ECONOMIC BULLETIN

Preview of New Zealand Budget 2025, 22 May 2:00pm.

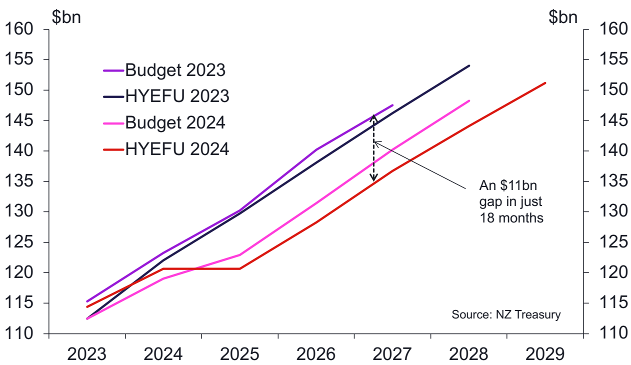
8 May 2025 | **Darren Gibbs**, Senior Economist | +64 9 367 3368 | +64 21 794 292 | darren.gibbs@westpac.co.nz

Steady as she goes

- **The Minister of Finance has stated that Budget 2025 will reaffirm the medium-term fiscal strategy outlined in the HYEFU.**
- **A weaker outlook for trading partner growth will weigh on forecast tax revenues, but the impact should be largely offset by the Minister's decision to reduce this year's operating allowance, together with other savings initiatives.**
- **As a result, consistent with the Minister's comments, we expect the Government will continue to forecast a return to surplus in 2028/29 (based on its preferred OBEGALx measure).**
- **While deficits from 2025/26 onwards will likely slightly exceed the HYEFU forecast, this year's deficit is on track to print slightly below expectations and NZDM are on track to overfund relative to the HYEFU forecast.**
- **As a result, on net, overall revisions to the outlook for the operating balance will likely not be a driver of large changes to the outlook for the government borrowing programme.**
- **There is more uncertainty about the Government's plans for capex: in particular, how much of foreshadowed new spending on defence will be met within existing unallocated capital allowances, as opposed to additional borrowing.**
- **On balance, we think that the cumulative four-year financing requirement will likely be around $4bn larger than forecast in the HYEFU, with the programme for 2025/26 likely unchanged given the overfunding in 2024/25.**
- **The sustained spending restraint that is likely to be depicted in the Budget will require significant discipline and ongoing tough choices. That said, it is possible that the economy – and tax revenues – could surprise to the upside, allowing an easier return to surplus. We will publish updated forecasts in our updated *Economic Overview* next week.**

Budget 2025 to convey stability.

Core Crown tax revenue, recent forecasts



The Minister of Finance, Nicola Willis, will present her second Budget at 2pm on 22 May. In recent times fiscal updates have not made pleasant reading, due mainly to successive large downward revisions to forecast tax revenue. These revisions have reflected downward revisions to expected growth in the nominal economy (i.e., the tax base) and the amount of tax revenue that might be expected for a given the size of the economy (i.e., the effective tax rate). They have dwarfed a downward revision to forecast core Crown spending, at least relative to the situation the new Government inherited in late 2023, leading to sizable upward revision to the Government's borrowing programme compared with earlier forecasts. We expect Budget 2025 to depart from that highly unfavourable trend, with the expected upward revision to the borrowing programme likely to be small compared with recent experience.

A favourable starting point.

One source of good news since the Half-Year Economic and Fiscal Forecast (HYEFU) is that actual fiscal outturns have been tracking favourably compared with the HYEFU forecast. Data released today for the nine months to March revealed that the accruals-based OBEGALx deficit was $6.6bn – some $0.5bn less than the Treasury had expected given its full-year HYEFU forecast.

Core Crown spending is running $0.6bn less than expected, although at least some of that variance may reverse by year-end. Core Crown tax revenue is running $0.2bn above forecast, reflecting stronger-than-expected tax flows from GST and tax paid by small businesses. However, tax received from wages and salaries is running $0.5bn before the HYEFU forecast, reflecting weaker-than-expected conditions in the labour market (including weaker wage growth).

The residual cash deficit – the aggregate most closely linked to the Government's funding requirement – was $1.7bn below forecast in the 9-months to March, reflecting lower than expected spending on capex and advances. It is possible that some of this may be due to timing and could reverse before the end of the fiscal year. Overall, with NZDM on track to issue an additional $2.5bn this year compared to the HYEFU forecast (assuming weekly tenders of $450m in June), a downward revision to the fiscal outlook from here will probably be coming off a slightly more favourable starting point than expected in the HYEFU.

Global growth downgrade to undermine future revenue.

Given all the moving parts, forecasting the fiscal aggregates is a difficult task at the best of times, with small differences between large spending and revenue numbers quickly accumulating to large changes in the borrowing programme. Indeed, as the Treasury noted in the HYEFU based on past forecast errors, even a 90% confidence interval for 2028/29 suggests that tax revenue could be close to $20bn higher or lower than the baseline forecast. Forecasting what the Treasury will forecast is also fraught with difficulty.

Fortunately, a pre-Budget speech given last week by the Minister of Finance, Nicola Willis, provided some useful guidance about what we should expect to see in the Treasury's forecasts. Most importantly for the bond market, the Minister indicated that the Government's fiscal strategy remains unchanged from that communicated in the HYEFU. A key component of the strategy is to achieve an operating surplus – measured on an OBEGALx basis – in 2027/28, if possible. The HYEFU pointed to surplus being achieved a year later in 2028/29 – an outcome, that the Minister would appear to find acceptable.

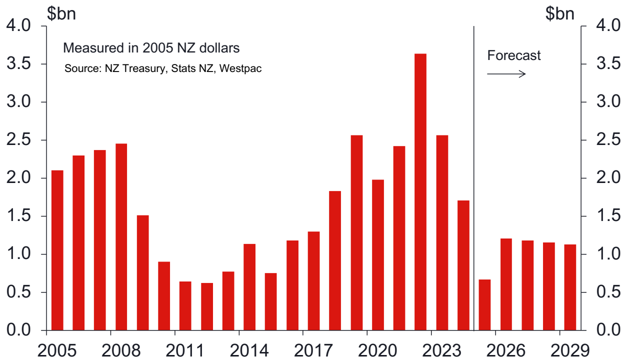
Prior to the Minister's speech, there had been some possibility the return to surplus would be delayed further in Budget 2025. This is because of downward revisions to the economic outlook associated with the global turmoil created by President Trump's tariff policy. The Treasury had previously indicated that US tariff policy could subtract 0.5pps from trading partner growth, while tariff-related uncertainty could also weigh on domestic activity. Subsequently, the Minister has indicated that the Treasury forecasts in Budget 2025 will project weaker real economic growth in New Zealand in 2025 and 2026 than expected at the time of the HYEFU, thus reducing forecast tax revenue. The size of those downward revisions is unclear, although the Minister noted that she still expects GDP growth to be sufficient to begin to lower the unemployment rate from later this year. This suggests that revisions to the Treasury's growth forecast are unlikely to be especially large.

A forecast of lower real growth is likely to be accompanied by a forecast of lower nominal growth, especially as the Treasury is likely to assume some passthrough from a weaker trading partner growth outlook into commodity prices (albeit from levels that are higher than those prevailing at the time of the HYEFU). As a rough guide, a 1% decline in nominal GDP growth in year one of the forecast costs the Government about $1.3bn in lost revenue each year. Lowering nominal growth by 1% for two successive years would mean a loss of $2.6bn from the second year onwards. Assuming a rebound in growth (relative to the counterfactual) in subsequent years – as the Treasury is likely to do – would begin to moderate those tax revenue losses. We think it is reasonable to assume that the Treasury's updated tax revenue forecast for the four years to 2028/29 might be around $5-6bn lower than forecast in the HYEFU. In the absence of remedial action, and in combination the impact of the automatic stabilisers on spending, the revenue loss by 2028/29 would cast doubt about achieving an OBEGALx surplus in that year (a surplus of $1.9bn was forecast in the HYEFU).

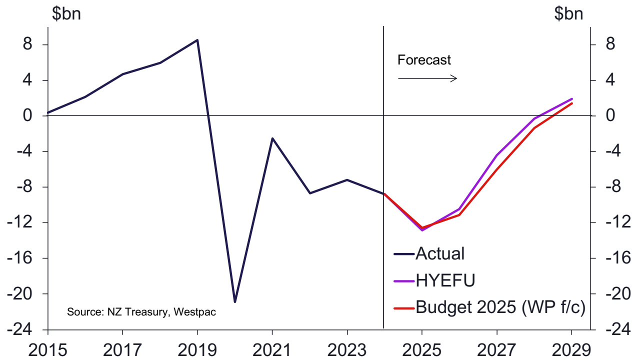
Adjusting spending to stay on track.

Rather than accepting a further delay in the return to surplus, the Minister announced last week that she has decided to reduce the size of the Budget 2025 operating allowance – the allowance for new spending or revenue initiatives – to just $1.3bn from the $2.4bn allowance set previously. This will save $1.1bn in each year of the forecasts.

Real operating allowance



Operating balance (OBEGALx)



Working within a $1.3bn operating allowance will not be easy. This is the smallest allowance set since 2015, and the smallest in inflation-adjusted terms since 2012. To achieve this, the Minister indicated that new spending initiatives would be strictly limited to the Government's most important priorities: health, education, law and order, defence, and a small number of social investments. She also said that she had found room for modest measures to support business growth and to provide some targeted cost of living relief. Importantly, beyond a small number of exceptions, government departments are not receiving additional funding in the Budget.

Meanwhile, following a line-by-line review of previous funding commitments, she indicated that further savings had been found that will also be used to fund the Government's priorities. For example, there has been some suggestion that the Government will means test its contributions to KiwiSaver, saving a portion of the current $1.1bn annual cost. Reports have also pointed to savings being made in the provision of emergency housing. Changes to the Pay Equity Act, which will make it harder for claims to succeed, and will delay the settlement of those that do succeed. It will also likely mean that that Government will lower provisioning for pay rises associated with these claims, possibly saving more than $1bn according to comments made by the Government.

It is worth noting that not all spending is directly controlled within the forecast operating allowances. Spending on the jobseeker benefit and finance costs sit outside the allowance and will vary depending on the state of the economy. Given a slightly weaker growth outlook, the Treasury will likely forecast slightly higher benefit expenses compared with the HYEFU. Financing costs will also likely be higher than estimated at the time of the HYEFU. This is especially so in the latter part of the forecast period, if the Treasury adopts a higher forecast for long-term bond rates than in the HYEFU.

According to the Minister, near-final Treasury Budget forecasts had indicated that the decline in next year's operating allowance – in concert with other savings – would be sufficient to preserve a return to surplus in 2028/29. That said, we do not expect the surplus to be as large as that forecast in the HYEFU.

On balance, following a slightly smaller-than-expected deficit in the current 2024/25 year, we expect Treasury to forecast deficits in subsequent years that are slightly higher than forecast in the HYEFU. Cumulatively, we expect the deficit over the five years to 2028/29 to be around $3bn larger than forecast in the HYEFU. Given that NZDM are on track to overfund this year's forecast deficit by around $2.5bn, this suggests that changes to the outlook for the operating balance will not be a significant driver of changes to the forecast bond programme.

What about capex?

This leaves open the possibility that the forecast bond programme might be impacted by changes to the Government's capital investment plans. In particular, the Government has recently announced a new Defence Capability Plan. This pledged to add $9bn of new defence spending over the coming four years, much of which will be new capital spending. The HYEFU forecast around $2.7bn of defence-related capital spending over the next four years, with around $12bn of capital spending yet to be allocated across all Government priorities. While it is feasible for all the additional defence-related capital spending to be met from within the existing unallocated capital budget, that would leave comparatively little to be allocated elsewhere. So it is possible that the Government will choose to lift the overall capital budget somewhat, which would raise the overall financing requirement. Indeed, today the Prime Minister announced in a pre-Budget speech that the net capital allowance for Budget 2025 would be $400m larger than forecast previously.

That said, the Minister of Finance spent some time in her speech last week bemoaning the sharp increase in debt financing costs seen in recent years – now greater than annual core Crown expenses for the Police, Corrections, the Ministry of Justice, Customs and the Defence Force combined. And she reasserted the Government's goal of reducing net Core Crown debt below 40% of GDP and then keeping it below that percentage. This suggests that the Minister is likely to be resistant to a large increase in the bond programme.

Table 1: NZ Government financing requirement

	24/25	25/26f	26/27f	27/28f	28/29f
Bonds					
HYEFU	40.0	40.0	38.0	28.0	22.0
Budget 2025 (Westpac f/c)	**42.5**	**40.0**	**40.0**	**28.0**	**24.0**
difference	+2.5	0.0	+2.0	0.0	+2.0
Short-term borrowings					
HYEFU	20.0	20.0	18.0	13.0	13.0
Budget 2025 (Westpac f/c)	**16.0**	**20.0**	**18.0**	**13.0**	**13.0**
difference	-4.0	0.0	0.0	0.0	0.0

Source: NZ Treasury, Westpac

The bottom line for bonds.

Given the overfunding undertaken this year – and with the deficit tracking slightly below expectations – we think that additional issuance forecast by the Treasury over the coming four years is likely to be no more than $5bn above the HYEFU forecast.

On balance, we assume an additional $4bn will added to the bond programme. We expect the programme for the coming 2025/26 year will be confirmed at $40bn. NZDM's recent reduction in the weekly tender to $450m certainly suggests no immediate funding pressure, reflecting the overfunding of the 2024/25 deficit. Given NZDM's tendency to forecast even numbers, we assume that $2bn will be added to the programme for 2026/27 (lifting it to $40bn) and a further $2bn to the programme for 2028/29 (lifting in to $24bn). The overfunding of this year's bond programme means that NZDM's forecast for short-term borrowings (Treasury bills and ECP) in the current year is likely to be lower than forecast in the HYEFU. Our sense is that the changes we are forecasting would likely not be a surprise to the market.

Westpac's fiscal forecasts.

Next week we will release our latest *Economic Overview*, updating all our forecasts including those for the Government's finances. We suspect that our baseline forecasts for the economy are likely to be more positive than the Treasury forecasts underpinning Budget 2025 and so will imply greater tax revenue generation. In particular, the baseline outlook for the terms of trade will likely be more negative in Treasury's forecasts compared to our own. Our forecasts will also include a downside scenario that may more closely match the Treasury's outlook for government revenue.

Our baseline forecasts would imply scope for the Government to achieve an OBEGALx surplus in 2028/29 even if spending restraint becomes *slightly* less restrictive from Budget 2026 onwards. The downside scenario would eliminate that scope.

Of course, a new General Election must be held in New Zealand no later than 19 December 2026, and the fiscal preferences of the next Government remain to be seen. Larger increases in spending, if not met by revenue increases, would obviously weaken the fiscal outlook. And of course it's possible that the taxation and expenditure profiles after next year could be significantly different under the next Government.

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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