15 December 2021

External Deficit To Widen Further

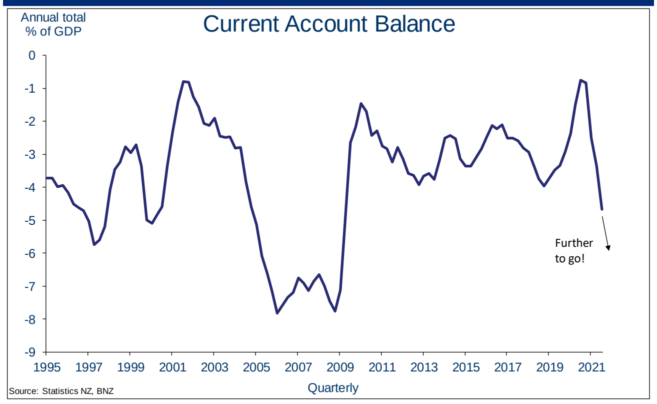
- **Annual current account deficit expands aggressively**
- **We think it will continue to do so**
- **To more market and rating agency attention**
- **No late mail for tomorrow's Q3 GDP data**
- **Net liability position halts decline**
- **More foreigners buy Government debt**

New Zealand's current account deficit for the year to September stood at 4.6% of GDP. This was a tick bigger than market expectations of a 4.5% result, although not quite as large as the 4.7% we had anticipated.

Forget the decimal points, the bigger picture is that the external deficit continues to widen aggressively. The annual deficit was 3.3% of GDP in the year to June and was only 0.7% of GDP a year ago (when domestic demand collapsed in the initial stages of the pandemic).

We have long been forecasting a bigger deficit – today's figures essentially confirm this trajectory. Importantly, we don't think the expansion has finished yet. We continue to forecast a bigger annual deficit ahead, approaching 6% of GDP through next year.

Deficit to Expand Further



The annual deficit is starting to get to a size that might garner some attention – from markets and rating agencies. It is a potential headwind for the NZ dollar. At 4.6% of GDP, the annual deficit is at its largest since 2009.

A bigger deficit indicates domestic saving is falling further behind investment. A bit like rising inflation, it adds to the case that demand is putting considerable pressure on the economy's productive capacity. As such, it supports the notion that recent trends are unsustainable such that further removal of monetary stimulus is required.

Of course, the RBNZ does not target the external deficit. But in the current context, a rapidly widening external deficit looks to be a symptom of a wider issue where the economy is exceeding its speed limit. Note the RBNZ, in its November MPS, anticipated an annual deficit equivalent to 4.3% of GDP for today's figures.

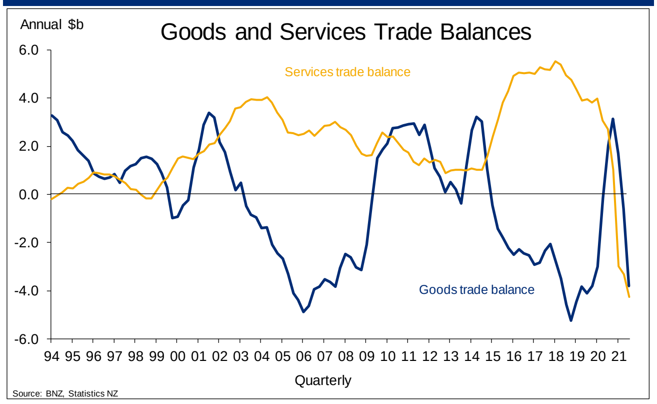
It is always worth pointing out that a deficit need not necessarily be a bad thing. It depends on what the money is used for. Invested wisely, the money can lift potential growth and generate positive future returns. But indicators suggesting excessive consumption and less saving is not so good. In any case, if the money is squandered, and future returns are not good enough, a bigger deficit can leave the country more vulnerable to future shocks and downturns.

Looking briefly at the components, familiar trends are seen:

- A lack of tourism (not helped this quarter by the closing of the Trans-Tasman bubble) sees travel exports around a quarter of their pre-COVID self.
- Higher international freight costs continue to lift the value of services imports. International transportation costs overall lifted another 25% in Q3, on a seasonally adjusted basis, to be nearly double that of a year ago.
- Very strong goods imports reflecting both robust domestic demand and higher prices. For Q3, Stats NZ note higher imports of crude oil, fertilisers, and vaccines.
- Rising goods export values, underpinned by buoyant primary product prices.

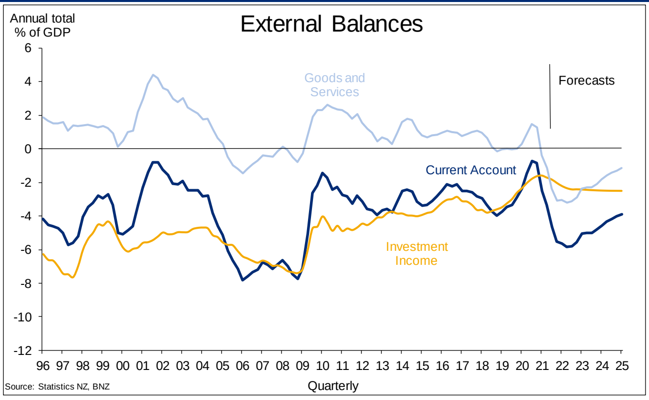
The first two points have contributed to a massive collapse in the services trade balance. From a circa $4b annual surplus pre-COVID to around a $4¼b annual deficit now.

Deficit Not Just A Lack Of Tourism



Meanwhile, the sheer strength of imports has overwhelmed resilient exports such that the annual goods balance is again nearing a $4b deficit (after pushing into surplus a year ago when imports slumped as the pandemic broke).

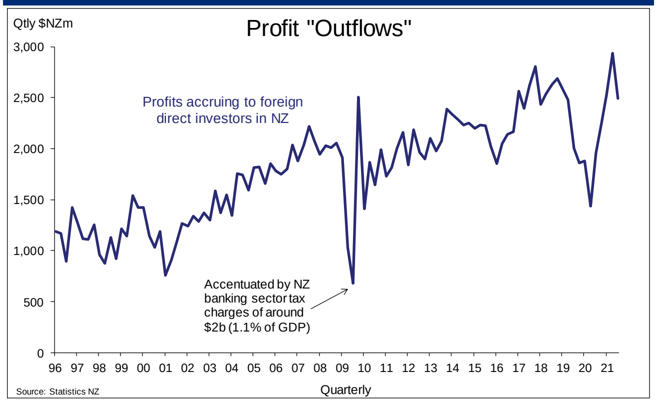
Bigger Deficits Expected To Persist



On the investment income side of things, we note profits accruing to foreign direct investors in NZ fell in Q3. We take that as a sign of generally lower profits in Q3, as economic activity was impaired by lockdowns from mid-August.

There was nothing into today's trade figures that require us to make any last-minute changes to our estimates for tomorrow's Q3 GDP figures. Somewhere around -4% remains our view, albeit with wide margins of error.

Lower Profits

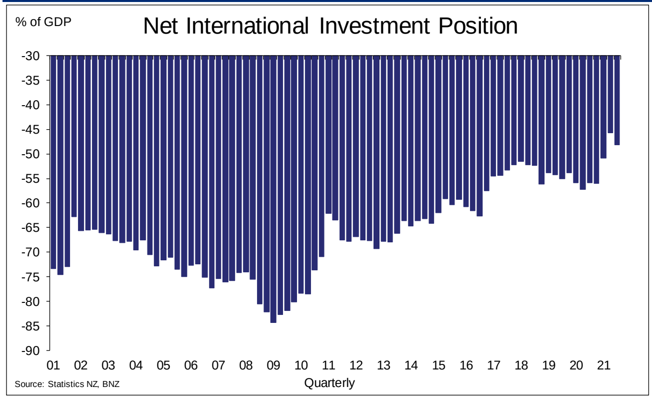


NZ's net international investment position (NIIP) stood at -47.7% of GDP as at the end of September. This represents a bigger net liability position compared to the -45.3% of GDP recorded in Q2, following a period of material net liability reduction (aided by offshore asset revaluations). This position will be worth watching as a bigger current account deficit starts to put upward pressure on net liabilities.

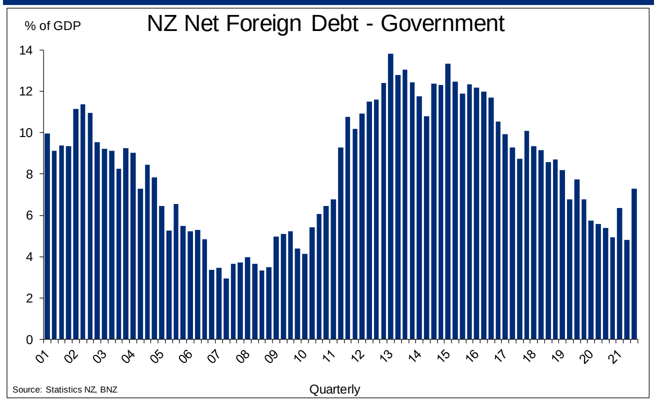
In Q3, the increase reflected a decline in NZ's international assets as sales more than offset some revaluation gains and an increase in NZ's holdings of IMF Special Drawing Rights. NZ's international liabilities rose.

Finally, an increase in the foreign investment in New Zealand Government issued debt securities followed the RBNZ halting buying using the Large-Scale Asset Purchases (LSAP) programme in July 2021. With the RBNZ stepping back from the market for NZGS, most of the September 2021 quarter's rise in the level of NZGS available to the market was taken up by non-resident investors. This coincides with a step up in the Government's net foreign debt (from a low 4.8% of GDP to a still low 7.3%).

Net Liability Reduction Stopped



Foreigners Buy More Government Debt



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