Research

Economy Watch

20 September 2023

External Deficit Coming Back from The Brink

- **Annual current account deficit slims to 7.5% of GDP**
- **Assisted by favourable revisions**
- **External deficit to abate further, gradually**
- **But fiscal deficits integral to the (many) headwinds**
- **No clear cause to change our Q2 GDP pick of 0.6%**

New Zealand's current account deficit has more clearly come down from its record heights of calendar 2022. But then it needed to, and needs to slim by a lot more yet, before it's perceived as being out of the danger zone.

From the figures released by Stats NZ this morning, the external deficit trimmed to 7.5% of GDP in the year to June 2023. This was a decent amount under market (and RBNZ) expectations of an 8.0% result. We anticipated 7.9%.

The June quarter deficit, of $4.21b, was about $350m less than expected, which helped. But net revisions to the better, predominantly to the March quarter (shared mainly across services and investment income), also assisted. Accordingly, the year to March deficit was revised to 8.2% of GDP, from its initially judged 8.5%.

This clearer turning down in the current account deficit is a definite relief, but hardly anything to celebrate for what it is. 7.5% of GDP annually – or $29.8b – is still a big number, even in New Zealand's long tradition of running deficits; averaging 3.7% of GDP since 1988. The record high, over that stretch, by the way, is still marked for calendar 2022, albeit now estimated at 8.8% of GDP, rather than 9.0%, as was previously measured.

Current Account - Q2 2023

$NZ billions	Actual	Mkt Expected	Previous
Annual Balance (% GDP)	**-7.5**	-8.0	**-8.2R**
Annual Balance	**-29.8**		**-31.8R**
Unadjusted Qtly Balance	**-4.2**	-4.6	**-4.7R**

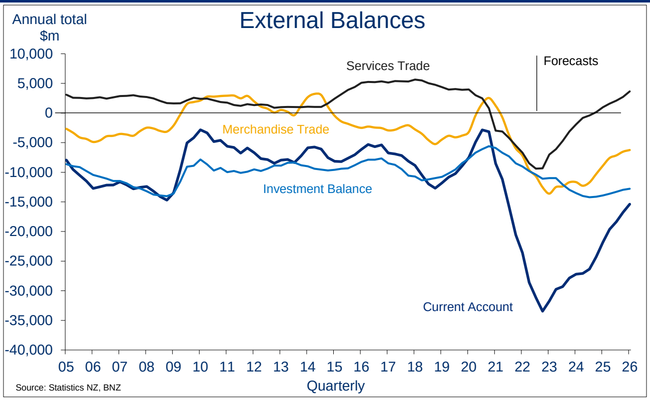
R - revised

From all of this, it's clear the external deficit needs to keep heading lower, if it's to give the impression of correcting itself. We do forecast further abatement. But nothing dramatic, with targets of 7.0% of GDP for calendar 2023 and 5.9% for 2024.

Important to this is a fuller recovery in the services balance of the current account, back into its customary surplus. This process is underway but patently has some way to go.

Helpfully, it looks as though travel services exports (think: spending by short-term visitors to NZ) posted a degree of further recovery in Q2, albeit not nearly as punchy as in prior quarters. We were earlier worried about a stumble for Q2 "tourism", but not so much now.

More reduction likely, on balance



Also, there is a slowdown in merchandise imports playing out, that is taking pressure off the current account deficit. This is following a veritable binge during the pandemic years (and associated lockdowns), which was a key part of why the external accounts blew out so much.

Indeed, we get the impression, from this morning's data, that import volumes fell with a bit of thump in Q2, whereas we have a moderate increase in goods imports factored into our GDP thoughts for the quarter. But we qualify this with the fact the balance of payments data for Q1 infers an increase in goods imports in real terms, whereas the GDP accounts showed a sizable fall.

The differences may or may not be reconciled by the unusually large "conceptual adjustments" that the balance of payments made to its imports data for Q1 and, to a lesser degree, Q2. But the bottom line is that the difficulties in estimating, and interpreting, quarterly movements in goods imports continues in size.

At the same time, however, there are clearly headwinds to the current account deficit naturally pulling its head in, like it has often done in years and decades past.

Even if imports are coming off the boil, New Zealand's commodity export prices have done so too. And the latter is yet to really wend its way into the annual current account tallies. This is a reminder of the terms of trade boom the nation benefited from during the pandemic period, but which has since lost its strength (even before global oil prices started ramping back up, as they now are).

Merchandise trade figures gave the first real taste of this in July, with exports dropping 14% compared to year-ago values. We expect Friday's trade figures, for August, to affirm the negativity.

True, this morning's dairy auction showed a further recovery in product prices. However, they were still down 24.5% on levels of a year ago. It is more about limiting downside, compared to last year, than anything to sustain such strong export returns.

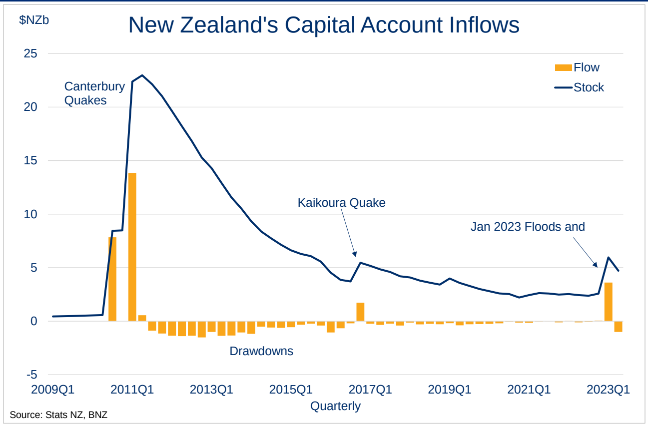
We expect Fonterra will affirm this broad picture, at its announcement of its 2022/23 results tomorrow. This is mindful the co-op's latest indication of the 2022/23 milk price is $8.20 and for 2023/24 is $6.75.

As much as the annual current account needs to brace for a backwash from commodity export prices, it also needs to factor in higher debt servicing costs, given interest rates have risen so much.

To be sure, New Zealand's net foreign debt, proportionate to the size of the economy, is nowhere near as high as it was as around the time of the Global Financial Crisis. But it still entails a decent amount of servicing, going forward.

Incidentally, New Zealand's international investment position, in Q2, used up about $1.0b of the $3.6b credit that came in for Q1 2023. The latter was mostly from reinsurance (paid by foreign-based insurers) related to the January/February storms, lest we forget those. For perspective, the reinsurance credits from the Canterbury quakes of 2010/11 were about $21.7b.

Accounting for the storms



That noted, we also need to point out the role fiscal policy is now playing, more fundamentally, in the current account deficit. The latter is equivalent, accounting wise, to the nation's imbalance between saving and investment. And the government operating deficits that were confirmed and forecast in last week's Pre-Election Economic and Fiscal Update highlight the degree of dissaving coming from the fiscal authorities. Meanwhile, the public investment side of the ledger will likely remain chunky. Infrastructure deficits, and all that.

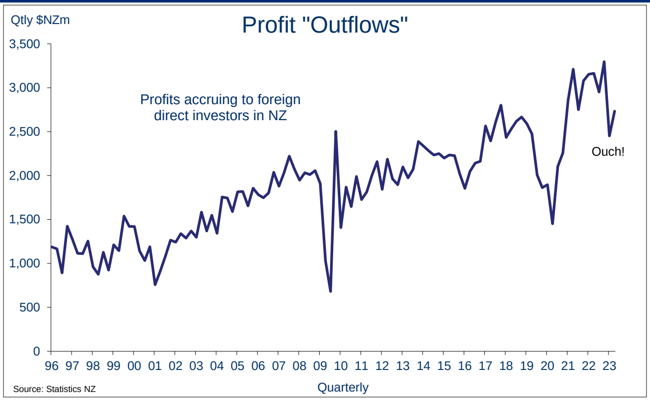
With all of this, deeply negative government cashflow is resulting, along with burgeoning Crown debt, which will require foreign investors to mop up.

This seems important, also, in that NZ governments, in running surpluses and limiting debt in years gone by, had built up a tradition of buying brownie points for assessing the nation's balance of payments. Especially in the eyes of the rating agencies. This aspect isn't inherent anymore.

Yet the credit rating agencies have found reason to maintain their relatively high ratings on the country. This is presumably on the basis New Zealand's fiscal deficits and debt – much enlarged as they are – are still not as bad as in many of the countries used as peer comparators. With the notable exception of Australia, which is running fiscal and current account surpluses.

While high rates of operating expenditure seem fundamental to New Zealand's fiscal deficits, a flattening in tax revenue is also a cause. And with corporate tax outright weakening. That business profitability is under the cosh was also indicated by the notional outflow of profits to foreign direct investors in today's Q2 current account statistics. Sure, it bounced a bit from Q1. But Q1 slumped quite a bit. The Q2 outflow of profits was still down 14% compared to year-ago levels.

One way to reduce the external deficit



As for how this measure, or any of today's data on exports and imports, of goods and services, might influence our view on Q2 GDP, it's very difficult to draw any strong conclusions, on balance. Even in a risk sense. So, we'll stick with our quarterly growth of 0.6% for tomorrow's GDP report but while also reiterating that the potential for non-trivial revision to prior quarters seems relatively high.

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