NZ Budget 2025 Preview

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The gradual consolidation continues

Summary

The Treasury's Budget Economic and Fiscal Update, Budget 2025, and the Government's Fiscal Strategy Report are out 22 May at 2pm. In a nutshell, here's what we expect:

- Lower operating allowances should shave a touch over $4bn from expenses over the four-year forecast horizon (assuming no changes to tax settings), but a weaker economic outlook is likely to add to non-discretionary expenses and weigh on the forecast tax take. A higher capital allowance (up $375mn to $4bn) will provide a small partial offset to the lower operating allowance in the near term.

- Significant cost savings and reprioritisations will continue to fund a significant portion of the Budget package. And given how much of the last Government's unsustainable expansion is still locked into baselines, there will probably be plenty of room for more of the same in future Budgets.

- As signalled by the Minister of Finance, the Treasury is likely to continue to forecast an OBEGALx surplus in the year to June 2029 (one year later than the Government's target). The forecast level of net core Crown debt is expected to be a bit higher than at HYEFU.

- The Minister has also signalled she intends to stick to the fiscal strategy laid out in December's Budget Policy Statement, with the main short-term operational target being a return to OBEGALx surplus in the year to June 2028. That should be easily achievable if the operating allowance for Budget 2026 and beyond is lowered as well (which could happen in the fullness of time).

- We estimate NZDM will lift its bond issuance guidance by $2bn over the forecast horizon (excluding the ~$2.5bn pre-funding already in the proverbial tin). There are scenarios (which are not our central expectation) where the bond programme is reduced.

Year to June	Jun-25	Jun-26	Jun-27	Jun-28	Jun-29	Total (26-29)
2024 Half-Year Update	40	40	38	28	22	128
Budget Update (ANZ central expectation)	**42.5**	**40**	**38**	**28**	**24**	**130**

Source: The Treasury, ANZ Research

- In terms of macroeconomic implications, the RBNZ is well placed to offset any negative impacts on aggregate demand caused by lower discretionary fiscal spending. All else equal, we estimate the reduction in the operating allowance could reduce pressure on the OCR by 5-10bps, with the slightly higher capital allowance meaning the impact could lean closer to the lower end of this range.

- Big picture: the Government's relatively gradual approach to consolidating the last Government's unsustainable expansion means the fiscal outlook is likely to remain challenged, and this is unlikely to be the last tight Budget. Structural deficits are likely to be forecast for years to come, with flip-a-coin odds that the debt to GDP ratio will be a decent clip above its pre-pandemic level when the next big global crisis or natural disaster comes along.

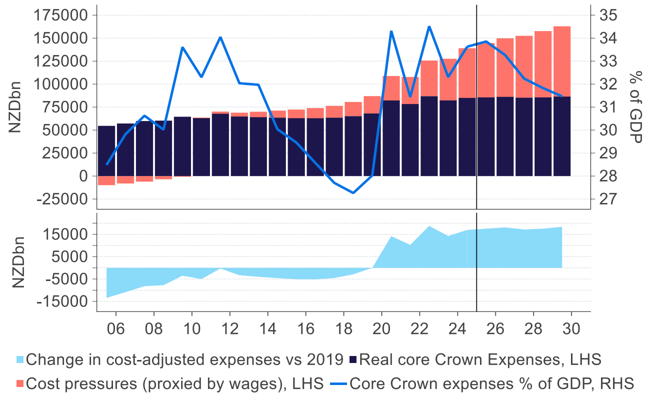
Big picture and monetary policy implications

On 22 May, the Treasury will open up the Government's books with the publication of the Budget Economic and Fiscal Update (henceforth Budget Update), and the Government will deliver its Budget (Budget 2025) and Fiscal Strategy Report (FSR).

Budget 2025 will be delivered amid challenging economic times, which, combined with the need to consolidate the last Government's unsustainable fiscal expansion before the next big crisis or natural disaster comes along, means it'll be a tight one. Indeed, a reduction in real (cost-adjusted) spending is implied by the fact that the reduced operating allowance signalled by the Minister of Finance ($1.3bn rather than $2.4bn) is considerably smaller than the expected increase in the cost of delivering key public services. But that's the *relative* story.

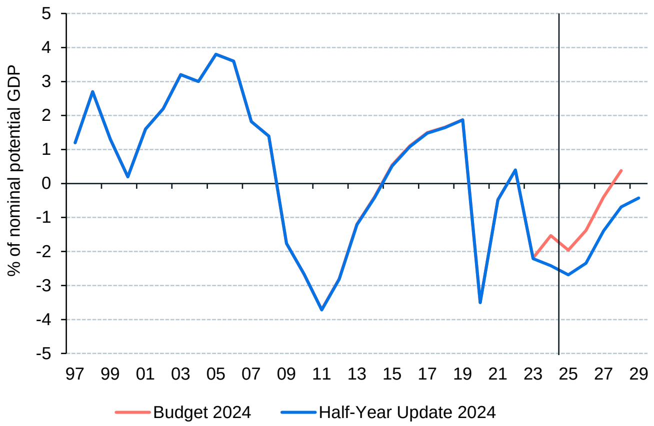
The *absolute* story is that a significant portion of the inflation-fuelling fiscal expansion undertaken by the last government still hasn't been unwound. Using December HYEFU forecasts, we estimate cost-adjusted government expenses were forecast to run around $15bn higher per year compared to just before the pandemic (2019). That suggests there is room for the Government to continue reprioritising less-effective spending from within existing baselines to meet new demands and priorities. Savings initiatives funded $3.8bn of Budget 2024's operating package (around $15bn over the four-year forecast horizon), and we could easily see a similar magnitude to that this year. That is, just because the operating allowance has been lowered, that doesn't mean the Government can't fund big initiatives by cutting back other programmes.

Figure 1. Government expenses (HYEFU forecasts)



Source: Treasury, Macrobond, ANZ Research

Figure 2. Structural balance



Source: Treasury, ANZ Research

The structural balance provides another important lens on the *absolute* story. This is a measure of the OBEGAL after stripping out automatic stabilisers and one-off expenditures associated with shocks such as natural disasters. And even after the reduction in the operating allowance (which represents around 0.25% of nominal GDP per year), the Treasury is likely to continue to forecast structural deficits for years to come.

The upshot: you can't pin persistent fiscal deficits on the state of the economy. Rather, these reflect a fundamental shortfall between government revenues and expenses left by the previous Government – a shortfall the current Government is addressing only gradually (by containing growth in new spending and allowing growth in the nominal economy to outpace that of the public sector). According to December's HYEFU forecasts, the Government was set to run 10 years of consecutive OBEGAL deficits since the onset of the pandemic. That compares to six consecutive deficits following the Global Financial Crisis and Canterbury earthquakes. At this pace there's certainly no guarantee the books will be back in the black before the next inevitable crisis/shock comes along.

One of the major uncertainties (that may persist after Budget 2025) is whether the Government will also reduce operating allowances from Budget 2026 onwards. The Minister has hinted that the previously signalled allowances of $2.4bn for these Budgets was more of a ceiling than a floor, but that doesn't mean they will be tweaked at this Budget. We note on page 5 what the bond programme might look like if the operating allowance was reduced to $1.3bn for Budgets 2026-2028. However, our central assumption going into Budget 2025 is that the Government will continue to signal $2.4bn operating allowances for Budgets 2026 onwards.

Turning to the capital allowance, the Prime Minister has said this will be increased from $3.625bn to $4bn for Budget 2025. Unlike the operating allowance, the capital allowance is a one-off injection (i.e. it doesn't get locked into baselines to the end of time), meaning it's likely the $375m increase at Budget 2025 will have limited implications for bond issuance over the forecast horizon. But like the operating allowance, we are currently in the dark as to what the Government is going to signal for Budget 2026 and beyond. Our working assumption is that the capital allowance for Budget 2026 and beyond will remain at $3.625bn.

There has been some speculation that the recently minted Defence Capability Plan will require an increase in capital and operating allowances down the track. But the signal sent by the Minister when asked about this is that she has no intention to increase allowances in order to specifically fund defence. Rather, this funding will be met through existing allowances and likely facilitated by reprioritisations (although that does limit how much reprioritising can be used for other initiatives).

In terms of monetary policy implications, we won't have to wait long to get the RBNZ's take on the updated fiscal outlook: the May Monetary Policy Statement is out six days later, on 28 May. All else equal, we estimate the reduction in the operating allowance could reduce pressure on the OCR by 5-10bps, with the near-term increase in capital spending pushing this towards the lower end of this range. That's not enough to move the dial if the RBNZ is cutting in 25bp increments, but it all goes into the mix.

All in all, Budget 2025 is shaping up to have limited implications for the broader macroeconomic outlook. The Government appears to be sticking to its fiscal strategy and gradually consolidating the last Government's mega expansion – a strategy that will require tight Budgets beyond this one. Importantly, reducing the operating allowance in the face of a weaker economy is not going to exacerbate any economic underperformance caused by global factors. That's because with inflation well under control the RBNZ can always respond to the growth/inflationary implications with a lower-than-otherwise OCR (supporting households and businesses).

Looking beyond Budget 2025, while the pursuit of public sector efficiency is a healthy exercise for the economy overall, there's only so much a restrained spending approach can achieve. Ongoing pressure on health and superannuation spending from an aging population, pressure on infrastructure from past underinvestment, and rising debt-servicing costs as higher Government bond yields meet the last Government's debt-funded spending spree are all major challenges waiting for us down the road – challenges that will be difficult to overcome in an equitable way without broadening the tax base. But adjusting revenue policy to address such challenges, let alone turning forecast structural deficits into surpluses sooner than otherwise, does not appear to be on this Government's agenda. Nonetheless, containing spending growth and focusing on improved public sector efficiency is a good first step towards addressing these challenges.

The starting point for the Treasury's forecast is a bit of a mixed bag…

The Q3 2024 GDP data (released just two days after December's HYEFU) surprised the Treasury's (and our) forecast to the downside (actual: -1.0% q/q; HYEFU: -0.1% q) and included material revisions to history: the level of real and nominal GDP was revised higher, but growth momentum in mid-2024 was revealed to be much weaker than previously thought. That said, GDP growth of +0.7% q/q in Q4 was stronger than the HYEFU forecast of +0.3%.

But it's nominal GDP that matters for the tax take, and on that front growth of -0.3% q/q and +0.1% q/q in Q2 and Q3 respectively was significantly weaker than that presented in the HYEFU (+0.6% q/q for both quarters). But just as real growth surprised to the upside in Q4, so too did nominal GDP growth: +2.2% q/q vs Treasury's forecast of 0.8% q/q.

Avid followers of the Treasury's forecasts may recall that it wasn't just a downgrade to the outlook for nominal GDP that resulted in a materially weaker tax outlook at HYEFU; the Treasury also made a few tweaks to their model assumptions. Indeed, the HYEFU noted that of the $13bn cumulative downgrade to the core Crown tax revenue forecast, lower nominal GDP accounted for $7.2 billion, while the remainder ($5.8bn) was owing to lower forecast tax relative to GDP. Now the big question is whether GDP revisions change the way the Treasury thinks about the tax outlook (potentially resulting in a partial unwind of the $5.8bn portion of HYEFU's downgrade) or if they remain happy with the changes made at HYEFU. Typically, relatively consistent revisions to the level of nominal GDP will have very little impact on the tax outlook, but changes in the Treasury's understanding of growth momentum are a different kettle of fish, and GDP revisions since the HYEFU have had both!

Turning to the starting point for the fiscals, monthly statements for the nine months to March show key accrual operating indicators (e.g. revenues and expenses) running close to the Treasury's HYEFU forecast. Meanwhile, the core Crown residual cash deficit was $1.7bn narrower than forecast owing to weaker-than-expected capital outflows, but the Treasury notes this is a timing story. It's not uncommon for capital spending to run into delays. All told, we don't see the starting point for the fiscals as having major implications for the bond programme or fiscal outlook come Budget. But changes to the Treasury's economic forecast and discretionary policy choices could be more meaningful.

…but the outlook is in for a downgrade (magnitude unknown)

In a pre-Budget speech, the Minister of Finance noted that the Treasury has downgraded its growth forecasts for 2025 and 2026, hinting this will translate into a weaker forecast tax take. The culprit: a more volatile and uncertain global outlook following US trade policy developments. She also signalled a reduction in the operating allowance for Budget 2025 from $2.4bn to $1.3bn, which, assuming no change to tax settings, implies $4.4bn less spending than otherwise over the four-year forecast horizon. We don't know if the Government intends to stick to the previously signalled $2.4bn operating allowance for Budget 2026 and beyond (2026 is an election year!), but if the operating allowance for Budgets 2026 to 2028 were also reduced to $1.3bn, discretionary spending would be around $11bn lower over the forecast horizon – we think that would more than offset the impacts of a weaker economy on the tax take and non-discretionary spending.

There's a lot more art than science involved when estimating what a weaker economic outlook might mean for the Treasury's forecast tax take. Our best guess (assuming the Treasury doesn't change its tax model assumptions) is that a weaker outlook for nominal GDP could shave a cumulative $5-7bn from the forecast tax take to June 2029.

We expect the Treasury will continue to forecast the first post-pandemic OBEGALx surplus for the 2028/29 fiscal year, but it'll likely be a little smaller than HYEFU's $1.9bn. The level of net core Crown debt is likely to be a little higher across the forecast horizon, but the ratio to GDP may not be all that different (given GDP revisions).

Gauging new capital spending across Budgets is about to get a little easier: the Government is moving away from the multi-year capital allowance approach and back to single-year allowances. In December's Budget Policy Statement, capital allowances were signalled to be $3.625bn per year over the next four Budgets. We know Budget 2025 will see that increase by $375m to $4bn. That's not a large increase, but we'll be watching to see if the signal for Budgets 2026 and beyond changes.

Most signs pointing to slightly higher bond issuance

Table 1 shows our central expectation for bond issuance guidance as well as a scenario where operating allowances beyond Budget 2025 are also reduced to $1.3bn from Budget 2026. For the central case, we've pencilled in a $2bn increase in issuance guidance to June 2029 compared to HYEFU, with no change until the 2028/29 fiscal year. Under the scenario, issuance guidance is $4bn lower. To get our central expectation and the scenario we have:

- Stripped $6bn out of the forecast tax take and bumped up non-discretionary spending slightly (reflecting the weaker economy and higher yields since HYEFU).
- Stripped out around $4bn in discretionary spending in our central forecast, reflecting the signalled change in the operating and capital allowance for Budget 2025, and stripped out around $11bn under the scenario.
- Accounted for NZDM's ~$2.5bn pre-funding of the 2026 programme (based on an assumed tender run rate of $450m for the remainder of the current fiscal year). This is reflected in the current year's programme (which only has a few weeks to go) lifting to $42.5bn. We've made no adjustment for starting point surprises in core Crown residual cash (the Treasury suggests that's a timing story).
- Added a smoothing factor to achieve a stable (downward sloping) profile and to ensure each year rounds to the nearest $2bn.

Table 1. NZDM bond issuance guidance ($bn)

Year to June	Jun-25	Jun-26	Jun-27	Jun-28	Jun-29	Total (26-29)
2024 Half-Year Update	40	40	38	28	22	128
Budget Update (ANZ central expectation)	**42.5**	**40**	**38**	**28**	**24**	**130**
Scenario: Lower operating allowance beyond Budget 2025	**42.5**	**40**	**38**	**26**	**20**	**124**

Source: The Treasury, ANZ Research

Forecasting bond issuance is notoriously difficult and there have been significant surprises in the past. It's worth noting that we see material risks in both directions. The Treasury's economic forecasts are always a wild card, but for the first time in a long time they didn't land on the optimistic side of our expectation at HYEFU, limiting the scope for downgrades now. And with HYEFU's whopping $20bn increase to bond issuance guidance fresh in our minds, we are nervous about the possibility that the Treasury unwinds (perhaps partially) recent tweaks to its tax model assumptions – a risk that we think skews towards a lower bond programme than otherwise.

Regarding the other bits and bobs we often get asked about: we've assumed no change to NZDM's liquidity buffer strategy, no change to Kāinga Ora funding (where maturing bonds over the Treasury's forecast horizon *are* provisioned for in NZDM's bond programme), and no change to the pace of the LSAP run-down.

Sticking to the fiscal strategy

When it comes to the broad management of the Government's books over coming years, we expect the Government to stick to its recently tweaked fiscal strategy. In December's Budget Policy Statement, the Government changed from targeting an OBEGAL surplus to an OBEGALx surplus (the latter excluding ACC). Specifically, the Government's short-term intention was to "return the operating balance (before gains and losses, excluding ACC) to surplus by 2027/28", which after accounting for the impact of stripping out ACC represented a one-year delay versus the target for returning to surplus.

It's also worth noting that the Treasury's HYEFU forecast had the OBEGALx returning to surplus one year later than this, suggesting the Minister is either expecting the economy will outperform the Treasury's forecast, or that further restraint in terms of new spending (e.g. cuts to operating allowances) will be required down the track (assuming the Government continues to refuse to entertain the possibility of lifting taxes). Should the Government reduce the operating allowance for Budgets 2026 and beyond, we think a return to surplus by 2027/28 would be quite achievable.

Lastly, we noticed that December's Budget Policy Statement omitted the line that "upside revenue surprises will contribute to reducing the deficit". The last Government tended to spend positive revenue surprises, meaning risks to bond issuance guidance were asymmetric, i.e. a stronger-than-expected economy didn't necessarily imply fewer bonds, but a weaker economy sure did. Maintaining a commitment to use positive revenue surprises to get the books back in the black sooner than otherwise would bring some symmetry back.

Summary

All up, even though we have a clear signal on Budget 2025's operating and capital allowance, there's still plenty of scope for surprise on the day:

- Just how much will the Treasury downgrade their economic and tax forecasts?
- Will the Treasury tweak its tax models following recent GDP revisions?
- Will the Minister signal lower operating allowances beyond Budget 2025?
- Will the signal on capital allowances beyond Budget 2025 change?

While we've landed on a central expectation that bond issuance guidance will be lifted by $2bn over the forecast horizon (excluding the ~$2.5bn overfunding of the current fiscal year), there are also scenarios where it could be lowered.

Given what we know about the operating and capital allowances, it's hard to see Budget 2025 being a game changer for the RBNZ. The mildly dovish implication of lower discretionary spending will probably matter less than changes to the RBNZ's outlook (owing to recent global wobbles) come the May MPS, but these developments do at least point in the same direction.

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