ANZ Research

NZ Forecast Update: Current account outlook

1 July 2020

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Contact

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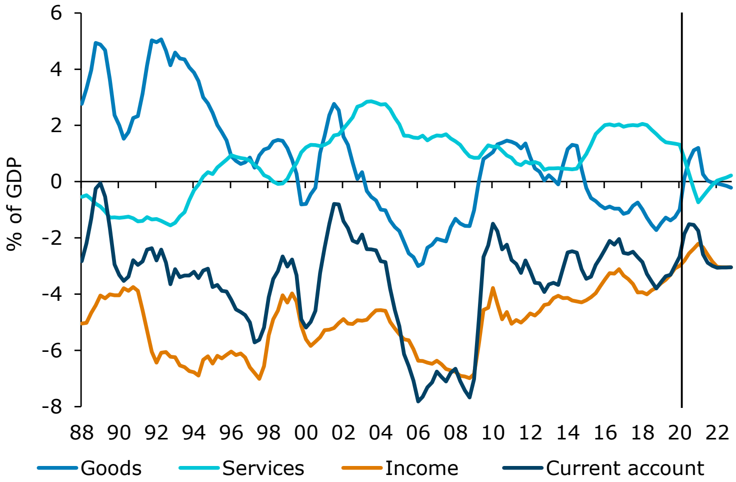
Contained

Key points

- We expect the current account deficit to remain contained, averaging 2.5% of GDP over the next couple of years. But there will be significant volatility in these data in the near term.
- Weak domestic demand, buoyant goods exports, and low debt servicing costs are expected to provide a substantial offset to a dramatic deterioration in net exports of travel services owing to border closures.
- There's little in this current account outlook to drive major adjustment in the NZD.

Figure 1. Annual current account outlook



Source: Statistics NZ, ANZ Research

New Zealand has a long history of running persistent current account deficits, and that's reflected in our relatively large net external liability position. In short, we tend to spend more than we earn, and that's cumulated into a position of the rest of the world owning more of us than we do of it.

Provided deficits remain broadly stable and sufficiently small as a share of GDP there isn't too much to worry about. However, a marked build-up in net external liabilities would make New Zealand vulnerable to a sharp and disruptive outflow of foreign capital. But that doesn't seem to be an issue for the here and now. This past business cycle has been characterised by relatively contained deficits (averaging around 3% of GDP over the past 10 years or so) and a shrinking net liability position (from over 84% of GDP in 2009 to 58% currently), and we think the structural elements that have contributed to this will continue for a while yet.

When it comes to forecasting the current account, there are lots of moving parts to consider. In this note we discuss the outlook for the various components that combine to make up the current account (ie net exports and income flows). We also discuss the broader macro drivers that influence the external balance. All up, we expect the current account deficit to remain broadly contained over the coming years.

Net exports and income outlook

Like most data at present, the current account is going to be quite noisy in the near term:

- Services exports and imports (eg tourism- and education-related travel) are going to shrink markedly in Q2 as travel services evaporate on the back of closed borders. And they won't bounce back until borders reopen.
- Trade disruption will be a source of volatility for both exports and imports of goods. Meanwhile, there have been some very volatile price moves, particularly oil, that's yet to work its way through the quarterly trade data.
- The timing and composition of net income flows will be impacted by the agreement between NZ's retail banks and the RBNZ not to pay any dividends on ordinary shares until further notice. Meanwhile, the massive increase in NZ Government bond issuance (a large portion being taken up by overseas investors) and the Reserve Bank's LSAP programme will create some gnarly inflows and outflows.

Looking through the noise (and there will be a lot of it), we expect the current account deficit to remain broadly contained. But there will be some significant offsets.

So long as our borders remain closed to short-term visitors, New Zealand's services balance is expected to flip into deficit. This balance had been running at a surplus of around 1.3% of GDP prior to this crisis. In fact, Q2 could mark the first recorded seasonally adjusted services deficit since 1998 as both travel services exports and imports fall off a cliff (figure 2).

In the year to December 2019, travel services exports (5.2% of GDP) exceeded travel services imports (2.2% of GDP) to the tune of around $9.5bn (figure 3). That's a big positive offset to deficits in other parts of the current account – and it's about to evaporate. Excluding travel, New Zealand typically runs a services deficit with the rest of the world, and many of these services (such as legal, IT, and intellectual property) will not be affected (at least as significantly) by border closures.

Figure 2. Weekly border crossings, arrivals

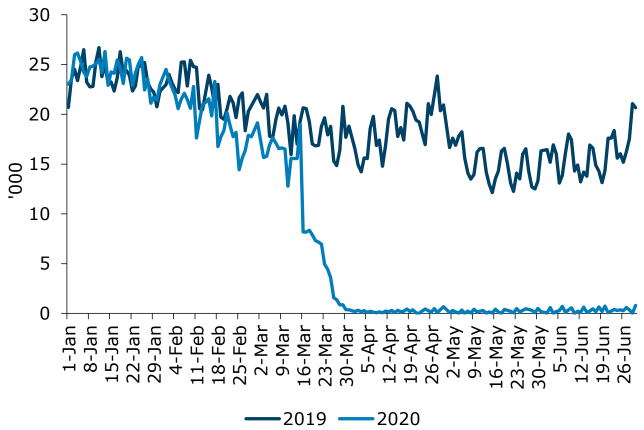
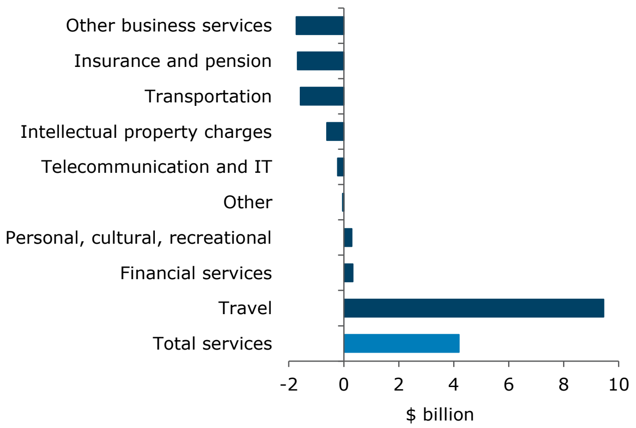


Figure 3. Annual net services exports by type (year to December 2019)



Source: Statistics NZ, ANZ Research

It's not just the impact on tourism that's reflected in these figures. Education-related travel services (which came in at $4.6bn in the year to December 2019, accounting for 17.6% of total services exports) are also largely closed for business until further notice.

The day our borders reopen to short-term visitors will be a glorious day for the services balance, but your guess is as good as ours in terms of when that might be. Ultimately, it's going to come down to virus developments. For forecasting purposes, we assume borders will begin reopening from Q1 2021, but given recent virus developments this is beginning to feel a little optimistic.

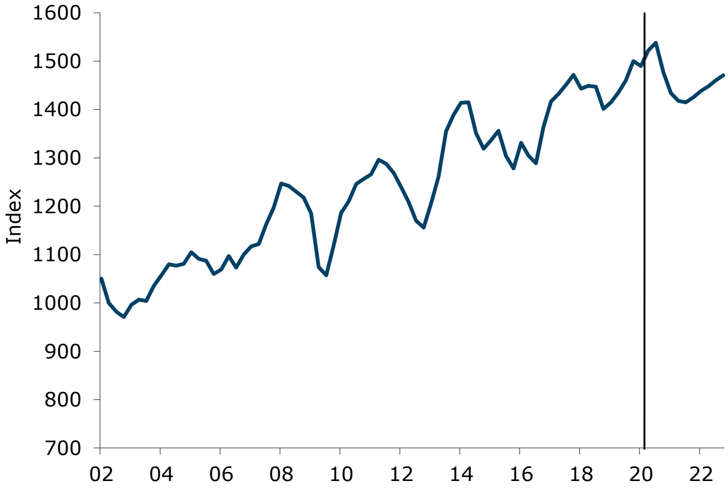
But even when borders reopen, the global economy is not going to be what it was. And that's going to make it pretty tough going for international tourism. Households (both here and abroad) will be feeling wary about the outlook, and some will be facing significantly reduced incomes through job losses, reduced hours and possibly pay cuts. Given an international holiday fits firmly into the nice-to-have basket when it comes to consumer spending, the number of visitors coming to New Zealand for a holiday is likely to be much lower than previously. So while the reopening of our borders is expected to see the return of services surpluses once again, export tourism receipts are expected to be softer. It will be a challenge for the tourism sector to pivot from the volume-driven growth model of the past towards higher-value tourists, but that's something that could provide some offset.

Education exports are more likely to return to normal once borders reopen. That's because fewer employment opportunities generally result in more people entering tertiary education. Combine that with NZ's COVID success story and demand could be quite high. However, we think keeping the general public COVID-free needs to take preference to export receipts. A second stint at Alert Level 4 lockdown would cost the economy a lot more than education exports could ever offset. Caution is warranted.

On the goods side (eg exports of dairy, meat, and logs and imports of cars and petrol), we expect the recent deficit will flip into surplus in short succession. That'll provide a broad offset to the services deficit. Aside from trade disruption, the main reasons for this are:

- **Weak domestic demand**. This will weigh on consumer, intermediate and capital goods import volumes. As is typical during a downturn, business investment is expected to contract particularly sharply and that will see capital goods imports plummet. See page 5 for more on aggregate investment dynamics. Conversely, weak import prices (owing to sub-par global demand) together with a buoyed NZD will provide some offset to softening import volumes, particularly of consumer goods. But overall, we expect imports to weaken.
- **Relatively buoyant agricultural exports**. While drought will weigh on export volumes in the near term, prices for key export commodities have proven relatively robust. Going forward we expect demand for our key exports to remain solid – people need to eat. However, softening global incomes will keep downward pressure on export prices.
- **Resilient terms of trade.** Beyond the near-term boost to the terms of trade (partly owing to very weak oil prices) we expect the weak global economy to drive a moderation in the terms of trade, but still see it holding at a respectable level (Figure 4). Nonetheless, this will unfortunately prevent significant widening in the goods surplus.

Figure 4. Goods terms of trade



Source: Statistics NZ, ANZ Research

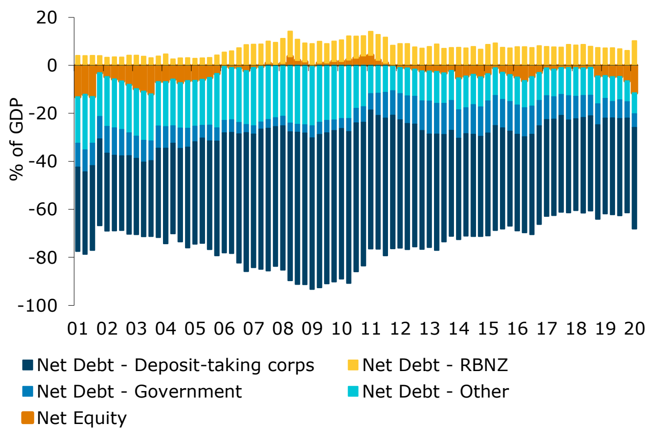
Over the medium term, prospects for a sustained net exports-led recovery will be hindered by the elevated NZD-TWI. While good for NZ consumers, an elevated NZD will provide little support to import-competing firms. It will also erode the competitiveness of our exporters in global markets and weigh on export earnings. And when the day finally comes that NZ's borders are reopened, the NZD will be a key determent of how many visitors decide to come to New Zealand, and how much they spend when they're here.

When it comes to the income balance, we expect to see quite a bit of volatility in both inflows and outflows in the near term. Over the medium term, however, we expect weak foreign investment into New Zealand (reflecting weak investment globally) and relatively buoyant domestic savings (see page 6) to keep net foreign liabilities contained.

That said, there will also be volatility in our net external position in the near term, with quarter-end valuations for Q1 occurring close to the recent trough in global equities (Figure 5), and Q2 looking like it will capture the pretty heroic recovery from 2020 lows since then.

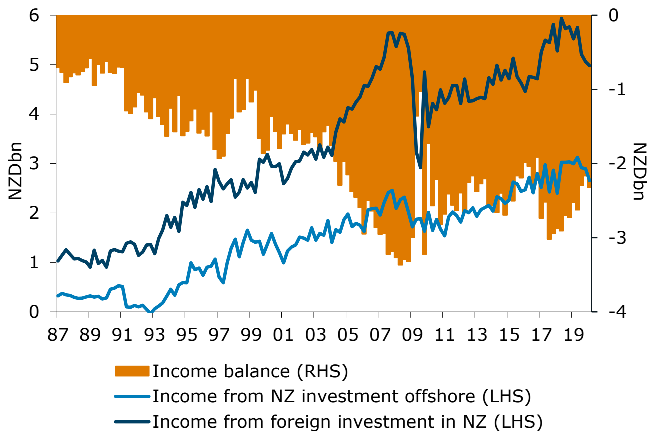
While the stock and composition of net external liabilities will influence net outflows significantly over the longer run, low global interest rates (both cyclically and structurally) are expected to keep debt servicing payments low. And that will help keep deficits contained.

Figure 5. Net international investment position



Source: Statistics NZ

Figure 6. Income inflows and outflows

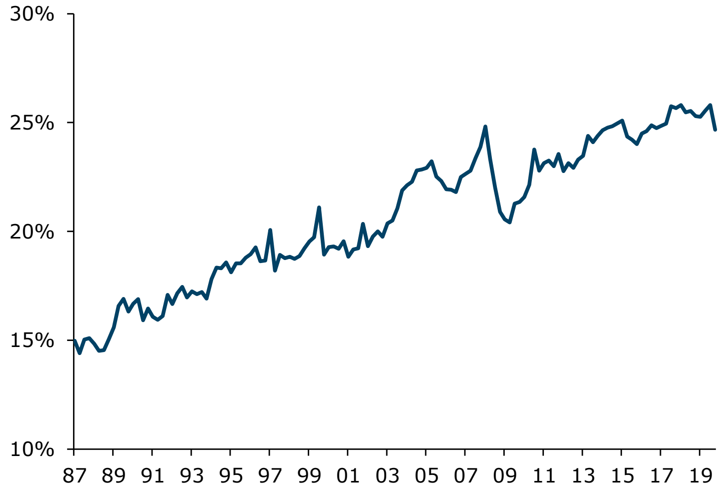


Domestic demand and external balance

Domestic demand plays a key role in determining the current account. That's because consumption and investment expenditure have a significant imported component – one that's been trending higher for quite some time (figure 7). But in times of crisis, this tends to shrink. There are a number of factors at play here.

- A lower exchange rate will typically weigh on import volumes by making them more expensive than otherwise (not that the NZD has fallen by much this time around).
- Demand for luxury and non-discretionary durable goods like big screen TVs (the stuff we don't tend to make in NZ) plummets.
- But what really cements this dynamic is weak business investment and lower capital goods imports, as this form of spending is particularly sensitive to economic uncertainty and weak consumer demand.

Figure 7. Import penetration ratio[1]



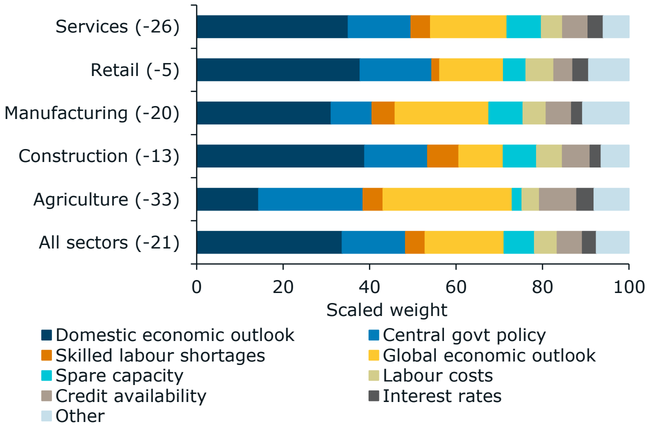
Source: Statistics NZ, ANZ Research.

In fact, there's a lot more to the relationship between investment and the current account than that. In an open economy, current account deficits arise when domestic savings are insufficient to fund total investment. That is, for a given level of national savings, an outlook for weak investment implies a narrower current account deficit than otherwise (in the case of NZ, at least, given the already large stock of external liabilities). And as is typical in a downturn, we expect investment to weaken materially.

Business investment makes up the lion's share of total investment, and even though the nominal cost of investment has reduced with a lower OCR, weak inflation expectations mean the real interest rate (which is what really matters for spending decisions) hasn't moved as much. As is typical in a crisis, we think it will take a while for business confidence to return to levels where investment begins to lift once more. Our ANZ Business outlook suggests that the main driver of net negative investment intentions is the domestic economic outlook (Figure 8), with interest rates and credit availability quite low down on the list (but this does vary a bit by sector). Ongoing uncertainty around the economic outlook is expected to weigh on investment for quite some time.

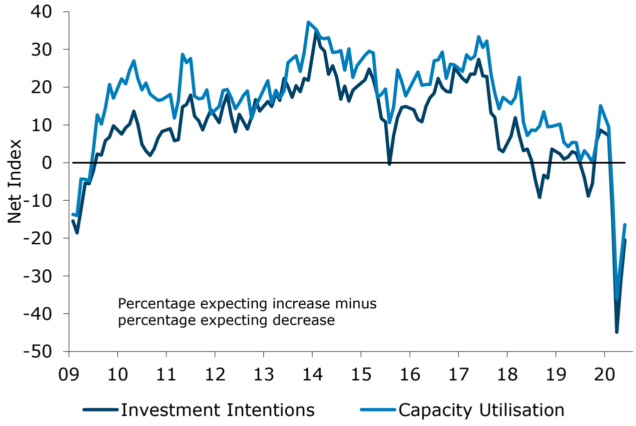
[1] Calculated as the ratio of total imports to Gross National Expenditure plus exports

Figure 8. Firms' key investment drivers by sector (June 2020)



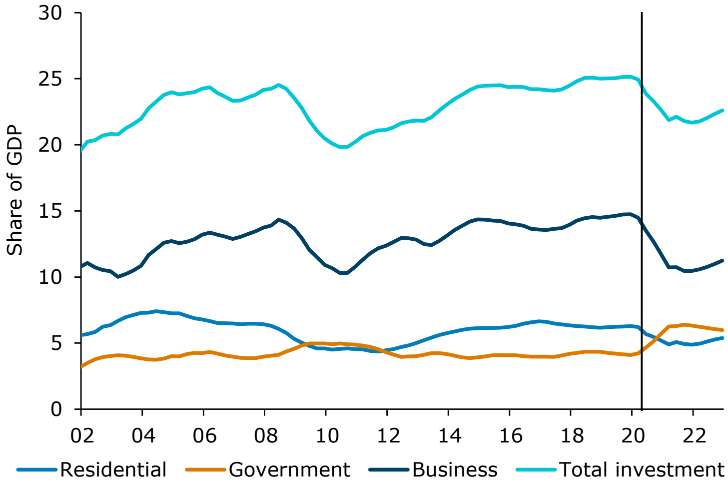
Source: ANZ Research

Figure 9. Investment intentions and capacity utilisation



While Government investment is expected to lift markedly, its relatively small share of the economy (figure 10) means it will only provide a partial offset to weak private sector activity – barely offsetting the expected decline in residential investment, let alone the fall in business investment.

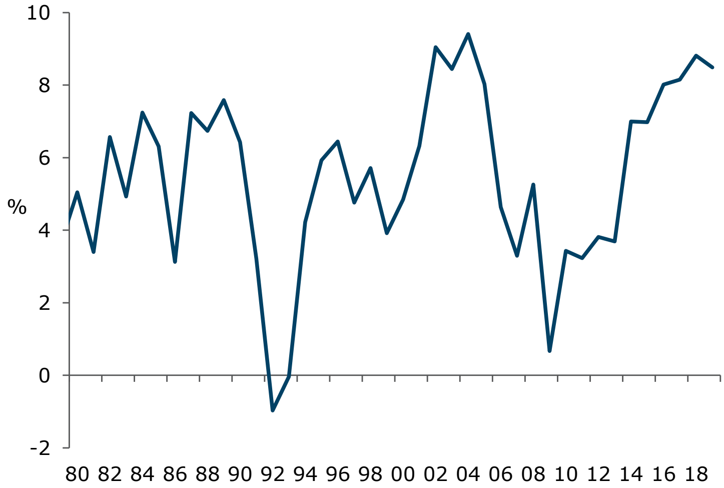
Figure 10. Investment share of GDP



Source: Statistics NZ, ANZ Research

On the other side of the ledger, the outlook for national savings is mixed. Caution among households is likely to drive up precautionary savings (as well as deleveraging), but weaker incomes will also see a few nest eggs gobbled up. Meanwhile, businesses are doing it tough, with many balance sheets under stress on the back of lockdown restrictions and missing tourists. Large transfers from the Government, alongside business lending schemes, will be causing some volatility in the near term. Overall, household savings are likely to lift slightly, with business savings remaining relatively buoyed. Conversely, Government savings are expected to deteriorate reflecting the outlook for large fiscal deficits. Overall, our expectation is that national savings as a share of disposable income will remain above 2008/9 lows, in part supported by QE, but some moderation is on the cards. Even so, weak investment is expected to keep the current account deficit contained.

Figure 11. National savings as a share of disposable income



Source: Statistics NZ, ANZ Research

That said, savings behaviour can swing markedly, with demographics, wealth and income expectations and consumption smoothing, real interest rates, inflation expectations, public debt and expectations for future taxes, and policy settings (such as superannuation) pushing and pulling in different directions. This crisis is set to materially impact a number of these savings drivers, making the outlook highly uncertain.

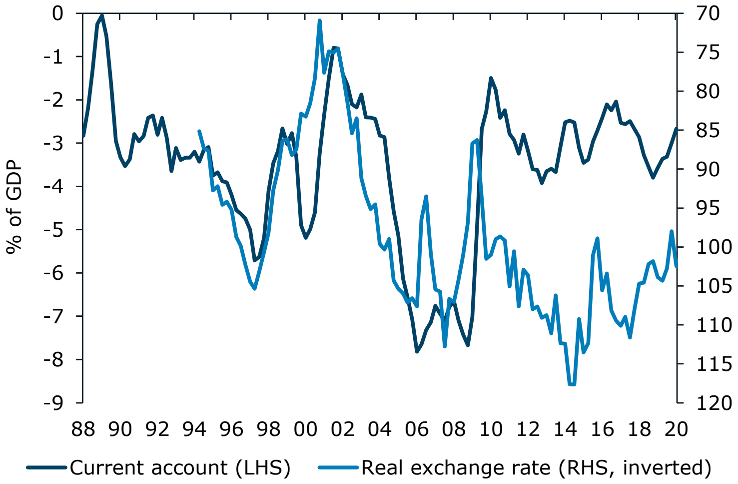
Implications for NZD

The relationship between the NZD and the current account is both uncertain and complex. This is especially true in the near term, where FX markets are driven by a range of factors such as risk appetite, expectations for policy settings, and high-frequency data flows.

Over the longer-term, the macro-balance theory of the exchange rate suggests that widening deficits will generally be associated with an offsetting NZD depreciation. However, figure 12 shows the relationship hasn't really adhered to this theory, with widening deficits associated with real exchange rate appreciations. This suggests that capital markets (influenced by the likes of relative interest rates and asset prices) have driven the exchange rate, which in turn has forced the current account to adjust (as opposed to causation going the other way).

There have also been compositional changes in the economy (such as import penetration) and financial markets (such as NZ's share of liabilities that are short term – ie less than 90 days – falling from almost 50% in 2008 to around 21% currently as banks lengthened their funding portfolios) that will be influencing FX dynamics. But importantly, our expectation that the current account will remain contained at around 2.5% of GDP over the next couple of years is consistent with our outlook for the NZD to remain close to current levels.

Figure 12. Real exchange rate and current account



Source: Statistics NZ, Bloomberg

Annual current account forecasts (% of GDP)

	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22
Current account	-2.7	**-1.9**	**-1.5**	**-1.5**	**-1.7**	**-2.6**	**-2.9**	**-3.0**	**-3.1**	**-3.1**	**-3.1**	**-3.0**
Goods balance	-1.0	**0.1**	**0.8**	**1.1**	**1.2**	**0.3**	**0.0**	**0.0**	**-0.1**	**-0.1**	**-0.2**	**-0.2**
Service balance	1.3	**0.8**	**0.3**	**-0.3**	**-0.7**	**-0.5**	**-0.3**	**-0.1**	**0.0**	**0.1**	**0.1**	**0.2**
Income balance	-3.0	**-2.8**	**-2.6**	**-2.4**	**-2.2**	**-2.3**	**-2.6**	**-2.8**	**-3.0**	**-3.0**	**-3.0**	**-3.0**

*forecasts in bold

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