ECONOMIC BULLETIN

Fiscal update, January 2025.

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

- **The HYEFU unveiled a much larger-than-expected deterioration in the fiscal outlook, mostly due to a lower assumed average effective tax rate.**
- **Taking onboard the information from the HYEFU, but assuming future spending restraint beyond 2025/26 is not as tight as indicated, implies that further upward revisions to the forecast bond programme can be expected over time.**
- **Our updated forecast indicates that OBEGAL will remain in deficit in 2028/29 and that the primary surplus will be insufficient to begin reducing net core Crown debt as a share of GDP until 2028/29.**
- **We will provide a further update in February with the release of our first *Economic Overview* for 2025.**

HYEFU recap – a weaker fiscal outlook.

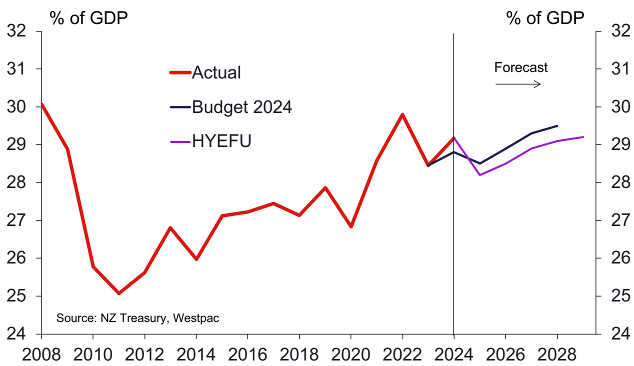
The Half-Year Economic and Fiscal Update (HYEFU), released on 17 December, revealed a much larger deterioration in the fiscal outlook – and thus increase in the Government's borrowing programme – than we and the market had expected. Indeed, the HYEFU portrayed a weaker outlook than even the relatively pessimistic forecast that we published in our last *Economic Overview* in October, which had allowed for further fiscal deterioration to be unveiled in future fiscal updates beyond the upcoming HYEFU.

To recap, relative to Budget 2024, the HYEFU forecast a cumulative $20bn increase in the operating deficit (OBEGAL) over the four years to 2027/28 and a consequent $20bn increase in the NZGB borrowing requirement. Whereas Budget 2024 had forecast that a small OBEGAL surplus would be achieved in 2027/28, the HYEFU forecast that the books would remain in deficit even in 2028/29. OBEGALx, the Government's new indicator which excludes the spending and revenue of the self-funded ACC, would achieve only a small surplus in 2028/29.

We estimate that around $6bn of the cumulative $20bn deterioration in the fiscal position can be attributed to the weaker outlook for nominal GDP than forecast in Budget 2024. This reflected the impact of the well-foreshadowed downward revisions to the Treasury's near-term outlook for GDP growth and to the Treasury's longer-term assumption regarding productivity growth. This contribution appeared to be well anticipated by the market and underpinned widely shared expectations that the HYEFU would likely reveal a $4-6bn lift in the bond programme.

So, what explains the remainder of the deterioration? In part, the market was blind-sided by an additional $7bn cumulative loss of revenue due to the Treasury forecasting a lower average economy effective tax rate than in Budget 2024 i.e., a lower tax take for a given size of the nominal economy. According to the Treasury, this revision was largely driven by three factors: (i) a downward revision to the forecast effective tax rate on GST, which relative to its theoretical base appears to have reverted to pre-pandemic norms; (ii) new estimates suggesting greater losses accumulated in the corporate sector, thus slowing the pace at which the corporate tax take will likely recover with the economy; and (iii) a slightly lower forecast for wage growth, implying less tax uplift from fiscal drag due to wage and salary incomes moving up into higher tax brackets.

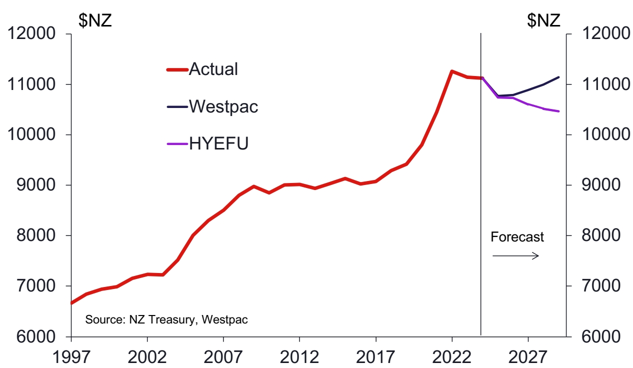
Core Crown tax revenue, % of GDP



The remainder of the unexpected deterioration was on the spending side of the accounts. At least for us, this reflects greater-than-expected spending outside of the core Crown sector and the impact of greater-than-expected financing costs due to compounding cost of funding larger deficits.

Updating our forecasts to incorporate the HYEFU.

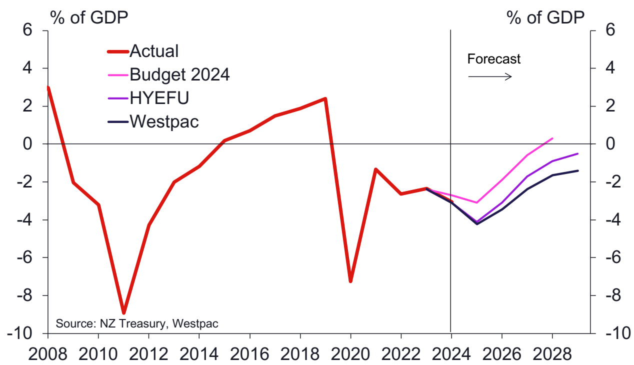
Real government consumption per capita



We will publish a complete economic update in mid-February when we release our first *Economic Overview* for 2025. However, as an interim step, Table 1 updates our October fiscal forecast taking on board the information gleaned from the HYEFU and extending our forecast horizon out to 2028/29. The economic outlook underpinning this update is essentially unchanged from the October *Economic Overview*, aside from starting point changes associated with data released since that forecast was finalised. Financial variables are assumed to evolve in line with our current published forecasts.

In this update we have assumed some minor revenue raising measures will be announced in Budget 2025 to try to address a portion of the deterioration unveiled in the HYEFU (for example, the Minister of Finance has indicated that she is reviewing the tax treatment of charities). In the near term, government consumption spending is assumed to evolve largely as forecast in the HYEFU (core Crown spending is forecast to be slightly higher than HYEFU due to our relatively higher forecast for interest rates, and thus financing costs). Beyond 2025/26, in common with the approach we have taken in previous forecasts, we think it is prudent to assume that spending will exceed the current very tight Government forecasts. This means that real public consumption spending per person rises modestly in line with the longer-term trend, rather than remain in a multi-year downtrend as predicted by the HYEFU. In addition, our higher forecast for long-term interest rates (a 10Y bond yield rising to 4.85%, rather than the Treasury's forecast of 4.0%), contributes to higher debt financing costs over time. Indeed, by 2027/28, our estimates point to an additional $1bn per year of financing costs, rising thereafter.

Operating balance (OBEGAL), % of GDP



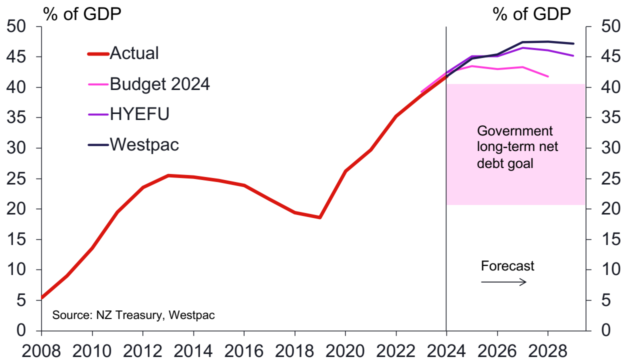
The main features of our updated forecast are as follows:

- The OBEGAL deficit will gradually decline but remain in deficit to the tune of around $7bn or 1.4% of GDP in 2028/29.
- Similarly, the OBEGALx deficit will gradually decline but will still record a deficit of around $3bn or 0.6% of GDP in 2028/29.
- Cumulative gross bond issuance of around $182bn would be required to fund the cash deficits out to 2028/29 - $14bn more than forecast in the HYEFU. Net core Crown debt would rise by around $74bn over this period.
- The primary balance (i.e., the cash balance excluding financing costs) would remain in deficit until 2027/28.
- Net core Crown debt will rise to a peak of over 47% of GDP in 2026/27.

- Given our forecast for interest rates, the primary surplus will likely remain insufficient to reduce net core Crown debt as a share of GDP until 2028/29 – a year later than the Government's forecast.

As noted above, over the coming month we will be undertaking a full update of our economic forecasts as we prepare our first *Economic Overview* for 2025. However, at this stage we don't anticipate that this will materially alter the outlook described above.

Net core Crown debt, % of GDP



Implications for NZ's credit rating.

As we discussed in some depth in the **credit rating primer we published in September**, international credit rating agencies have remained relatively sanguine about New Zealand in recent years, noting still-low general government debt levels relative to peer economies, New Zealand's strong governance institutions and legal and monetary frameworks, and forecasts pointing to an improvement in the fiscal position over time. However, as wrote in our **review of the HYEFU**, while the Government has reaffirmed its commitment to maintaining tight control of operational spending, the risks to New Zealand's current strong credit rating are growing given the increasing persistence of fiscal deficits at a time when the country is also running a persistently elevated current account deficit. Any future lessening of that commitment would increase the likelihood of a credit rating downgrade or at least the likelihood of the rating being placed on 'watch' for possible downgrade. This is especially so given New Zealand's exposure to large and costly natural disasters and biological events that could sharply curtail New Zealand's export revenue.

Westpac forecast: Key fiscal indicators

	June years							
	2022	2023	2024	2025f	2026f	2027f	2028f	2029f
Core Crown tax revenue ($bn)	108	112	121	120	128	136	145	153
Core Crown spending ($bn)	126	128	139	145	151	155	162	170
Operating balance excl. gains and losses ($bn)	-9.7	-9.4	-12.9	-18.3	-15.6	-11.4	-8.3	-7.5
Net core Crown debt ($bn)	129	155	175	194	205	226	238	249
Core Crown tax revenue (% of GDP)	29.8	28.5	29.2	27.8	28.1	28.5	28.7	28.8
Core Crown spending (% of GDP)	34.3	31.8	33.1	33.4	33.1	32.0	31.4	30.9
Operating balance excl. gains and losses (% of GDP)	-2.6	-2.4	-3.1	-4.2	-3.4	-2.4	-1.7	-1.4
Net core Crown debt (% of GDP)	35.2	38.7	41.8	44.8	45.3	47.4	47.5	47.2

Source: NZ Treasury, Westpac

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