MOODY'S
INVESTORS SERVICE

CREDIT OPINION
29 June 2016

Update

Rate this Research

# Government of New Zealand - Aaa Stable

Semi-Annual Update

**Contacts**

Atsi Sheth 65-6398-3727
*MD-Sovereign Risk*
atsi.sheth@moodys.com

Steven A. Hess 212-553-4741
*Senior Vice President*
steven.hess@moodys.com

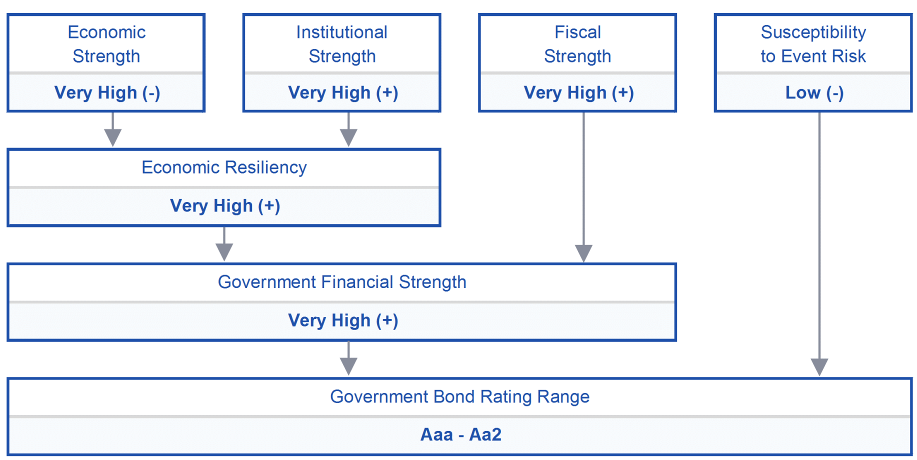
Alastair Wilson 44-20-7772-1372
*MD-Sovereign Risk*
alastair.wilson@moodys.com

## Summary Rating Rationale

» The **credit strengths** underpinning New Zealand's Aaa rating include: (1) its advanced economy with strong government finances and sound monetary policy, (2) government debt levels that are lower than the median for Aaa sovereigns, despite a rise in recent years, (3) a strong fiscal framework and political consensus on targeting balanced budgets and low debt, and (4) a strong banking system that is mainly foreign owned, lessening the government's contingent liability.

» The main **credit challenges** facing New Zealand include: (1) a resource-based economy that, on balance, remains exposed to volatile export earnings, and (2) one of the largest net external liability positions of advanced economies.

Exhibit 1
**New Zealand's Aaa stable sovereign rating is determined by four factors**




*Source: Moody's Investors Service*

This Credit Opinion provides a discussion of the credit rating(s) for the Government of New Zealand and should be read in conjunction with Moody's most recent Credit Analysis and rating information available on Moody's website.

## Key Indicators

| New Zealand | 2010 | 2011 | 2012 | 2013 | 2014 | 2015E | 2016F | 2017F |
|---|---|---|---|---|---|---|---|---|
| Real GDP (% change) | 2.0 | 1.9 | 2.8 | 1.7 | 3.0 | 3.4 | 2.6 | 2.5 |
| Inflation (CPI, % change, Dec/Dec) | 4.0 | 1.8 | 0.9 | 1.6 | 0.8 | 0.1 | 1.1 | 1.8 |
| Gen. Gov. Financial Balance/GDP (%)[1] | -6.5 | -6.1 | -2.5 | -1.5 | -0.1 | 0.3 | -0.1 | 0.1 |
| Gen. Gov. Primary Balance/GDP (%)[1] | -4.8 | -4.2 | -0.5 | 0.2 | 1.5 | 2.0 | 1.5 | 1.6 |
| Gen. Gov. Debt/GDP (%)[1] | 26.9 | 31.5 | 32.0 | 30.8 | 30.8 | 30.4 | 30.0 | 28.9 |
| Gen. Gov. Debt/Revenues (%)[1] | 79.0 | 93.0 | 94.4 | 90.8 | 90.1 | 86.9 | 85.4 | 83.0 |
| Gen. Gov. Interest Payment/Revenues (%)[1] | 5.0 | 5.7 | 5.9 | 5.2 | 4.9 | 4.9 | 4.6 | 4.3 |
| Current Account Balance/GDP (%) | -2.3 | -2.8 | -3.9 | -3.2 | -3.1 | -3.1 | -3.0 | -2.7 |

[1] Central Government

## Summary Rating Rationale (continued)

New Zealand's Aaa rating is based on the country's high economic strength, very high institutional and government financial strength, and low susceptibility to event risk. New Zealand's flexible and market-oriented economic policies have supported economic performance that has become stronger and less subject to external shocks. Although per capita income is at the low end of the Aaa range, it is nonetheless high by global standards. The relatively small scale of the economy is also a factor considered in assessing economic strength. Institutional strength is very high, as measured by governance, rule of law, and transparency. In addition, Moody's expects that the government, regardless of the party in power, will maintain a policy of low debt and fiscal discipline.

While the fiscal balance deteriorated as a result of a recession and the earthquakes that struck the country in 2010 and 2011, the government that first came into office in 2008 and is now in its third term has indicated its intention to return debt to a prudent level. Gross “total crown” debt has peaked at well below 40% of GDP before beginning to decline, although the IMF reports a lower value using market value of the debt. We believe that the debt trajectory and the policy to deal with shocks remain compatible with a Aaa rating.

The external liability position will remain high. However, there are several factors that make the large external liability position less risky than it might appear, including the high proportion of liabilities denominated in NZ dollars and of foreign currency liabilities that are hedged, and the related-party nature of much of bank liabilities. The composition of the external liability position supports an assessment of low susceptibility to event risk.

## Rating Outlook

The stable outlook is anchored by the government's low debt relative to most other Aaa-rated countries and our expectation that New Zealand will continue with fiscal and monetary discipline and market-oriented policies

## Factors that Could Lead to a Downgrade

An upward government debt trajectory in the next few years could cause the rating to move down. A major problem with access to external finance that affected New Zealand banks and the Australian banks that operate in the country would also pressure the rating.

## Recent Developments

During the first quarter of 2016, the economy continued to grow at a fairly strong pace. Expenditure on real GDP was up 0.5% from the previous quarter and 3.1% for the year ended in March. (Figures in the Key Indicators table are for calendar years.) This followed a 3.2% rise in the year ended March 2015. On a production basis, which is the series most generally used in New Zealand, the quarterly rise was 0.7%, led by a very strong 4.9% increase in construction, mainly of infrastructure and housing. Net immigration, which is near record levels, has also contributed to GDP growth, as has tourism, which has been strong in the past couple of years. We expect that service exports and construction will continue to grow at a relatively strong pace, supporting growth of above 2% annually over the next two years.

After four reductions in the Official Cash Rate during the course of 2015, the Reserve Bank lowered the rate again in March to 2.25%, its lowest level in recent history. The reduction in the interest rate target has occurred despite the relatively solid economic growth, because inflation as measured by the CPI remains below the RBNZ's target range of 1-3%. After reaching a low point of a 0.1% year-over-year increase in the fourth quarter of last year, the annual change in the CPI rose to 0.4% during the first quarter of 2016, still well below the target range. The RBNZ said in its June Monetary Policy Statement that the rate could possible go down further. The policy dilemma is that while consumer price inflation remains low, lower interest rates are a contributing factor in the rise in housing prices. Further macroprudential measures may be considered to dampen house price rises while maintaining an accommodative monetary policy.

Dairy prices, after falling more than 50% in 2014 and further in early 2015, later in 2015 and in early 2016 but are once again on a downward trend. Nonetheless, while they remain below historical averages, they are well above their low points reached in 2015. Fonterra, the cooperative milk marketing organization, expects relative stability in the coming nine months. Lower average prices have placed strain on farm balance sheets and NZ banks are likely to see problem loans rising in the sector. However, the proportion of total bank assets in the dairy sector remains fairly low, meaning that this problem remains manageable for the banking system.

The Budget Economic and Fiscal Update was released with the budget in May, showing a small estimated operating surplus of 0.3% of GDP for the fiscal year ending June 30, 2016 following a surplus of 0.2% during the previous fiscal year. The balance for the latest fiscal year had previously been estimated as a deficit. The government's forecasts show rising surpluses in the coming four fiscal years, reaching 2.2% of GDP in 2019-20. As the government is committed to not raising taxes, and revenues as a percentage of GDP will remain fairly steady, the rising surplus is based primarily on expenditure controls. If these forecasts are realized, the ratio of gross debt to GDP would decline to 27.9%by 2020 from the estimated peak of 36.2% at in 2017. The government has indicated a goal of a net debt figure (now about 25% of GDP) of around 20% of GDP or less by 2020, and the latest forecasts indicate this figure at 20.8% in that year.

## Rating Methodology and Scorecard Factors

### Rating Factors Grid - New Zealand

| Rating Factors | Sub-Factor Weighting | Indicator | Factor Score |
|---|---|---|---|
| **Factor 1: Economic Strength** | | | VH- |
| **Growth Dynamics** | **50%** | | |
| Average Real GDP Growth (2011-20F) | | 2.6 | |
| Volatility in Real GDP Growth (Standard Deviation, 2006-15) | | 1.4 | |
| WEF Global Competitiveness Index (2015) | | 5.3 | |
| **Scale of the Economy** | **25%** | | |
| Nominal GDP (US$ billion, 2015) | | 172 | |
| **National Income** | **25%** | | |
| GDP per Capita (PPP, US$, 2015) | | 36,172 | |
| **Factor 2: Institutional Strength** | | | VH+ |
| **Institutional Framework and Effectiveness** | **75%** | | |
| Worldwide Government Effectiveness Index (2014) | | 1.9 | |
| Worldwide Rule of Law Index (2014) | | 2.0 | |
| Worldwide Control of Corruption Index (2014) | | 2.3 | |
| **Policy Credibility and Effectiveness** | **25%** | | |
| Inflation Level (%, 2011-20F) | | 1.6 | |
| Inflation Volatility (Standard Deviation, 2006-15) | | 1.3 | |
| **Economic Resiliency (F1xF2)** | | | VH+ |
| **Factor 3: Fiscal Strength** | | | VH+ |
| **Debt Burden** | **50%** | | |
| General Government Debt/GDP (2015) | | 30.4 | |
| General Government Debt/Revenues (2015) | | 86.9 | |
| **Debt Affordability** | **50%** | | |
| General Government Interest Payments/Revenue (2015) | | 4.9 | |
| General Government Interest Payments/GDP (2015) | | 1.7 | |
| **Government Financial Strength (F1xF2xF3)** | | | VH+ |
| **Factor 4: Susceptibility to Event Risk** | **Max. Function** | | L- |
| **Political Risk** | | | |
| Worldwide Voice & Accountability Index (2014) | | 1.6 | |
| **Government Liquidity Risk** | | | |
| Gross Borrowing Requirements/GDP | | 1.5 | |
| Non-Resident Share of General Government Debt (%) | | 74 | |
| Market-Implied Ratings | | -- | |
| **Banking Sector Risk** | | | |
| Average Baseline Credit Assessment (BCA) | | a3 | |
| Total Domestic Bank Assets/GDP | | 200 | |
| Banking System Loan-to-Deposit Ratio | | 148 | |
| **External Vulnerability Risk** | | | |
| (Current Account Balance + FDI Inflows)/GDP | | -3.6 | |
| External Vulnerability Indicator (EVI) | | -- | |
| Net International Investment Position/GDP | | -61.4 | |
| **Government Bond Rating Range (F1xF2xF3xF4)** | | | **Aaa - Aa2** |
| **Assigned Foreign Currency Government Bond Rating** | | **Aaa** | |

**Note:** While the information used to determine the grid mapping is mainly historical, our ratings incorporate expectations around future metrics and risk developments that may differ from the ones implied by the rating range. Thus, the rating process is deliberative and not mechanical, meaning that it depends on peer comparisons and should leave room for exceptional risk factors to be taken into account that may result in an assigned rating outside the indicative rating range.
For more information please see our Sovereign Bond Rating Methodology

**Footnotes: (1) Rating Range:** Factors 1, Economic Strength, and Factor 2, Institutional Strength, combine with equal weight into a construct we designate as Economic Resiliency or ER. An aggregation function then combines ER and Factor 3, Fiscal Strength (FS), following a non-linear pattern where FS has higher weight for countries with moderate ER and lower weight for countries with high or low ER. As a final step, Factor 4, a country's Susceptibility to Event Risk, is a constraint which can only lower the preliminary Government Financial Strength rating range as given by combining the first three factors. **(2) 15 Ranking Categories:** VH+, VH, VH-, H+, H, H-, M+, M, M-, L+, L, L-, VL+, VL, VL- **(3) Indicator Value:** If not explicitly stated otherwise, the indicator value corresponds to the latest data available.

## Moody's Related Research

- **Sector In-depth**: High Public, Private Sector Leverage Poses Credit Risks Across the Region, 26 April 2016
- **Issuer Comment:** The 2016-17 Budget: Strong Economic and Fiscal Outlooks Are Credit Positive, 27 May 2016
- **Credit Analysis**: Government of New Zealand, 24 March 2016
- **Country Statistics**: New Zealand, Government of, 1 June 2016
- **Banking System Outlook**: Outlook Remains Stable But Pressure on Asset Quality Is Rising, 5 April 2016
- **Rating Methodology**: Sovereign Bond Ratings, 18 December 2015

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

## Authors

**Steven Hess**
*Senior Vice President*
steven.hess@moodys.com

**Matt Kulakovskyi**
*Associate Analyst*
matt.kulakovskyi@moodys.com

REPORT NUMBER 1033004

MOODY'S
INVESTORS SERVICE