ECONOMIC BULLETIN

Credit rating primer.

18 Sep 2024 | **Darren Gibbs**, Senior Economist | +64 9 367 3368 | +64 21 794 292 | darren.gibbs@westpac.co.nz

NZ's credit rating: stable for now, but vulnerable

- **New Zealand is one of the world's most highly rated sovereigns, holding a Aaa foreign currency rating with Moody's and a AA+ rating from both S&P and Fitch.**
- **New Zealand's strong ratings stem from our strong political, legal and monetary frameworks and its advanced and generally well-functioning economy.**
- **Key vulnerabilities to these ratings are New Zealand's significant current account deficit and private external debt, and more recently its sustained fiscal deficit and rising public debt.**
- **While ratings agencies currently seem comfortable with New Zealand's rating, downgrades could occur in the event of a major negative economic shock or natural disaster, or a change in fiscal strategy that brings into doubt the commitment to reduce debt and deficits over time.**
- **Risks to New Zealand's rating could be at least partially mitigated if the Government takes steps to build buffers that allow for the impact of inevitable future negative events.**

Introduction.

Credit ratings are one of the key metrics used by investors when deciding on the allocation and pricing of capital. And a country's sovereign rating sets the ceiling for ratings of other entities operating in that country (no entity can be more highly rated than the sovereign considering the latter's coercive ability to tax these entities). Therefore, all entities operating in New Zealand have an interest in the Government's creditworthiness.

New Zealand is one of the world's most highly rated sovereigns. It holds a Aaa foreign currency rating from Moody's Investor Services – the highest rating achievable. It holds a AA+ foreign currency rating from Standard & Poor's Global Ratings (S&P) and Fitch Ratings – one notch below the highest rating for those agencies.

When borrowing in domestic currency, New Zealand has the highest possible rating from both Moody's and S&P. S&P's 'split' rating reflects the fact that defaults on local currency debt are rarer than those on foreign currency debt. Fitch rates New Zealand's local currency borrowing in line with its foreign currency rating.

Table 1: New Zealand's Credit Ratings

Rating Agency	Domestic Currency	Foreign Currency	Latest update
Moody's Investors Service	Aaa (stable outlook)	Aaa (stable outlook)	16-Apr-24
S&P Global Ratings	AAA (stable outlook)	AA+ (stable outlook)	07-Sep-23
Fitch Ratings	AA+ (stable outlook)	AA+ (stable outlook)	20-Aug-24

In all cases, those ratings have a "stable outlook". This indicates that these agencies don't expect that they will have to change the rating over the next two years.

In this note we look at the factors that the ratings agencies consider when assigning sovereign credit ratings. In particular, we focus on the factors that could cause New Zealand to be placed on "negative outlook", which would indicate a risk that the credit rating might be lowered at a future review within that two-year period.

How are ratings assigned?

The major ratings agencies take a similar approach to assigning a sovereign credit rating. Countries are assessed against qualitative and quantitative criteria that the agencies think will affect a sovereign government's willingness and ability to service its debt on time and in full. In the case of S&P, these criteria are grouped as follows:

1) Institutional factors: Sovereigns are assessed based on how institutions within the country help to deliver stable, predictable and transparent policymaking that results in sustainable public finances, balanced economic growth and an ability to endure and adapt to economic and political shocks. This includes a sovereign's track record in managing past shocks or crises; any potential challenges to political institutions including the cohesiveness of civil society; perceived levels of corruption; and the independence of statistical agencies and the media. A sovereign's debt payment culture and geopolitical or external security risks are also considered here.
2) Economic factors: Based on historical experience, wealthy, diversified, market-driven economies with a record of sustained growth are more likely to have a revenue base that can support a high debt-bearing capacity. Therefore, agencies look at factors such as a country's absolute income levels, growth prospects and economic diversity.
3) External factors: Agencies assess a country's ability to obtain the foreign exchange required to meet its obligations to non-residents. Factors affecting this assessment include a country's net external debt; its external liquidity (debt servicing obligations as a proportion of current account receipts and official reserves); and whether the sovereign's currency is widely used in international transactions (and so less exposed to shifts in investor sentiment).
4) Fiscal factors: Agencies assess a sovereign's fiscal position (whether it is running a surplus or deficit and its starting debt levels); how the fiscal position is expected to evolve; the structure of its debt; the flexibility afforded by any large liquid financial assets; a sovereign's perceived willingness to raise revenues if required to meet a shortfall; and any risks arising from contingent liabilities. In making this assessment, agencies look at the fiscal position across the whole public sector, including the fiscal performance of local or regional governments.
5) Monetary factors: A flexible monetary policy can help to moderate a deterioration in a sovereign's creditworthiness following a negative economic shock. So agencies assess the effectiveness of a country's monetary policy regime, including its credibility; its coordination with fiscal policy; the depth of financial markets; and the exchange rate regime (a floating exchange rate offers more flexibility than a fixed exchange rate).

For each country, the agencies assign a score against the various indicators that are used to assess the above criteria. These scores are then weighted together to generate an overall score and an indicative credit rating. However, the final rating assigned by the agency can also be adjusted up or down by a notch or two to capture special or unique factors not adequately recognised in the general modelling framework. For example, S&P assign the United States a credit rating that is one notch higher than the indicative rating, which is attributed to the credit strengths and policy flexibility associated with the US dollar's role and unique status as the world's premier reserve currency.

Where does New Zealand score well?

Based on the framework above, table 2 on the following page shows how S&P have arrived at their rating for a selection of advanced economies, including New Zealand.

Unsurprisingly, New Zealand scores very highly with respect to institutional factors. Amongst other things, this reflects the country's long history of meeting its obligations; its transparent legislated fiscal and monetary policy frameworks, and how these have helped the economy to adapt to a variety of economic shocks; its low level of corruption; and the scrutiny that that is made possible by a trusted statistical data agency and the media (albeit partly in government ownership).

Similarly, New Zealand scores very highly with respect to both economic and monetary factors. It is a relatively wealthy country, with a record of sustained growth and with a reasonable level of diversity in the economy, albeit with an export base that is dominated by the primary sector. The monetary framework has a track record of delivering sustained low inflation and the floating NZ dollar provides a natural buffer that allows the economy to adjust to economic shocks.

Table 2: S&P Global Ratings - Selected Countries

Issuer	Sovereign Foreign-Currency Ratings	Institutional assessment	Economic assessment	External assessment	Fiscal assessment: budget performance	Fiscal assessment: debt	Monetary assessment	Indicative rating	Notches of supplemental adjustments and flexibility	Long-term Foreign-Currency Rating
Australia	AAA/Stable/A-1+	1	1	5	1	1	1	aaa	1	AAA
Canada	AAA/Stable/A-1+	1	1	2	1	3	1	aaa	0	AAA
Germany	AAA/Stable/A-1+	2	1	1	2	2	2	aaa	0	AAA
Netherlands	AAA/Stable/A-1+	2	1	2	2	2	2	aaa	0	AAA
Norway	AAA/Stable/A-1+	1	1	1	1	1	1	aaa	0	AAA
Singapore	AAA/Stable/A-1+	1	1	1	1	1	1	aaa	0	AAA
Sweden	AAA/Stable/A-1+	1	1	2	1	1	1	aaa	0	AAA
Switzerland	AAA/Stable/A-1+	1	1	1	1	1	2	aaa	0	AAA
Austria	AA+/Stable/A-1+	2	1	1	3	3	2	aaa	-1	AA+
Finland	AA+/Stable/A-1+	2	1	4	1	2	2	aa+	0	AA+
New Zealand	AA+/Stable/A-1+	1	1	5	3	3	1	aa+	0	AA+
Taiwan	AA+/Stable/A-1+	3	1	1	2	2	2	aaa	-1	AA+
United States	AA+/Stable/A-1+	2	1	2	5	6	1	aa	1	AA+
Belgium	AA/Stable/A-1+	3	1	2	4	4	2	aa	0	AA
Korea	AA/Stable/A-1+	3	1	1	1	4	2	aa+	-1	AA
Ireland	AA/Stable/A-1+	2	1	3	2	2	2	aa+	-1	AA
United Kingdom	AA/Stable/A-1+	2	1	2	4	5	1	aa+	-1	AA
France	AA-/Stable/A-1+	2	1	4	4	5	2	aa-	0	AA-
Japan	A+/Stable/A-1	2	2	1	6	6	2	aa-	-1	A+

1 = strong, 6 = weak

What are New Zealand's vulnerabilities?

As table 2 also shows, New Zealand scores much less highly when it comes to external and fiscal metrics. Indeed, in the opinion of S&P, external factors are the key weight on New Zealand's credit rating, scoring a 5 on a 1-6 scale (where 1 is 'strong' and 6 is 'weak'). And in its most recent review of New Zealand, Fitch noted that a failure to reduce current account deficits, leading to rapid build- up of net external debt, could lead to a ratings action or downgrade. Table 3 below shows how New Zealand compares to a selection of other countries from table 2 across several external indicators that S&P consider when scoring a sovereign's external credentials, ranked left to right according to the size of the current account deficit as a share of GDP.

Of the countries in table 3, New Zealand has by far the largest current account deficit as a share of GDP. As a share of current receipts, the US has a similar-sized deficit to New Zealand, as the US is a much less open economy than most. While the US has higher external debt and net external liabilities (as a share of current receipts) than New Zealand, S&P regard external factors as less of a weakness to the US rating. This reflects the fact that the US generates net positive investment income despite its net negative external liabilities, whereas New Zealand runs a persistent investment income deficit.

Australia is currently running a much smaller current account deficit than New Zealand and has much smaller net external liabilities. However, external factors are nonetheless regarded as Australia's single credit weak

Table 3: External sector indicators, selected countries

	NZ	US	UK	AUS	CAN	FIN	JPN	SWE	IRE
Current account % of GDP	-5.6	-3.4	-3.1	-1.4	-0.9	-0.3	2.7	5.7	8.6
Current account % of current receipts	-20.2	-20.3	-7.1	-5.2	-2.1	-0.5	8.4	8.1	5.1
Net external debt % of current receipts	196.1	361.3	234.5	206.9	101.0	194.6	-55.0	106.2	128.6
Net external liabilities % of current receipts	180.6	300.5	73.9	112.5	-135.5	-0.2	-268.4	-46.3	57.5
Net portfolio equity inflow % of GDP	0.9	-0.2	1.0	-1.8	-1.7	-1.0	-1.8	-2.3	16.5

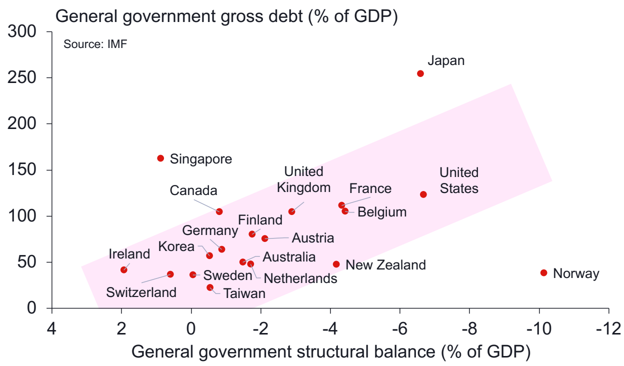
Source: S&P Global Ratings 2024 estimates point. This is because of the high degree of volatility in Australia's terms of trade in recent years, which could mean that its current relatively favourable current account balance is not sustained in the future.

New Zealand's other vulnerability is its direct fiscal metrics. Table 4 below shows how New Zealand compares to the same selection of countries as above across several fiscal indicators that S&P consider when scoring a sovereign's credentials. Note that the balance and debt figures in this table are for the general government sector (albeit dominated in New Zealand by the central government, given its highly centralised system of government).

As can be seen, New Zealand's current general government deficit is at the top end of the spectrum amongst advanced economies. However, this is mitigated by the fact that New Zealand's gross and net debt lies at the lower end of the spectrum and far below that seen in the likes of the US, UK and especially Japan – countries for which the fiscal metrics are the key weights on their respective credit ratings.

The chart below shows a similar picture across a larger sample of countries (this time based on IMF estimates). New Zealand has a relatively large structural deficit but importantly has a relatively low level of general government debt. Were New Zealand's debt levels to be similar to those in France, the UK or Belgium (countries with similar deficit levels) we think it is very likely New Zealand's credit rating would be lower than it is today – probably AA.

IMF budget estimates for 2024



In its most recent review of New Zealand, Fitch noted that a ratings action or downgrade could be triggered by a failure to put general government debt/GDP on a sustained downward path over the medium term. Similarly, in its review, Moody's argued that downward pressure on New Zealand's rating would occur if a large external or domestic shock resulted in a large and sustained increase in government indebtedness.

What events could expose these vulnerabilities?

While the major agencies have assigned a "stable outlook" to their assessment of New Zealand's current credit rating, there are a number of developments that could take place that would put that outlook at risk. Some of those developments are within New Zealand's direct control, but some are not.

For example, the external assessment could be weakened by one or more of the following:

- A sharp decline in global commodity prices, perhaps due to unexpected sustained weakness in the global economy;
- A biological event that caused a sharp curtailment of New Zealand's primary export revenue, such as an outbreak of foot and mouth disease;
- Geopolitical tensions or worse that threatened New Zealand's ability to trade with a key trading partner, such as China;
- Any event that prevented tourism-related revenues returning to their pre-Covid highs; or
- A large rise in global interest rates, raising the cost of funding New Zealand's considerable net external debt.

The realisation of one or more of the above negative shocks to the economy would likely be accompanied by a depreciation of the exchange rate, helping the economy to adjust over time. However, this might be insufficient to prevent a credit rating downgrade.

With regard to the fiscal assessment, downside risks could be driven by:

- A large natural disaster or similar event that unavoidably weakened the outlook for the public finances;
- A reassessment of the likely fiscal costs that might be associated with climate mitigation strategies or meeting New Zealand's climate commitments;

Table 4: Fiscal indicators, selected countries

	US	JPN	NZ	UK	FIN	CAN	SWE	AUS	IRE
General government balance % of GDP	-6.2	-5.8	-5.0	-4.5	-2.9	-1.7	-1.0	-0.4	1.6
General government gross debt % of GDP	102.3	226.7	48.1	101.9	78.4	89.1	31.0	48.6	42.5
General government net debt % of GDP	95.0	156.6	32.1	99.1	37.4	48.1	24.3	23.9	33.8
Gross debt % of Revenues	334.3	633.4	139.1	246.8	149.3	210.3	66.1	139.1	176.7

Source: S&P Global Ratings 2024 estimates

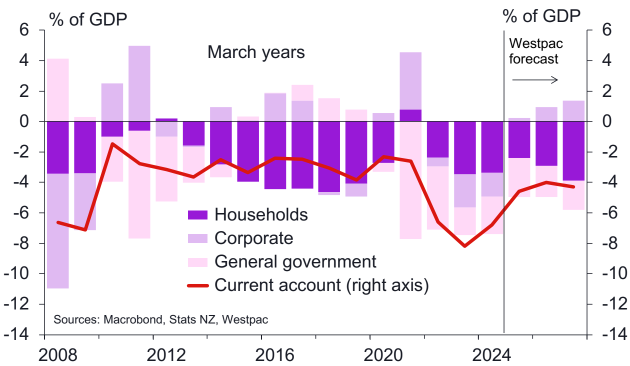
- A lessening of the Government's commitment to expenditure restraint, perhaps due to perceived political pressures, or an unwillingness to raise additional revenues to meet unbudgeted expenditures;
- Sharply higher global interest rates, putting upward pressure on debt servicing costs, especially if also accompanied by a period of weak trend growth in the economy; or
- Weaker than expected trend growth in the economy, so undermining growth in tax revenues.

What can NZ do to minimise these vulnerabilities?

If the Government wishes to reduce the likelihood of a future ratings downgrade (or increase the likelihood of a ratings upgrade from S&P or Fitch), the most obvious action that it could take would be to run a tighter fiscal policy stance. Returning to a small operating surplus sooner rather than later would also hasten the day at which net core Crown debt begins moving down to levels consistent with the Government's long-term target of 20-40% of GDP. And most importantly it would provide a larger buffer for the Government to absorb the fiscal impact of inevitable future negative shocks, without the risk of a credit rating downgrade.

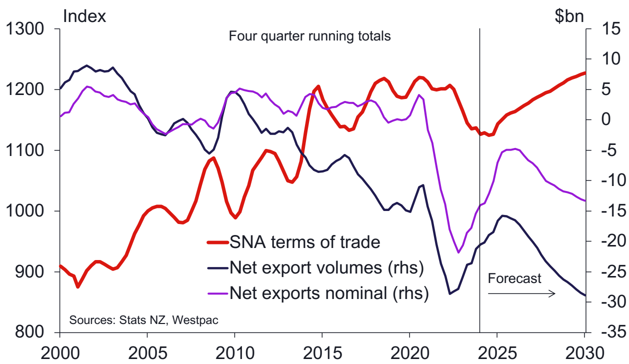
Addressing the Government's own savings-investment imbalance would also contribute to New Zealand running a smaller overall current account deficit. On average, a tighter fiscal policy would probably allow monetary policy to be less restrictive than would otherwise be the case, potentially lowering the exchange rate and supporting the transfer of activity to the export and import-competing sectors of the economy. Increasing revenue without undue increases in expenditure would also help balance the government's books a bit faster.

Net lending by major sector and current account



That said, achieving a significant smaller current account deficit and so reducing New Zealand's net external debt will also require a stronger savings performance within the private sector (especially household sector), or at least investment that boosts New Zealand's ability to earn foreign exchange. We note that a continuation of the trend decline in export volumes seen in recent years (as a share of GDP) would quickly widen the current account deficit if the recent favourable trend in New Zealand's terms of trade were to slow or even reverse.

Terms of trade and net exports



Ultimately, many of the internal and external imbalances that give rise to risks to our credit worthiness reflect the low level of New Zealand's productivity growth and associated weak trend GDP growth. Policies that boost productivity could help balance both sides of the ledger as stronger growth without excessive import growth or inflation will help boost real tax revenues and bring the current account into better balance. The current government's focus on streamlining regulation and improving competitiveness in the economy, if successful, would be useful in reducing risks to New Zealand's creditworthiness.

CONTACT

Westpac Economics Team | **westpac.co.nz/economics** | economics@westpac.co.nz

Kelly Eckhold, Chief Economist | +64 9 348 9382 | +64 21 786 758 | kelly.eckhold@westpac.co.nz

Satish Ranchhod, Senior Economist | +64 9 336 5668 | +64 21 710 852 | satish.ranchhod@westpac.co.nz

Darren Gibbs, Senior Economist | +64 9 367 3368 | +64 21 794 292 | darren.gibbs@westpac.co.nz

Michael Gordon, Senior Economist | +64 9 336 5670 | +64 21 749 506 | michael.gordon@westpac.co.nz

Paul Clark, Industry Economist | +64 9 336 5656 | +64 21 713 704 | paul.clark@westpac.co.nz

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