ECONOMIC BULLETIN

Review of Half-Year Economic and Fiscal Update and Budget Policy Statement.

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

More borrowing, yet again.

- **The HYEFU revealed a significantly weaker fiscal outlook than portrayed in Budget 2024, and much weaker than market expectations.**
- **The deterioration reflects higher spending, and weaker revenue, the latter due to a weaker outlook for nominal GDP and a lower effective tax rate.**
- **The Government has confirmed a tight operating allowance of $2.4bn to fund new core spending in Budget 2025 – unchanged from the Budget 2024 forecast.**
- **The Treasury now expects an OBEGAL deficit of $17.3bn this year (up from $13.4bn previously), with this measure expected to remain in deficit in 2028/29.**
- **OBEGALx – a new measure excluding ACC revenue and expenses – is forecast to return to a small surplus in 2028/29 – 2 years later than implied by the Budget 2024 forecast.**
- **NZDM has lifted forecast NZGB issuance by a cumulative $20bn over the four years to 2027/28, with this year's programme raised by $2bn to $40bn.**
- **NZDM will conduct two further tap syndications this fiscal year – the first in the March quarter.**
- **Net core Crown debt is expected to peak at 46.5% of GDP in 2026/27 and decline to 45.2% of GDP by 2028/29 – still well above the long-term target of 20-40% of GDP.**
- **The Treasury's revised estimate of the fiscal impulse suggests a far bigger stimulus to growth in the current fiscal year. Policy is assumed to tighten by a similar degree as in Budget 2024 over subsequent years.**
- **The 10yr NZGB yield spread to swap has widened around 5bps on the back of today's release and spread to 10yr AGCB has widened about 5bps. There has been little reaction in the FX markets.**

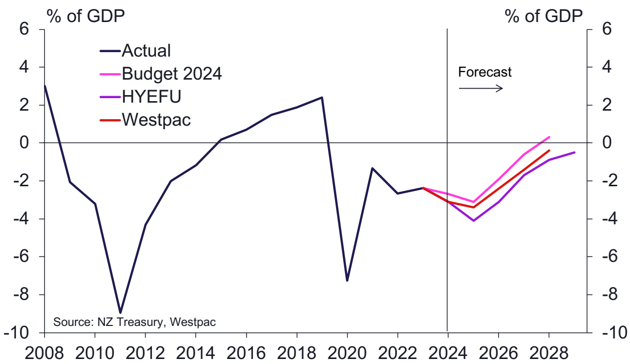
Today the Government released the Half-Year Economic and Fiscal Update (HYEFU) and Budget Policy Statement (BPS). The HYEFU updated the economic and fiscal forecasts set out in Budget 2024 – including the addition of a first forecast for the 2028/29 fiscal year – whereas the BPS set out the Government's priorities for Budget 2025 and its long-term fiscal objectives. In summary, the HYEFU portrayed a fiscal outlook that was far weaker than suggested in Budget 2024, necessitating a further substantial lift to the Government's borrowing programme.

Operating deficit to slowly improve from a worse starting point.

Table 1 sets out some of the key fiscal metrics updated in the HYEFU, comparing these to the forecasts made in Budget 2024 and to the forecasts in our October Economic Overview.

An operating (OBEGAL, ex minority interests) deficit of $17.3bn (4.1% of GDP) is now forecast for the current '24/25 fiscal year, compared to the $13.3bn deficit forecast at Budget time. The Government has introduced a new measure (OBEGALx) that excludes spending and revenue associated with the ACC scheme. An OBEGALx deficit of $12.9bn (3.0% of GDP) is forecast for the current fiscal year, compared with the $9.6bn (2.2%) deficit that was implied for this measure by the Budget 2024 forecast. Around two-thirds of the deterioration in the OBEGALx deficit reflects a downward revision to forecast tax revenue. That's due to weaker than expected nominal GDP growth and a lower-than-expected effective tax rate, with the remainder due to an upward revision to core Crown spending.

Operating balance (OBEGAL), % of GDP



Thereafter, the Government is continuing to plan on very skinny allowances for new operational spending of just $2.4bn per year in subsequent years. After pre-commitments (including in the health sector) and assumed other non-discretionary spending (given current policy settings), the Government only has on average $0.7bn per year available to fund all new initiatives and other cost pressures at Budget 2025. Given that a share of the Budget 2025 allowance will be needed to fund cost pressures, the Treasury notes that "...the Government will need to consider expenditure savings, expenditure reprioritisation and revenue-raising policy changes to stay within the signalled Budget allowance". Needless to say, the risks around this profile are heavily skewed towards higher spending.

Given the tight assumption for core government spending – which is forecast to decline from 33.9% of GDP in 2024/25 to 31.5% of GDP by 2028/29 – the OBEGAL deficit is forecast to gradually decline to $2.4bn by 2028/29 (0.5% of GDP). OBEGALx is forecast to improve so that a small surplus of $1.9bn (0.4% of GDP) is forecast for 2028/29. Compared with Budget 2024, the HYEFU foresees an additional cumulative increase in the OBEGAL deficit of about $20bn over the four years to 2027/28, whereas the additional cumulative OBEGALx deficit is about $18bn. Core Crown expenses are around $6bn higher over this period, while core Crown revenue is about $19bn lower than forecast previously. Again, the latter reflects a weaker outlook for nominal GDP and a lower assumed effective tax rate than assumed in Budget 2024. The economic outlook underpinning this new forecast is discussed later in this note.

Table 1: Key fiscal metrics

	23/24	24/25f	25/26f	26/27f	27/28f	28/29f
Core Crown spending $bn						
HYEFU	139	145	150	153	158	163
Budget 2024	139	144	148	151	156	n/a
Core Crown tax revenue $bn						
HYEFU	121	121	128	137	144	151
Budget 2024	121	123	131	140	148	n/a
OBEGAL $bn*						
HYEFU	-12.9	-17.3	-14.1	-8.2	-4.3	-2.4
Budget 2024	-11.1	-13.4	-8.5	-3.1	1.5	n/a
Westpac	-12.9	-14.5	-11.1	-6.5	-1.8	n/a
OBEGAL % of GDP*						
HYEFU	-3.1	-4.1	-3.1	-1.7	-0.9	-0.5
Budget 2024	-2.7	-3.1	-1.9	-0.6	0.3	n/a
Westpac	-3.1	-3.4	-2.5	-1.4	-0.4	n/a
Net core Crown debt (% of GDP)						
HYEFU	42.4	45.1	45.1	46.5	46.1	45.2
Budget 2024	43.1	43.5	43.0	43.3	41.8	n/a
Westpac	44.6	44.6	44.6	45.2	44.9	n/a
OBEGALx $bn**						
HYEFU	-8.8	-12.9	-10.5	-4.4	-0.3	1.9
Budget 2024	-8.8	-9.6	-5.1	-0.2	4.7	n/a

* ex minority interests ** ex ACC spending and revenue

Source: NZ Treasury, Westpac

Table 2: NZ Government Bond Programme ($bn)

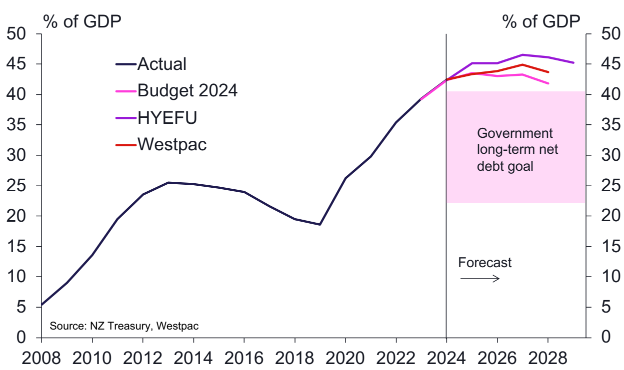
	23/24	24/25	25/26f	26/27f	27/28f	28/29f
HYEFU	39.3	40.0	40.0	38.0	28.0	22.0
Budget 2024	38.0	38.0	36.0	32.0	20.0	n/a
difference	1.3	2.0	4.0	6.0	8.0	

Source: NZ Treasury

2, 4, 6, 8: The bond market does not appreciate.

The substantial deterioration in the underlying fiscal situation has necessitated a further sharp increase in the Government's forecast borrowing programme (see Table 2). The funding requirement for the current fiscal year (2024/25) has been raised by $2.0bn to $40bn, despite the partial prefunding of this year's initial forecast requirement that was done back in June. The cumulative increase in the programme across the four years to 2027/28 has been revised up by $20bn to $146bn – far above the market expectations of a $4bn to $6bn increase. Given upcoming maturities and repurchases associated with the $5bn per year winding down of the RBNZ's Large Scale Asset Purchase programme (LSAP), the revised bond programme implies a cumulative $59.5bn of net bond issuance into the market over the five years to 2028/29.

Net core Crown debt, % of GDP



According to NZ Debt Management (NZDM), short-term borrowings (Treasury Bills and Euro-Commercial Paper) at the end of 2024/25 are forecast to be $20bn. These borrowings are expected to remain at this level until 2025/26 – higher than forecast in Budget 2024 – before declining to their previously forecast long-term level of $13bn by 2027/28 (NZDM notes that a flexible approach will be taken to borrowings intra-year). Subject to market conditions NZDM expects two further nominal tap bond syndications in 2024/25. The first will be a tap syndication of the existing 15 May 2035 nominal bond, in the March 2025 quarter, while the second will be announced in a later update. Gross issuance of inflation-indexed bonds is still expected to be less than $1bn.

Given the additional borrowing requirements, net core Crown debt is forecast to remain above the Government's unchanged long-term goal of 20-40% of GDP though out the forecast period. From 42.4% of GDP in 2023/24, the Government's favoured debt measure is expected to peak at 46.5% in 2026/27 and only decline to 45.2% of GDP in 2028/29.

International credit rating agencies have remained relatively sanguine about New Zealand in recent years, noting still-low debt levels relative to peer economies, New Zealand's strong governance institutions, and forecasts pointing to an improvement in the fiscal position over time. Given that the Government has reaffirmed its commitment to maintaining tight control of operational spending, we expect that the rating agencies will likely be prepared to accept the additional delay in returning the operating balance to surplus. However, the risks to the credit rating outlook are growing given the persistently elevated net debt profile at a time when the country is also running a persistently elevated current account deficit. The Government's approach of absorbing a downward adjustment to revenue expectations in the deficit and debt profile, as opposed to reducing spending, might also add to risks. Any future lessening of that commitment would increase the likelihood of a credit rating downgrade.

Fiscal impulse implies policy currently adding to demand.

In the November Monetary Policy Statement, the RBNZ reaffirmed that the assumed further easing of policy settings in 2025 and beyond is conditional upon, amongst other things, "the extent to which government consumption and investment evolve consistent with the fiscal forecasts, including final operating allowances, in Budget 2024".

A rough proxy of the overall impact of fiscal policy – including the impact of both spending and revenue generation – on aggregate demand can be obtained from the Treasury's estimate of the Total Fiscal Impulse (TFI), which is set out in Table 3. The TFI is a cash-based measure of fiscal outlays and revenues, that adjusts for some items that do not directly affect aggregate demand (such as defence spending on equipment). It measures the first-round demand impact of a change in the fiscal stance (rather whether the fiscal stance is expansionary or contractionary in an outright sense), but does not capture supply-side impacts on the economy. And how the economy reacts to a given fiscal impulse – the fiscal

Table 3: Fiscal impulse (% of nominal potential GDP)

	22/23	23/24	24/25f	25/26f	26/27f	27/28f	28/29f
HYEFU	-1.27	1.26	2.13	-2.60	-0.27	-1.80	-0.62
Budget 2024	-1.27	1.53	0.33	-1.91	-0.92	-2.07	
difference	0.00	-0.27	1.80	-0.69	0.65	0.27	n/a

Source: NZ Treasury, Westpac

multiplier – will depend on factors such as the state of the economic cycle.

With that said, the updated TFI estimates imply that in the fiscal policy is far more stimulatory in the current year than was implied by the Budget 2024 forecast, with the estimate revised up by 1.8ppts of nominal potential GDP. This reflects the worse starting point for the fiscal balance. From that worse starting point, on average the fiscal impulse is negative and similar to the Budget 2024 forecast, reflecting the fiscal consolidation – mainly through assumed tight spending control – that is assumed in these forecasts. It remains to be seen what the RBNZ will take from the combination of easier fiscal policy now versus promises of greater restraint in the future.

Risks to HYEFU forecasts for inflation and interest rates to the upside.

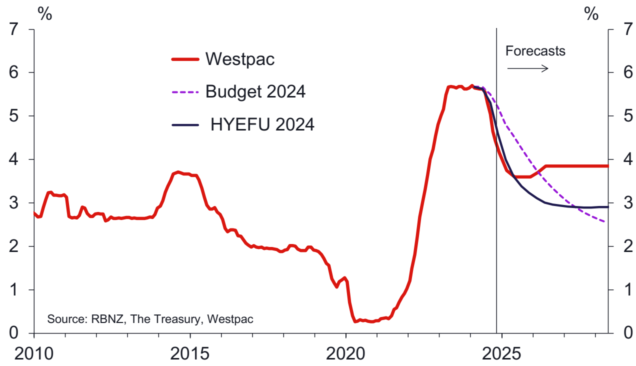
Turning to more of the detail, the key economic assumptions underpinning the fiscal outlook depicted in the HYEFU are set out in Table 4, comparing these with the assumptions made in Budget 2024 and Westpac's own forecasts.

The key issue with the Treasury's updated forecasts is the assumption of a very benign inflation outlook that allows for a significant easing in borrowing costs. The HYEFU forecasts assume that the 90-day bank bill rate will fall to 2.9% over the next few years. That would be consistent with an OCR of 2.75%. In contrast, the RBNZ's own forecasts from November show the OCR bottoming out around 3.1% in 2027, and we think it'll only reach a low of 3.5% next year.

But despite the assumed easing in borrowing costs, the Treasury has assumed very restrained household spending growth (which implies modest imports and a narrowing current account deficit), moderate house price growth and well contained domestic inflation. There are likely upside risks to these views which lean in the direction of higher-than-expected future borrowing costs and a higher current account deficit.

We also note the Treasury is not factoring in a significant fall in the NZD despite assuming a pronounced fall in interest rates. This helps to keep imported inflation contained in their forecasts which may be subject to upside risks if the exchange rate depreciates.

90-day interest rate



There are also questions around the assumed composition of growth. The Treasury's forecasts for growth are underpinned by an improving outlook for net exports, while soft consumer spending means that import growth remains low. However, we think it's likely that export growth will be more moderate, while consumption spending could be stronger. That could mean that New Zealand's current account position does not improve like the Treasury expects.

Nominal quarterly GDP

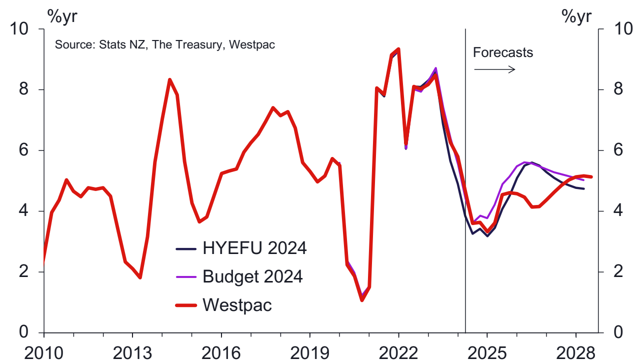


Table 4: Key economic assumptions (June years)

	23/24	24/25f	25/26f	26/27f	27/28f	28/29f
Real GDP growth (ann. avg.)						
HYEFU	-0.2	0.5	3.3	2.9	2.6	2.4
Budget 2024	-0.2	1.7	3.2	2.9	2.7	n/a
Westpac	-0.2	0.1	2.4	2.7	2.6	2.7
Nominal GDP growth (ann. avg.)						
HYEFU	4.7	3.4	5.4	5.0	4.7	4.5
Budget 2024	4.4	4.2	5.6	5.3	5.0	n/a
Westpac	4.7	3.7	4.6	5.2	5.5	5.1
Unemployment (June qtr)						
HYEFU	4.6	5.4	4.8	4.5	4.3	4.3
Budget 2024	4.9	5.2	4.8	4.5	4.4	n/a
Westpac	4.6	5.4	5.1	4.3	4.0	4.0
CPI inflation (ann %)						
HYEFU	3.3	1.8	2.1	2.0	2.0	2.0
Budget 2024	3.4	2.2	2.0	2.0	2.0	n/a
Westpac	3.3	1.8	2	2.3	2.3	2.4
90-day rate (June qtr)						
HYEFU	5.6	3.6	3.0	2.9	2.9	2.9
Budget 2024	5.7	4.5	3.5	2.9	2.5	n/a
Westpac	5.6	3.6	3.9	3.9	3.9	3.9
10-yr bond rate (June qtr)						
HYEFU	4.7	4.4	4.2	4.1	4.0	4.0
Budget 2024	4.6	4.4	4.2	4.1	4.0	n/a
Westpac	4.7	4.8	4.9	4.9	4.9	4.9

Source: NZ Treasury, Westpac

Budget Policy Statement.

Key priorities for Budget 2025.

According to the BPS, the following will be the key priorities that the Government will seek to address as it puts together Budget 2025 (likely to be released sometime in May).

- Lifting economic growth through measures to address New Zealand's long-term productivity challenges.
- Implementing a social investment approach to drive better results from the Government's investment in social services and thereby improve life outcomes for people with high needs.
- Keeping tight control of government spending while funding a limited number of high priority Government policy commitments and cost pressures that cannot be met from reprioritisation.
- Developing a sustainable pipeline of long-term infrastructure investments.

Long-term fiscal objectives.

The Government's long term objectives are unchanged and are:

- Reduce core Crown expenses towards 30 percent of GDP over time.
- Return OBEGAL to surplus by 2027/28.
- Put net core Crown debt as a percentage of GDP on a downward trajectory towards 40 percent and in the longer term keep it below that percentage.

Spending constraint remains a prime focus.

Spending constraint is the key tool the Government is deploying to contain the deterioration associated with lower government revenue over the forecast period. The BPS indicates a high bar will be applied to new initiatives in Budget 2025 and that additional savings will need to be identified. Hence operating allowances are unchanged from Budget 2024 at $2.4 billion per annum.

The Government notes that it faced a choice between making further cuts to an already challenging operating allowance target or allow the short-term path for fiscal policy to deviate from that required to converge to the government's long term fiscal targets expeditiously. The latter path was chosen implying a longer return to surplus and a higher net debt profile.

Reframing expectations – changing capital spending budgeting.

The Government is changing the approach it takes for budgeting for capital spending. In recent years, the Government has set a multiyear capital allowance (MYCA) to cover spending over the next four budgets in the forecast period. The Government plans to move away from this approach from Budget 2025 and will instead focus on implementing annual capital spending allocations. The practical implications of this change in HYEFU is limited as the Government has included an extra $7bn in the MYCA to cover spending until 2029 as a transitional measure. However, from Budget 2025 the practice will change which might make it harder to discern the implications of future capital spending increases for the government's borrowing needs (and the impact of government capital spending on the real economy).

Reframing expectations II – a new measure of the fiscal balance.

The Government is also implementing a new measure of the fiscal balance that it is directing its fiscal strategy towards. Instead of OBEGAL the Government plans to use OBEGAL ex the Accident Compensation Corporation (ACC) – OBEGALx. As ACC's fiscal position has been deteriorating in recent years (and is now under independent review), this has the impact of improving the measured fiscal balance. To the extent that the cost increases in ACC reflect past increases in inflation that are increasingly being felt in the health sector and ACC costs, this has the effect of insulating the Government's measured fiscal position from the impact of past inflation. However, given that ACC is funded from levies, ACC's year-to-year position has no impact on the Government's bond programme.

Notwithstanding the change in fiscal target measure, the fiscal outlook has deteriorated to the extent that fiscal balance will only likely be achieved at least a year later than previously forecast (2028/29 for OBEGALx and sometime afterwards for OBEGAL).

The Government's growth strategy.

The Government emphasises it is taking great effort to arrest the deterioration in the fiscal situation by taking measures to improve productivity growth – and in so doing reaping the benefits of the associated gains in growth and government revenue in future budgets. Five key areas of focus are:

- Developing the workforce through improved education.
- Simplifying regulation and improving competition.
- Creating regulatory certainty to encourage investment in gene technology.
- Developing new markets through new trade agreements and arrangements.
- Developing infrastructure via private-public partnerships and increasing the use of "value capture tools" to fund infrastructure investment.

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

Past performance is not a reliable indicator of future performance. The forecasts given in this document are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

DISCLAIMER

UK: The contents of this communication, which have been prepared by and are the sole responsibility of Westpac Banking Corporation London and Westpac Europe Limited. Westpac (a) has its principal place of business in the United Kingdom at Camomile Court, 23 Camomile Street, London EC3A 7LL, and is registered at Cardiff in the UK (as Branch No. BR00106), and (b) authorised and regulated by the Australian Prudential Regulation Authority in Australia. Westpac is authorised in the United Kingdom by the Prudential Regulation Authority. Westpac is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

This communication is being made only to and is directed at (a) persons who have professional experience in matters relating to investments who fall within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order") or (b) high net worth entities, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(2)(a) to (d) of the Order (all such persons together being referred to as "relevant persons"). Any person who is not a relevant person should not act or rely on this communication or any of its contents. The investments to which this communication relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this communication or any of its contents. In the same way, the information contained in this communication is intended for "eligible counterparties" and "professional clients" as defined by the rules of the Financial Conduct Authority and is not intended for "retail clients". With this in mind, Westpac expressly prohibits you from passing on the information in this communication to any third party. In particular this communication and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction. This communication is made in compliance with the Market Abuse Regulation (Regulation(EU) 596/2014).

Investment recommendations disclosure.

The material may contain investment recommendations, including information recommending an investment strategy. Reasonable steps have been taken to ensure that the material is presented in a clear, accurate and objective manner. Investment Recommendations for Financial Instruments covered by MAR are made in compliance with Article 20 MAR. Westpac does not apply MAR Investment Recommendation requirements to Spot Foreign Exchange which is out of scope for MAR.

Unless otherwise indicated, there are no planned updates to this Investment Recommendation at the time of publication. Westpac has no obligation to update, modify or amend this Investment Recommendation or to notify the recipients of this Investment Recommendation should any information, including opinion, forecast or estimate set out in this Investment Recommendation change or subsequently become inaccurate.

Westpac will from time to time dispose of and acquire financial instruments of companies covered in this Investment Recommendation as principal and act as a market maker or liquidity provider in such financial instruments.

Westpac does not have any proprietary positions in equity shares of issuers that are the subject of an investment recommendation.

Westpac may have provided investment banking services to the issuer in the course of the past 12 months.

Westpac does not permit any issuer to see or comment on any investment recommendation prior to its completion and distribution.

Individuals who produce investment recommendations are not permitted to undertake any transactions in any financial instruments or derivatives in relation to the issuers covered by the investment recommendations they produce.

Westpac has implemented policies and procedures, which are designed to ensure conflicts of interests are managed consistently and appropriately, and to treat clients fairly.

The following arrangements have been adopted for the avoidance and prevention of conflicts in interests associated with the provision of investment recommendations.

(i) Chinese Wall/Cell arrangements;

(ii) physical separation of various Business/Support Units;

(iii) and well defined wall/cell crossing procedures;

(iv) a "need to know" policy;

(v) documented and well defined procedures for dealing with conflicts of interest;

(vi) steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.

U.S: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission ("CFTC") as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC ('WCM'), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 ('the Exchange Act') and member of the Financial Industry Regulatory Authority ('FINRA'). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. All disclaimers set out with respect to Westpac apply equally to WCM. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.

Westpac Banking Corporation.