



ECONOMIC BULLETIN

Preview of New Zealand Budget 2026,
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14 May 2026 | **Darren Gibbs**, Senior Economist | +64 9 367 3368 | +64 21 794 292 | darren.gibbs@westpac.co.nz

Fiscal strategy unchanged, but more debt near term.

- Prior to the Iran war, Budget 2026 was set to reveal a rare improvement in the fiscal outlook. That is no longer the case.
- The Government has cut the operating allowance for Budget 2026, but the conflict will lift spending on items that sit outside the allowance. It will also lead to slightly lower revenue.
- The magnitude of the impact will depend on the Treasury's assumption about the duration and implications of the conflict, which is uncertain.
- We assume the Treasury's economic forecast will be pitched near the less severe end of the range of scenarios that the Minister of Finance presented last month.
- As a result, we expect the cumulative OBEGALx deficit over the forecast period to rise by around \$8bn, with the largest deterioration occurring in 2026/27.
- The Prime Minister has reaffirmed that the Government's fiscal strategy remains to achieve an OBEGALx surplus in 2028/29. We expect the Treasury will forecast a return to surplus (just) in 2029/30.
- The net capital allowance for Budget 2026 has been raised to \$5.7bn from \$3.5bn previously. This will add to the forecast borrowing requirement.
- Depending on the spending assumption from Budget 2027 onwards, we expect the cumulative four-year financing requirement will be around \$7-9bn larger than forecast in the HYEPU, with the programme for 2026/27 lifted by \$2-3bn.
- Net core Crown debt will likely be projected to peak at around 48% of GDP in 2028/29, before declining gradually thereafter.
- We think that the outlook above would come as no surprise to the credit rating agencies, and on its own would be unlikely to cause a ratings downgrade.
- Given the impending General Election, the Treasury will need to publish a fiscal update (the PREFU) by early October. Depending on the path of the conflict, this could lead to marked changes to the Budget forecasts.

The Minister of Finance, Nicola Willis, will present her third Budget at 2pm on Thursday 28 May. At the beginning of this year, we had thought that the Budget 2026 would unveil a rare improvement in the fiscal outlook, with the potential to return the OBEGALx measure of fiscal balance back to surplus in 2028/29. This would have been a year earlier than forecast in last year's Half-Year Economic and Fiscal Update (HYEFU), but consistent with the revised strategy that the Government expressed in the last Budget Policy Statement (BPS). Comments made by the Minister and Prime Minister last month suggest that this would indeed have been the case.

Unfortunately, Budget 2026 will be set against the background of the ongoing Middle East conflict. As we set out in our own recent **Economic Overview**, this conflict seems set to dampen – but not derail – the economic recovery that began to take hold during the second half of last year. Comments made by the Minister of Finance

suggest that this will also be the Treasury's assessment. As a result, a favourable revision to the fiscal outlook no longer seems likely. Importantly, the Prime Minister has confirmed this week that the Government's fiscal strategy remains unchanged – that is, to work towards achieving an OBEGALx surplus in 2028/29 and therefore to set the fiscal stance on a course that would eventually reduce net core Crown debt to below 40% of GDP.

The rest of this note sets out our expectations for Budget 2026. We caution that there is significant uncertainty about the key economic assumptions that the Treasury will use in compiling the fiscal forecasts – most notably about the path of the conflict from here and the implications for energy prices, global growth and the impact on New Zealand's economic outlook. And actual outcomes could prove markedly different to the Budget forecasts if developments in the Middle East invalidate whatever assumptions the Treasury has made.

A favourable starting point.

One source of good news is that actual fiscal outturns have been tracking favourably compared with the HYEFU forecast, at least through to March. For the first nine months of the fiscal year the OBEGALx deficit stands at \$7.8bn, which is \$2.1bn smaller than the Treasury had expected based on the HYEFU full-year forecast deficit of \$13.9bn. While core Crown tax revenue is running a modest \$0.4bn below forecast, core Crown expenses are running \$1.3bn below forecast due to lower-than-expected spending across a range of functions. In addition, the combined operating balance of the various SOEs and other Crown entities is running \$1.3bn above forecast.

Importantly, the core Crown residual cash deficit – which is more closely tied to the Government's actual bond financing needs – is also tracking favourably. The deficit of \$5.0bn in the nine months to March was \$2.7bn smaller than the Treasury had expected. According to the Treasury, this reflects a combination of higher-than-expected tax receipts, lower-than-expected operating outlays and lower-than-expected net capital outflows. As a result, net core Crown debt of \$187.8bn was \$3.4bn lower than forecast in the HYEFU at 42.2% of GDP.

While some of this favourable variation is likely to be a matter of timing, and some will likely be eroded over the final quarter of the 2025/26 fiscal year due to the weaker economic conditions that now prevail, it seems likely that the fiscal outturn for 2025/26 will be no worse than the HYEFU forecast.

Maintaining tight control of the controllable.

This week the Prime Minister announced that the operating allowance for Budget 2026 has been revised down to \$2.1bn from the \$2.4bn signalled in the HYEFU.

Across the four years of the forecast, this will save the Government \$1.2bn. This represents a very tight operating allowance by historical standards, especially in inflation-adjusted terms. Given existing precommitments, this will leave well under \$1bn per year, on average, to fund new initiatives. Any additional initiatives will need to be funded by ongoing savings and reprioritisations within existing departmental baselines.

At this stage we have been given no guidance as to whether the Budget 2026 operating allowance of \$2.1bn will be assumed to apply to future budgets too (rather than the \$2.4bn per year allowance that was assumed in the HYEFU). It is possible that the Government could assume a similarly tight operating allowance at each of the following three budgets, in part to appease the increased concern that rating agencies have expressed about the lack of fiscal consolidation (more on this below). If so, the total fiscal saving across the four-year forecast period will amount to \$3bn, and baseline spending in 2029/30 would be \$1.2bn lower than would otherwise be the case. This would lower the Government's borrowing requirement commensurately.

Iran war fiscal transmission channels.

Unfortunately, the conflict in the Middle East will negatively affect the Government's finances through a variety of channels that sit outside of its immediate control (although in principle these impacts could be offset by discretionary policy actions).

While the Government can control departmental spending through its setting of the operating allowance, this only covers a portion of total spending. Notably, social security and welfare payments and debt servicing costs – which comprise around 40% of core government spending – sit outside the operating allowance.

- A weaker outlook for the economy over the coming year will translate to an increased number of work-related benefit recipients. More significantly, the lift in inflation this year will increase the cost of all benefits, with next year's inflation adjustment on 1 April likely to be around twice as large as the Treasury had expected in the HYEFU.
- Interest rates are tracking well above the Treasury's HYEFU forecast. For example, the HYEFU had assumed an average 10-year bond rate of 4.0% in the current quarter compared with the current yield of around 4.75%. If the Treasury lifts its forecasts of interest rates for at least the next year or two, as seems likely, this will raise estimated financing costs over time as new debt is issued and existing debt is refinanced. Refinancing costs will also be raised to the extent that other transmission channels lead to larger fiscal deficits.

The Iran war will also impact forecasts of tax revenue.

- In the near term, a weaker outlook for employment will generate weaker growth in personal income tax receipts, which account for around half of all tax revenue raised. However, if higher near-term inflation allows some employees to obtain compensation for that inflation, the resulting rise in wage growth will provide at least a partial offset over time (and potentially more than fully offset the employment impact, with fiscal drag contributing to tax revenues as more people move into higher marginal tax brackets).
- Pressures on disposable incomes and precautionary saving will likely lead to lower volumes of consumer spending, thus tending to reduce GST revenue (which accounts for around a quarter of all tax). However, given that GST is levied on nominal spending, rather than real, higher inflation will work in the opposite direction. If there is little precautionary saving and nominal spending is unchanged, then there could be little impact on GST revenues.
- The implications for corporate tax seem more straightforward. To the extent that cost increases cannot be passed through to the consumer, a reduction in corporate profitability will lead to a period of lower corporate tax payments.
- Finally, there are also likely to be impacts on some smaller sources of revenue. For example, withholding taxes on interest income will be lifted by higher interest rates, providing a partial offset to the lift in the Government’s financing costs.

So what does this mean for the operating balance?

Given all the moving parts, forecasting the fiscal aggregates is a difficult task at the best of times, with small differences in assumptions about growth in spending and revenue quickly compounding into large changes in the forecast borrowing programme.

Forecasting what the Treasury will publish as its forecast is fraught with even greater difficulty, as there is significant uncertainty about what the Treasury will have assumed about the path of the Middle East conflict, let alone the Treasury’s assessment of how the economy might be impacted by a given conflict scenario.

That said, we think that some guidance can be taken from the scenarios that the Minister of Finance presented at a press conference on 24 April. These scenarios, developed by the Treasury in late March, illustrated different paths for the economy dependent on three possible paths for oil prices (see Table 1). Her presentation also confirmed that the Treasury’s pre-war “base” economic forecast was more positive than that in the HYEFU.

The oil price was sitting just under \$110/bbl in late April when the Treasury reopened and then finalised the economic forecasts that will underpin Budget 2026. Therefore, our best guess is that the Treasury will have positioned its final economic forecast close to Scenario 1 (which had assumed a \$110/bbl oil price) but with a probable nod towards Scenario 2. The Treasury’s Scenario 1, while weaker than the pre-war forecast, was in fact similar to the HYEFU forecast. However, as the economic forecast leans further towards Scenario 2, the outlook for activity in 2026/27 becomes notably weaker. That said, this weakness is largely reversed in 2027/28 when conditions in the oil market are assumed to normalise. If replicated in Budget 2026, such a forecast profile would significantly mitigate the damage to the medium-term fiscal projections.

Given the above, if the Government retains a \$2.4bn operating allowance assumption for future budgets, our best guess is that Budget 2026 will show the following:

- A cumulative deterioration in the OBEGALx balance of just over \$8bn over the next four years, with the largest impact (around \$3bn) in the 2026/27 year and the difference compared with the HYEFU decaying over time.

Table 1: Treasury pre-Budget forecast scenarios

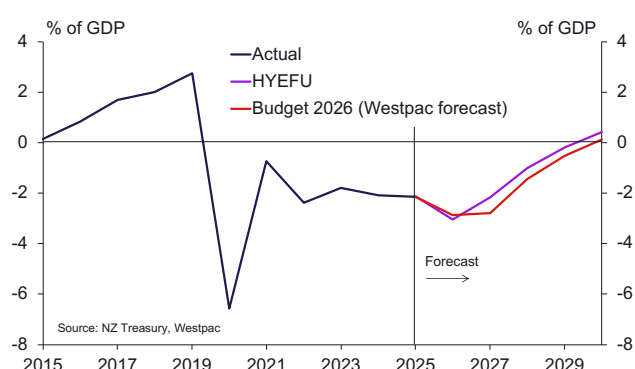
		HYEFU 2025	Base	Scenario 1	Scenario 2	Scenario 3
GDP	25/26	2.0	2.3 ↑	2.0 →	1.5 ↓	0.8 ↓
	26/27	3.5	3.3 ↓	3.4 ↓	2.6 ↓	1.7 ↓
	27/28	2.6	2.7 ↑	3.0 ↑	3.7 ↑	4.4 ↑
Inflation	25/26	2.4	2.7 ↑	3.9 ↑	5.2 ↑	7.4 ↑
	26/27	2.2	2.3 ↑	1.5 ↓	1.8 ↓	2.1 ↓
	27/28	2.1	2.2 ↑	2.1 →	1.4 ↓	1.2 ↓
Unemployment rate	25/26	5.3	5.3 →	5.3 →	5.4 ↑	5.7 ↑
	26/27	4.8	4.7 ↓	4.7 ↓	5.5 ↑	6.6 ↑
	27/28	4.6	4.4 ↓	4.3 ↓	4.7 ↑	5.4 ↑

Base = Pre-War forecast; Crude oil = \$110/bbl in Scenario 1, \$135/bbl in Scenario 2, \$180/bbl in Scenario 3
Arrows indicate direction of change since HYEFU forecast

Source: NZ Treasury

- Cumulative core Crown spending around \$4bn higher than forecast in the HYEFU, roughly equally divided between higher social welfare spending and higher debt financing costs.
- Cumulative core Crown tax revenue a little over \$4bn lower than in the HYEFU, assuming cumulative nominal GDP is around \$15bn lower than the HYEFU forecast.
- A small OBEGALx surplus of just under \$1bn achieved in 2029/30, compared with the \$2.3bn surplus forecast in the HYEFU.
- Net core Crown debt will likely be projected to peak at around 48% of GDP in 2028/29, before declining gradually thereafter.

Operating balance (OBEGALx), % of GDP



What about capex?

In a speech this week, the Prime Minister also announced that the net capital spending allowance would be \$5.7bn. This is \$2.2bn larger than had been signalled previously. The Prime Minister's comments indicates that some of the additional investment will be used to improve New Zealand's national energy security and to provide some of the funding needed to progress the Government's Defence Capability Plan (which envisages a significant uplift in defence spending, much of which will be new capital spending). We assume that Budget 2026 will continue to forecast \$3.5bn of new capital spending in future budgets. We think actual spending will be eventually prove higher, but this may not be reflected in Budget forecasts until decisions are made regarding some of the more costly defence investments (such as the proposed frigate replacement programme).

The bottom line for bonds: \$7-9bn additional issuance.

Putting this all together, we have:

- A roughly \$8bn increase in the cumulative OBEGALx balance; and
- A roughly \$2bn increase in the capital budget; but
- A probable slight overfunding of the cash requirement in 2025/26.

As a result, we think that additional issuance forecast by the Treasury over the coming four years is most likely to be around \$9bn above the HYEFU forecast. However, it could be around \$2bn less if the operating allowances from Budget 2027 onwards are lowered to match the Budget 2026 operating allowance. Assuming some smoothing between years, Table 2 sets out a plausible forecast for the bond programme. This would see a \$3bn increase in the forecast programme for the coming 2026/27 year (lifting the programme to \$37bn) and a \$2bn increase in the forecast programme over each of the subsequent three years. If the overall additional funding requirement proves to be closer to \$7bn, then the coming year's programme would likely be raised by \$2bn to \$36bn.

What will the credit rating agencies think?

Reflecting the weaker fiscal outlook, last month Moody's joined Fitch in attaching a negative outlook to New Zealand's sovereign credit rating. Both Moody's and Fitch currently assign New Zealand a higher rating than forecast by their respective models, with both agencies granting a discretionary uplift based on an assessment that the weakening of New Zealand's fiscal metrics will improve over time (a view based on New Zealand's past success in correcting fiscal imbalances). The recent assignment of a negative outlook clearly indicates that these agencies are considering removing that uplift due to the ongoing delay in returning the fiscal books back to surplus.

If Budget 2026 is broadly in line with our expectations, we expect that it will also be broadly in line with the revised expectations of the ratings agencies too. So, barring a further major deterioration in the outlook, we would not expect to see further actions taken by either Moody's

Table 2: NZ Government financing requirement (\$bn)

	24/25	25/26f	26/27f	27/28f	28/29f	29/30f
Bonds						
HYEFU	42.6	35.0	34.0	34.0	32.0	30.0
Budget 2025 (Westpac forecast)	42.6	35.0	37.0	36.0	34.0	32.0
Difference	0.0	0.0	+3.0	+2.0	+2.0	+2.0

Source: NZ Treasury

or Fitch this year (it is possible that Standard and Poor's could revise its outlook, although we note that its current AA+ rating is not founded on a discretionary uplift). It seems more likely that the ratings agencies will reassess the outlook in 2027, potentially after the winner of this year's General Election delivers Budget 2027.

Next update likely in October.

Ahead of the General Election on 7 November, the Treasury will need to publish a Pre-Election Economic and Fiscal Update (PREFU). The PREFU needs to be published between 20-30 working days before election day. Based on history, this is most likely to occur in early October. So, depending on developments in the Middle East, a substantial rework of the fiscal outlook (and bond programme) could emerge just four months after the release of Budget 2026.

Finally, should a PREFU be released on or after 1 October, it is worth noting that there will be no legislative requirement to publish a further fiscal update until the release of Budget 2027 in May next year, i.e. there will likely be no HYEPU released at the end of this year.

Contact

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



Connect with us

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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