscal rules that will shape fiscal policy decisions in the post-pandemic era:

- Surpluses will be kept within a band of 0 to 2 percent of GDP to ensure new day-to-day spending is not adding to debt.
- A new debt measure will be introduced to bring New Zealand closer in line with other countries (discussed above).
- A debt ceiling of 30% of GDP (50% under the old net debt definition) represents a limit on (not a target for) debt.

At first blush, changes to the treatment of debt under these rules (from the pre-pandemic strategy of maintaining the old net debt measure between 20-25% of GDP) could be seen as a significant loosening of fiscal settings. While this might be a loosening at the margin, it's certainly not a case of throwing all caution to the wind. New Zealand will, in all likelihood, maintain relatively low levels of government debt by international standards (not a bad idea, given relatively high levels of household debt).

Achieving surpluses will now become the big constraint on fiscal expansion, and the headline fiscal indicator. And that raises the importance of surpluses actually being achieved (as opposed to always being forecast by the Treasury, but seldom achieved in practice).

The operating balance before gains and losses (OBEGAL) is unchanged and remains the Government's key operating balance indicator. This does not capture capital spending directly, but it does include depreciation. That means large increases on the capex side won't result in a front-loaded deficit, but it will weigh on the OBEGAL very slowly over time as the asset depreciates.

Overall, removing net debt as a key *target* is likely to reduce a key constraint on new capital spending (provided net debt isn't sailing too close to the ceiling at the time, which would seem very unlikely).

Importantly, however, new fiscal rules will of course do very little to address capacity constraints in the economy (eg. labour shortages, capital stock, and red tape), meaning there will be limits in terms of how much capital spending the Government can actually get out the door at any one time (whether inflationary or not). Spending delays in a capacity-constrained economy are the norm.

The last point worth mentioning on the new debt ceiling is that, provided small surpluses are achieved on average, the nominal economy continues to expand, and big (one-off) capital spending initiatives don't become too large and/or too frequent, the debt to GDP ratio should shrink over time, and the *level* of debt should remain broadly stable or perhaps shrink on average too. The sniff test for any voter will ultimately be whether they are comfortable with the pace of debt reduction.

If you really want to get in to the details on fiscal rules, see this paper from the Treasury released alongside today's announcements. It's a great read for anyone who may be concerned with fiscal sustainability in light of today's announcements.

Good, bad, or indifferent?

Overall, today's announcements appear to be a slightly looser set of fiscal rules than those prevailing before the pandemic. That's particularly true on the capex front. From an economic perspective, there's a number of ways to look at this. But for simplicity, we'll just focus on the cyclical vs structural implications.

From the perspective of the economic cycle, any fiscal rules that are looser than they could be are likely to lead to more macroeconomic stimulus than otherwise. And when the economy is already deploying all the available workers and capital it has available (as it appears to be doing now), this is going to lead to more inflation than otherwise, and therefore more monetary tightening by the RBNZ than otherwise. In other words, the RBNZ will have to offset fiscal settings more than otherwise, crowding out private sector activity with higher interest rates.

The NZ economy is looking extremely stretched right now, meaning if the Government wanted to be subtracting from inflation pressures and rising interest rates it should be focusing on fiscal consolidation at the macro-level, looking at non-spending ways to free up economic capacity (eg via migration or cutting red tape), while still maintaining timely, temporary and targeted support to those who really need it. That would go some way towards reducing inflation and ensuring tax payers get value for money.

However, the reason capacity constraints are biting so hard is partly due to decades of under-spending on the infrastructure front as the population expanded. That's weighed on productivity, which is the holy grail of sustainable growth in real incomes.

Infrastructure spending takes time to plan and any Government that chooses a strategy of turning it on and off as economic conditions warrant risks losing capacity in the industry. This industry requires a lengthy pipeline of projects in order to maintain capacity (such as construction workers and investment in plant and machinery). So while economic cycles come and go, we may all end up better off maintaining a lengthy pipeline of projects through the cycle. It's a fine balance, and value for money needs to be at the core of it all, but tweaking fiscal rules such that the debt target is less of a constraint on infrastructure spending may well pay for itself over a long enough time horizon.

What does it mean for markets?

The answer to this question is "probably not a lot", at least in the near term. These fiscal rules are consistent with fiscal consolidation over time, but it might just be a little slower than it could be.

The Minister of Finance signalled today that the Government does not intend to lift the multi-year capital envelope at Budget 2022, implying these new rules haven't changed things yet. However, Budget 2023, and beyond, may see a little more capex spending than otherwise. That means a little more debt and bond supply compared to the Government's pre-pandemic (old) fiscal rules, but in reality the difference will be impossible to quantify.

Importantly, sovereign credit rating agencies consider their own definitions of Government debt when accessing NZ's fiscal sustainability. That means they're likely to be concerned only if it's looking like these new rules are leading to an unsustainable path for fiscal settings. And that seems very unlikely.

To sum it all up, the new fiscal rules appear a little looser than those prevailing prior to the pandemic, but they are still consistent with the rebuilding of fiscal buffers over time. The new rules will reduce some of the constraint on capex spending (ie a near-term debt target won't get in the way of going ahead with good Government investments). But let's be honest, planning to spend money is the easy part. Changing regulatory settings and focusing on positive supply-side policies to get the industry moving is much harder, and right now the only thing that's likely to see the industry get more done any time soon.

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Last updated: 28 February 2022

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