14 June 2017

For Better Or Worse?

- Current account deficit unexpectedly widens
- But external accounts remain benign
- As net international liability position continues to shrink
- Nominal income growth looks strong
- But we have reservations for tomorrow's real GDP
- Cyclone fueled food prices nudge our Q2 CPI pick higher

The annual current account deficit for the year to March 2017 was 3.1% of GDP. This was a bigger deficit than the 2.7% figure both the market and we expected and a push wider from the (upwardly revised) 2.8% result for calendar 2016.

We believe today's external accounts reveals a few important dynamics in the NZ economy at present. One is that nominal income growth is strong. But be wary that because it is being boosted by the terms of trade it need not necessarily show up in real GDP growth. Today's figures also suggest that some of the extra nominal income is being channeled more toward investment rather than saving – that is tantamount to a bigger current account deficit.

In today's figures, the surprise, to us at least, was chiefly in a bigger investment income deficit driven by the debit side. Higher profits accruing to offshore entities, in effect. This can be seen as a positive to the extent that it signals a generally better profit environment in the economy as a whole, with foreigners taking their share as payment for the use of their capital. A supportive profit environment sits well with a buoyant sharemarket, positive business confidence and firms' elevated profit expectations from various business surveys.

The goods and services trade figures overall were also a small net contributor to the wider overall deficit compared to our expectations. While Q1 exports of services were 0.7% higher than a year earlier, it was less than we expected. It might well be a timing issue, related to the timing of Easter this year, which possibly affected the seasonally adjusted figures as well. We expect a bounce back in Q2. It could well be a very big bounce back given the extra tourism boost from NZ hosting the Masters Games and the current Lions Rugby tour during the quarter.

The indicative strength in profits says good things for nominal GDP growth, with Q1 figures due out tomorrow. However, we still have reservations about real GDP

Current Account - Q1			
$NZ billions	**Actual**	Mkt Expected	Previous
Annual Balance (% GDP)	**-3.1**	-2.7	**-2.8R**
Annual Balance	**-8.1**		**-7.2R**
Unadjusted Qtly Balance	**+0.2**	+1.0	**-2.4R**

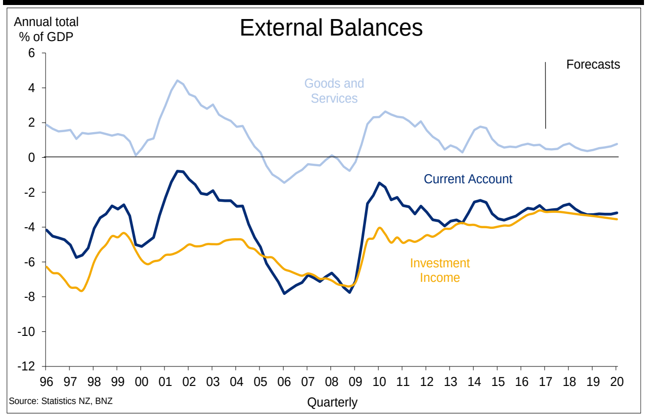
R - revised

growth for the quarter. Indeed, the details in today's trade data only add to those reservations. For example, deflating the nominal services export figures above suggest a decline in real terms on a quarterly seasonally adjusted basis. That would be a drag for real growth in the quarter. Also, nominal goods imports were stronger than we inferred from the previously released overseas trade figures. Deflating these implies stronger import volume growth than was indicated by the earlier trade data.

Our formal forecast for Q1 GDP tomorrow remains 0.5% q/q, based on the production indicators. But today's trade figures do make our expenditure-based measure of GDP look sick in Q1. Maybe we are under cooking investment in the quarter, given the prevailing strong profitability conditions and widespread high levels of resource use that is evident across the economy. Or maybe expenditure-GDP is due to come in well under the official production measure of GDP, following a run of outperformance over the past couple of years.

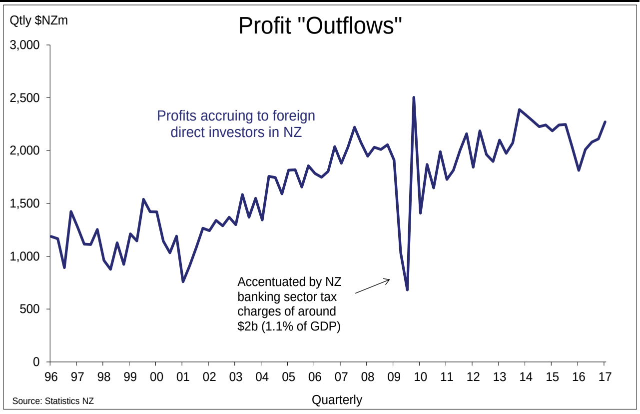
What today's numbers do seem to confirm is that nominal income growth is strong and that the nation's external accounts remain relatively benign. Sure, the tick wider in the current account deficit bears watching to see if it widens further. But at current levels, it remains small by NZ standards and well shy of its 10-year average (4.1% of GDP) and even further below the level that gets on investors' and rating agencies' risk monitors.

Looking Benign

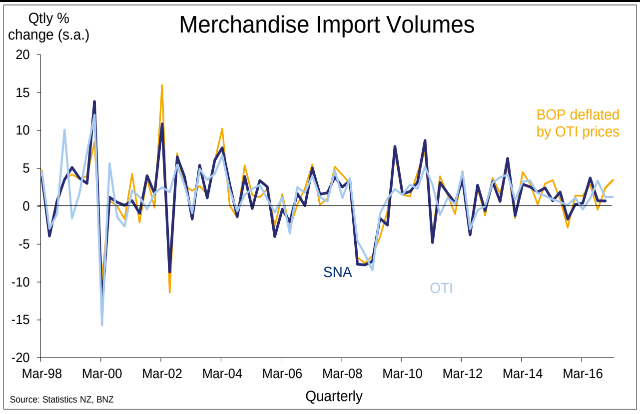


National Australia Bank

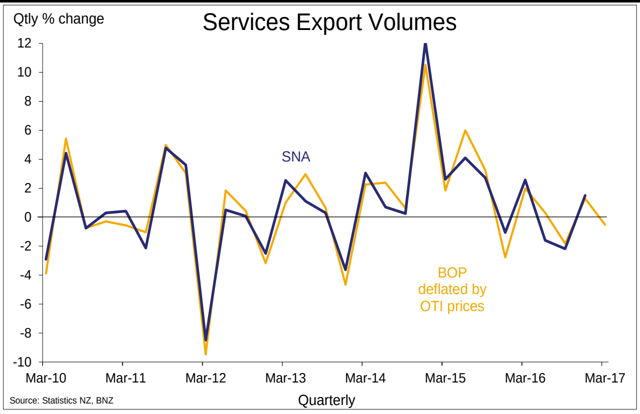
A General Profit Imporvement?



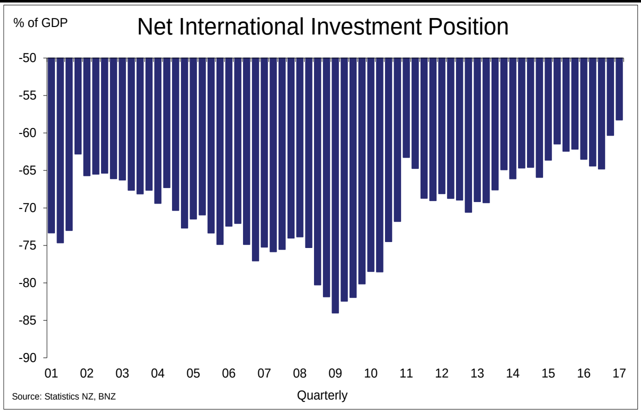
Imports Volumes Much Stronger



Easter Timing?



Small Net Liability Position



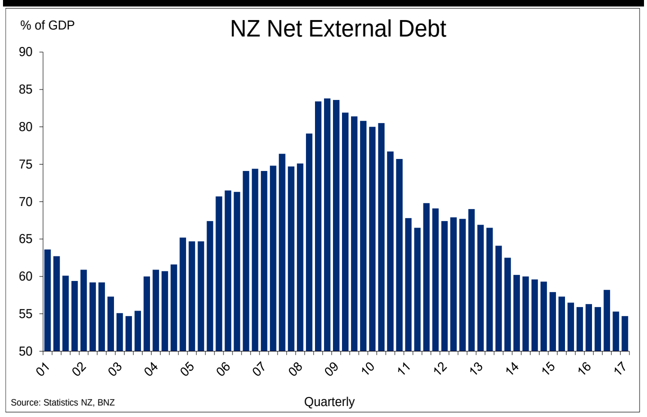
In this vein, it is worth pointing out that the current account deficit has been small enough to help the NZ's net international investment position (NIIP) show a smaller liability position as a share of the economy over recent years – a trend that has continued into 2017. As at the end of March 2017, the NIIP stood at -58.5% of GDP, a smaller net liability position than the -60.4% recorded a quarter earlier, and a significant reduction from the peak liability position of -84.0% recorded early in 2009.

While the overall position remains an economic vulnerability, it is the smallest net liability position as a share of the economy since the current series started back in 2000. The NIIP's direction of travel is encouraging. NZ's net external debt has fallen to 54.7% of GDP from a peak of 83.8% in 2008.

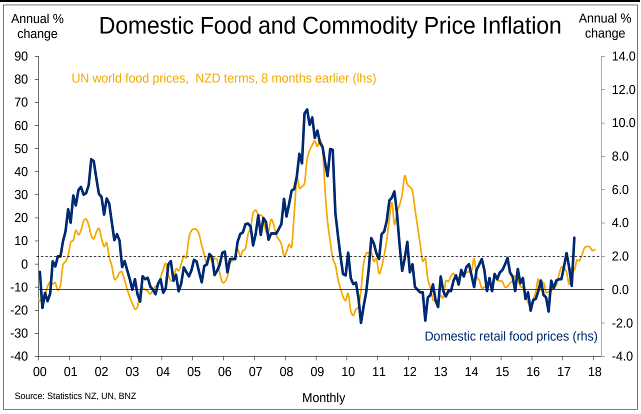
But it is worth watching the current account deficit ahead, given the hint it today's numbers of more of a tilt toward investment away from saving than we were anticipating. Maybe we are understating future investment given the likes of current constraints and strong (nominal) income growth. While that could see stronger economic growth than we are projecting, it could also see a wider current account deficit that the circa 3% we see over the coming year or so and maybe also a bit more inflationary pressure than we anticipate in the first instance.

Speaking of inflation, this morning's data that showed a 2.4% lift in May food prices was more than the 1.1% increase we had penciled in. Food prices are up 3.1% on a year earlier. Extreme weather in April (remember the cyclones) drove prices higher in May with vegetable prices up 16.2% m/m, following a 10.1% lift in April. Vegetable prices are up 30.9% on a year earlier. While the weather effect will unwind in time, May's food prices do nudge our estimate for Q2 CPI upwards. We see annual CPI inflation at 0.2% q/q and +1.9% y/y in Q2. Today's food prices also help set the base for Q3 CPI calculations where we currently see +0.7% q/q and 2.2% y/y. For comparison, in its May Monetary Policy Statement the RBNZ forecast annual CPI inflation at 2.1% for both Q2 and Q3.

Net External Debt Down



Food Prices Spike



Through the monthly food price wiggles, recent international food price and currency movements suggest that there is likely some upward drift in food price inflation occurring, beyond the near term weather/vegetable spike.

doug_steel@bnz.co.nz

Contact Details

BNZ Research

Stephen Toplis
Head of Research
+(64 4) 474 6905

Craig Ebert
Senior Economist
+(64 4) 474 6799

Doug Steel
Senior Economist
+(64 4) 474 6923

Jason Wong
Currency Strategist
+(64 4) 924 7652

Main Offices

Wellington
60 Waterloo Quay
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Phone: +(64 4) 473 3791
FI: 0800 283 269

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Phone: +(64 9) 976 5762
Toll Free: 0800 081 167

Christchurch
111 Cashel Street
Christchurch 8011
New Zealand
Phone: +(64 3) 353 2219
Toll Free: 0800 854 854

National Australia Bank

Peter Jolly
Global Head of Research
+(61 2) 9237 1406

Alan Oster
Group Chief Economist
+(61 3) 8634 2927

Ray Attrill
Global Co-Head of FX Strategy
+(61 2) 9237 1848

Skye Masters
Head of Interest Rate Strategy
+(61 2) 9295 1196

Wellington

Foreign Exchange	+800 642 222
Fixed Income/Derivatives	+800 283 269

Sydney

Foreign Exchange	+(61 2) 9295 1100
Fixed Income/Derivatives	+(61 2) 9295 1166

London

Foreign Exchange	+(44 20) 7796 3091
Fixed Income/Derivatives	+(44 20) 7796 4761

New York

Foreign Exchange	+1 212 916 9631
Fixed Income/Derivatives	+1 212 916 9677

Hong Kong

Foreign Exchange	+(85 2) 2526 5891
Fixed Income/Derivatives	+(85 2) 2526 5891

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