NZ Insight: New Zealand's trade balance

19 October 2023

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Contact

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Confused by acronyms or jargon? See a glossary here.

Finding external balance

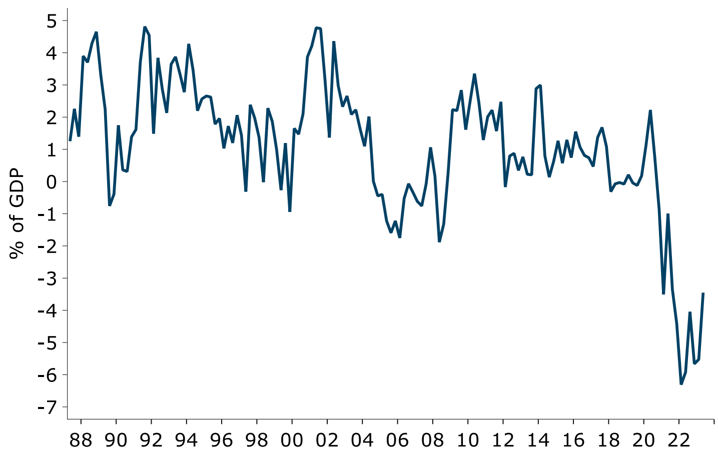
Summary

- New Zealand's trade balance is -3.5% of GDP – staggeringly wide by historical standards. To comfortably service our debts to the world we need it to close.
- Tourists returning, export prices recovering, and contractionary monetary policy will all help, but are unlikely to solve the problem alone.
- China's economic challenges (both cyclical and structural), environmental constraints and deglobalisation will make it difficult to continue to grow export values at the rate we have in recent years.
- If we don't fix our trade balance through proactive policy, everything we import (cars, computers, rice etc) may become more expensive through a weaker exchange rate, and interest rates may need to be higher than otherwise.

Broad context: we are living beyond our means

New Zealand is living beyond its means. Historically, New Zealand has earned more in export revenue than we have paid for our imports, allowing us to service our sizeable debts to the world. This is currently no longer the case. Our trade balance as a share of GDP was -3.5% in the June quarter of this year, compared to its 1987-2020 pre-pandemic average of around +1%.

Figure 1. Goods and services trade balance as a share of GDP



Source: Stats NZ, Macrobond, ANZ Research

This note lays out the cyclical and structural factors that are currently impacting New Zealand's external imbalance with a view to identifying which ones are temporary and on a clear path to improvement, if we're patient, versus those that look longer lasting and will require more than business cycle dynamics to address.

Our forecast for the current account incorporates both cyclical and structural factors as best we can, and when we weighed it up, we saw a relatively protracted period of deficits ahead. Our forecast is for the goods and services balance to narrow significantly from current unsustainable levels but to remain in deficit over our forecast horizon (to December 2025).

As a net debtor nation, New Zealand is reliant on the (self-serving) 'kindness' of strangers for funding. Unless we restore our ability to pay our way in the world within a reasonable timeframe, the world will force it upon us, either through a lower exchange rate, higher interest rates, or both. This would fix our external deficit by eroding our standard of living – everything we import (cars, computers, rice etc) would become more expensive, which is unpleasant at the best of times but potentially problematic if domestic inflation were still to be running high at the time. The most extreme scenario would be an availability of credit shock where New Zealand is forced to undergo the adjustment in a very short space of time, equating to a nasty recession.

Temporary and cyclical factors

Some of the deterioration in the trade balance can be explained by temporary and cyclical factors: border settings (both NZ and foreign); central bank tightening across many of our trading partners, weighing on demand for our exports; and an overheated domestic economy, which has boosted imports.

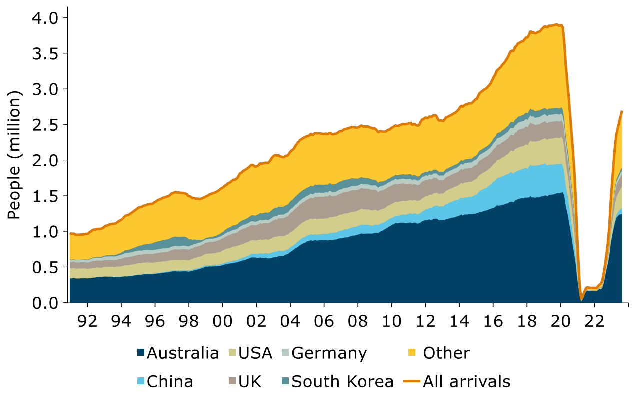
Tourists are returning

With the border now having been open for a year, the tourism recovery is well underway. Tourists are back and spending, albeit not yet to the same extent as pre-pandemic. Right now, we are seeing strong volumes from the US and Australia but tourist arrivals from China remain very subdued (figure 2, over). This compositional change reflects three things:

1. Demand from our tourist markets closely tracks the performance of their local economies. When consumers have spare income and are confident about the future, they are much likelier to take a holiday to somewhere far flung. The US economy continues to surprise with its resilience, with near-record-low unemployment, while China's economy is currently struggling on a number of fronts, including real estate, which is near and dear to consumers.
2. China spent more time in lockdown than in most western countries, and emerged later. Tourists from the US were free to travel much earlier.
3. Tourist numbers from China have been low partly because, until very recently, China banned outbound group travel to Australia. Around 80% of China group tourists go to Australia and New Zealand as a combo tour, so although NZ was one of a few favoured nations to be unbanned earlier this year it didn't make a big difference. But Australia being unbanned might.

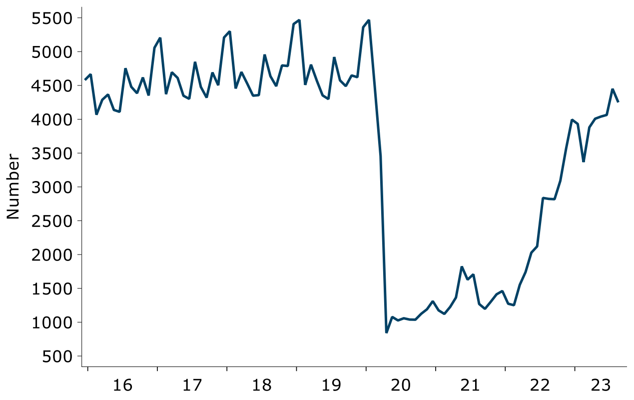
We still don't know how much of the tourist rebound is a temporary boost from pent-up demand and how much reflects the start of a sustained recovery, given where we are in the global economic cycle. We are expecting reduced tourist volumes from China to continue for a while yet and risks are skewed towards Chinese tourist numbers taking longer to recover to pre-COVID levels than hoped.

Figure 2. Short-term visitor arrivals



Source: Stats NZ, Macrobond, ANZ Research

Figure 3. Auckland Airport international aircraft movements



Source: Auckland International Airport Ltd, Macrobond, ANZ Research

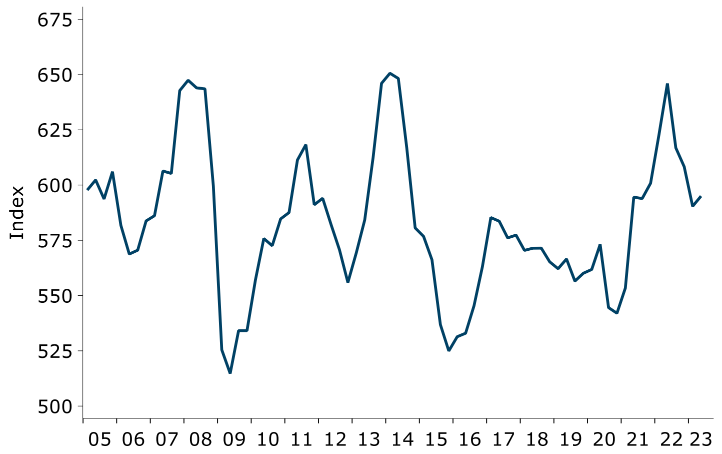
Our tourism recovery is also being delayed by a lack of aircraft worldwide. Many airlines reduced their fleet sizes over the pandemic and have not yet been able to replenish them. For example, Air New Zealand retired its eight 777-200ER aircraft and is not intending to replace them, lowering airline capacity to/from New Zealand unless/until competitors choose to fill the gap or new, replacement aircraft arrive. Recently this has resulted in higher airfares and less overall capacity compared to pre-COVID – not good if you're a tourism business reliant on volumes. However, overall airline capacity to New Zealand continues to steadily increase, while still being beneath pre-pandemic levels (figure 3).

Agricultural exports are under pressure from weak prices – and now a potential drought

New Zealand's food export prices are not keeping up with on-farm costs – in fact they've been going in opposite directions! A lot of this is cyclical weakness as our trading partners are going through tougher economic times – some deliberately engineered by monetary policy to cool inflation, some not (China). Dairy prices are now improving, but from extremely low levels. And it is not just the dairy industry that is struggling; prices have tumbled for virtually all of our export commodities, from lamb and mutton, to logs and wine – see our Agri Focus.

The recent lower prices for export goods were not reflected in the Q2 trade numbers, which are close to their long-run average in real terms. The extent of cyclical weakness will only become fully apparent later this year.

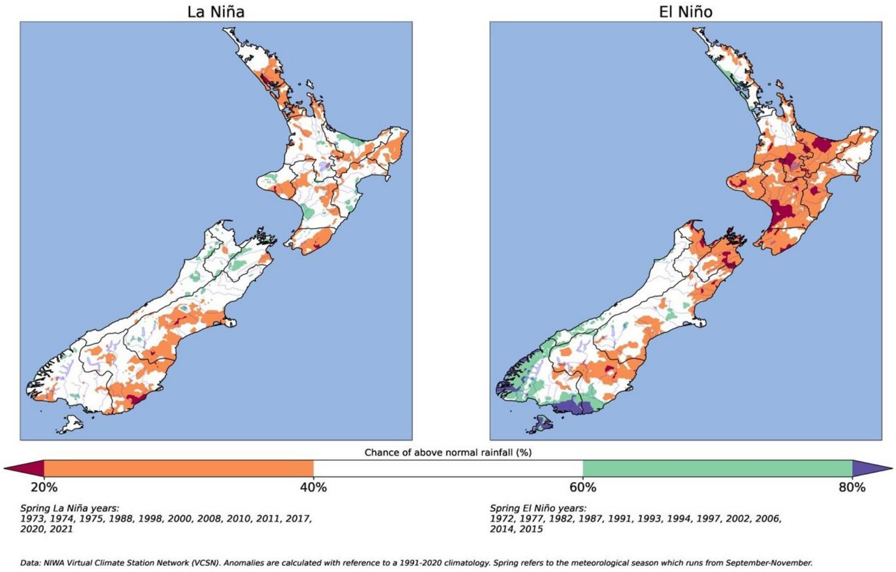
Figure 4. Export prices in real TWI terms



Source: Stats NZ, RBNZ, Macrobond, ANZ Research

The other near-term risk to agricultural export values is an El Niño event this summer, which has the potential to cause a drought, depressing milk volumes but bolstering meat production in the near term (as farmers destock). El Niño is expected to develop in the next month or two, with NIWA assessing a 95% chance of it continuing through summer 2023-2024. No El Niño is exactly the same – each comes with a unique set of climate characteristics and therefore can influence the weather differently. But this one is looking like the strongest in decades.

Figure 5. Typical rainfall patterns during El Niño - NIWA

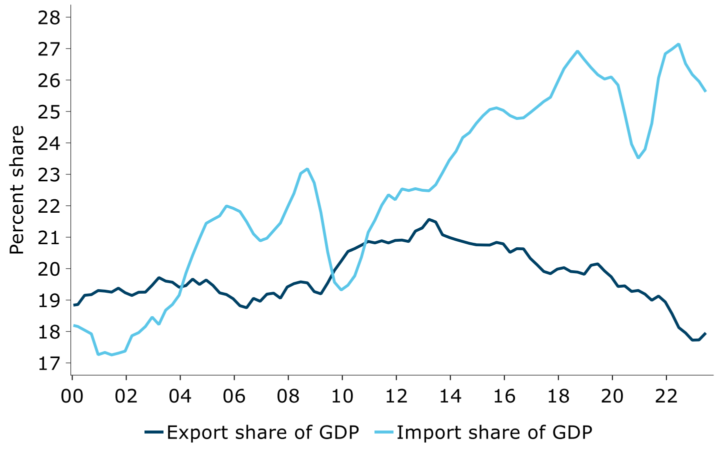


Contractionary monetary policy will reduce import volumes

Cyclically, import volumes are elevated, due to a period of buoyant domestic demand. As the RBNZ's 525bps of OCR hikes work their way through the economy, domestic activity and hence import volumes are cooling. The discretionary element of private consumption is skewed towards goods imports (think smartphones, whiteware, new cars), meaning the cooling of the economy will reduce the import share of GDP. It's a similar story for business investment, where high interest rates will reduce the amount of new plant and machinery imported.

The power of this cyclical channel is evident in the data – the recession associated with the Global Financial Crisis did wonders for the trade balance, even though exports were challenged by a drought. Exports were also helped at this time by a structural lift in demand for dairy products from China, due to the melamine crisis which severely limited demand for China's local dairy produce, as consumers favoured imports goods that they considered safer.

Figure 6. Goods exports and imports as a share of GDP



Source: Stats NZ, Macrobond, ANZ Research

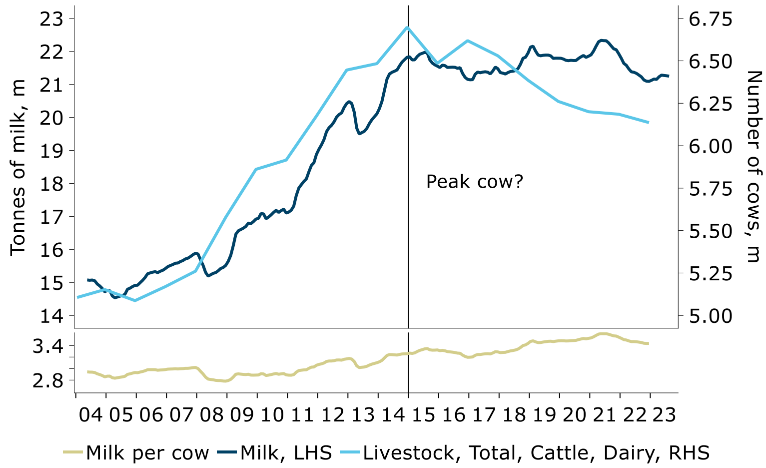
Longer-term factors

The business cycle is one thing. But structural elements are at play in New Zealand's trade balance as well. In this section we outline some of the factors that are playing on our minds when we think about longer-term economic forecasts.

Peak cow

New Zealand's dairy herd is declining. A combination of environmental regulation, limited high-quality land, and rising costs are contributing to the national herd size falling. Despite this, New Zealand's milk solids output has remained relatively steady, as dairy cattle and pasture productivity has improved. This has allowed the country to produce more with less resources. However, ongoing productivity growth alone is unlikely to be sufficient to return our export volumes to early-2000s growth rates, meaning we either need attain higher prices for our export goods – by adding value [1], or services exports will have to take up the baton, or we will have to import less.

Figure 7. Peak cow



Source: Stats NZ, DCANZ, Macrobond, ANZ Research

[1] We don't attempt to answer the question of how best to achieve that in this paper. But see for example Fit for a Better World – Update 2023, Integrated value chains and Moving from volume to value: how do we make it happen.

Export commodity prices should find long-term support…

Although New Zealand’s export commodity prices have fallen significantly recently, there are structural factors that will support them over the medium term.

Demand for food, particularly high-quality foodstuffs, is likely to keep growing in line with world population growth. Despite declining birth rates in western economies, the world’s population continues to grow, driven by Africa and the Indian subcontinent. At the same time, global land supply is fixed and water supplies are becoming less reliable, meaning there is limited ability for the world to increase food production without significant negative environmental impacts. The current structural imbalance in food supply is likely to provide a long-term floor to our export commodity prices and keep them on an upward trend for the foreseeable future – albeit still with significant cycles around that trend.

From a longer-term perspective, prices of different food commodities tend to move together – for example if milk gets cheaper relative to other sources of protein, buyers will substitute to buying dairy. While this doesn’t help farmers get through this season, it does provide optimism that the good times will return.

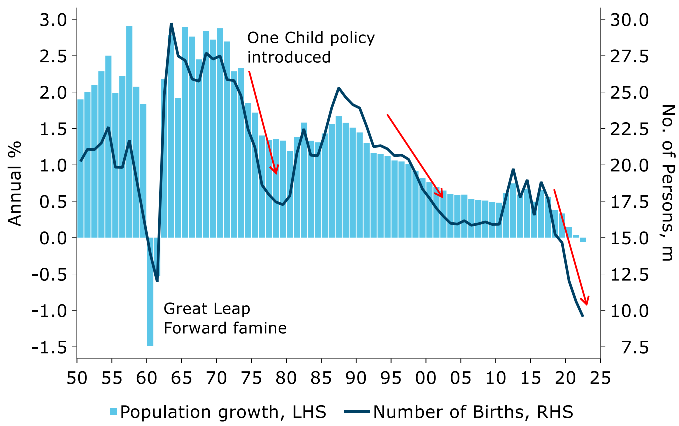
… but China’s demographics presents structural risks…

While these long-term factors are likely to provide a floor for our export prices, they are currently being offset by weaker demand from our traditional export markets and the threat of new synthetic alternatives. In the past year the population of China declined (figure 8) and the historical one-child policy means China’s growing elderly population is dependent on an ever-smaller base of income earners. China’s property sector is also showing the limitations of debt-fuelled growth and there's no quick fix.

These structural changes in China will persist, and mean that while their demand can still grow, it won’t be at the rate we have benefited from over the past 15 years. But even if China can only maintain growth of 2-3% y/y that’s still a lot of extra demand, given the size of their economy. At the end of the day we can only feed one ‘small’ Chinese city.

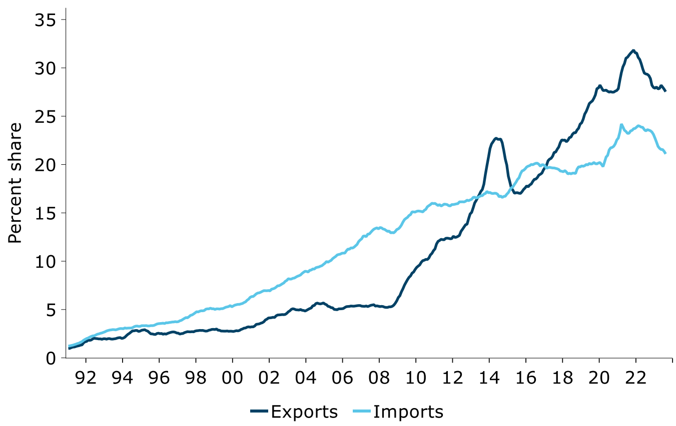
While it is easy to talk about diversifying our exports to other markets, this tends in practice to be slow and laborious, and may be difficult to do in a world of rising protectionism. Diversifying would make us more resilient. India is the obvious candidate for diversification, but the big issue there is lack of a reliable cool chain and current protectionist trade policies. Trade will grow, but probably not as fast as we’d prefer.

Figure 8. China’s birth rates



Source: NBS, Macrobond, ANZ Research

Figure 9. China’s share of NZ trade



Source: Stats NZ, Macrobond, ANZ Research

… and synthetic meat and dairy may reduce demand for the real thing

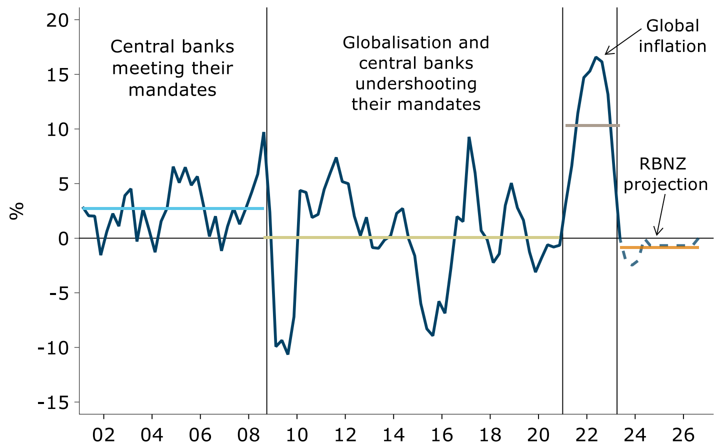
Our agricultural industry risks being partly supplanted by synthetic meat and dairy, particularly for low-value, volume-based products. Scientific breakthroughs such as fermented foods must and will eventually play a larger role in the global food production system if the world is to be fed, but at present this can’t be achieved in an economically sustainable manner. Much like electric vehicles, as this technology matures it will become higher quality, cheaper and more accessible to mass-market consumers. New Zealand’s high-quality, grass-fed, low-emission protein products will always have a place in this new world, but are unlikely to have the growth opportunities of the last two decades presented on a plate, as it were.

Deglobalisation

Globalisation allowed New Zealand to import goods ever more cheaply as global productivity enhancements improved supply-chain efficiencies and lowered production costs abroad. This slow-burn positive supply shock contributed to inflation in many advanced economies undershooting central bank mandates in the 2010s and contributed to the neutral long-run OCR declining from around 5% pre-GFC to 2.25% today (going by the RBNZ’s estimates). Some of these efficiencies, such as shifting factories to countries with lower labour costs, were one-off purchasing-power benefits to New Zealand that cannot be replicated in coming decades.

The limitations and risks of globalisation came to the fore during the COVID period, when just-in-time and highly specialised supply chains were shown to be highly fragile. This has prompted something of a rethink, particularly as regards essential goods like energy and medicines, encouraging governments and multinationals to ‘re-shore’ production at home or amongst friends, in countries with higher cost bases. For now, the normalisation of supply chains and weaker global demand is seeing imports get cheaper (as demonstrated in the Q3 CPI outturn), but prolonged periods of falling import prices appear less likely going forward.

Figure 10. New Zealand import prices



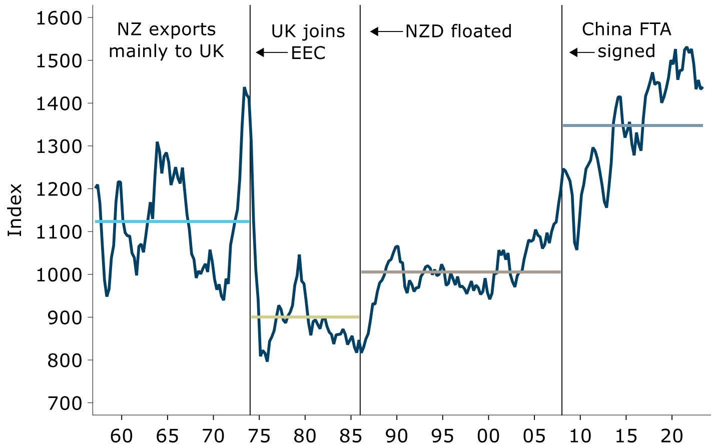
Source: RBNZ, ANZ Research, Macrobond

The globalisation trend is also under pressure from intensifying geopolitical tensions between China and the United States and the general division of the world into ‘opposing’ camps. Tariffs have been re-imposed on US imports from China, under both the Trump and Biden administrations. A less-globalised world means it's harder to sell exports, and we possibly have fewer options when we go shopping for imports as well.

Lower global trade volumes probably also don't help shipping links to a little country at the unfashionable end of the world, potentially adding to import costs.

More expensive imports relative to exports would imply a lower standard of living is required to achieve external balance, all else equal. But as noted above, our export prices are also trending up, and it’s far from clear that New Zealand is going to be on the wrong side of it overall. The price of meat versus a laptop has been trending New Zealand’s way for the past 15 years, even if it doesn’t feel like it right now. But the upward trend in our terms of trade (export prices divided by import prices) may flatten off somewhat.

Figure 11. New Zealand’s merchandise terms of trade



Source: Stats NZ, Macrobond, ANZ Research

New Zealand is relatively well placed to adapt to climate change

The other complication to throw into the long-term mix is climate change. Hotter temperatures and more weather extremes will make food production more volatile. Droughts, floods and cyclones will more frequently damage crops and require expensive recovery efforts. We can pivot towards crops more resilient to hotter and more extreme weather, and these are being developed globally as a matter of urgency. But whether this will be sufficient to offset lost production in our current highly productive industries remains to be seen.

Despite lower production, scientific modelling suggests New Zealand’s food production capacity may be less hard-hit from climate change than our competitors, including Australia[2], although there will likely be significant variation across New Zealand. We are surrounded by vast ocean, which insulates our temperatures to some extent, absorbing extra heat from the atmosphere. In relative terms, this is a competitive advantage. Upwards pressure on the price of our exports means the overall effect of climate change on the value of our agricultural exports and our trade balance is uncertain.

Transitioning to a lower-carbon world is likely to place a small offset on the imports side of the ledger. Currently, the New Zealand economy is heavily reliant on imported oil. To the extent we manage to reduce that dependency, we will reduce our import volumes relative to the size of our economy, all else equal.

[2] Chapter 11 of Climate Change 2022: Impacts, Adaptation and Vulnerability from the IPCC comprehensively discusses changes to New Zealand and Australia’s food production from climate change. Tables 11.3a and 11.3b outline projected changes by climate variable.

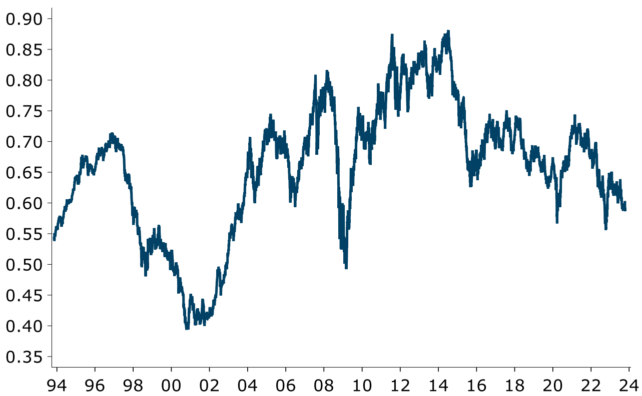
The path of adjustment

New Zealand's extraordinary trade deficit is a reflection of the imbalances brought about by the COVID era. But it is unlikely to just be a cyclical blip. Structural imbalances have also emerged over the last decade. On net, these structural factors seem likely to be negative for the country's trade balance going forward. If it's going to be more difficult to grow export values going forward, something has to give.

There are several ways our trade imbalance could adjust to more sustainable levels, after accounting for the temporary movements discussed earlier. A good news story would be if new technologies, or more efficient land use, or ever-higher prices for our exports could return the economy to rising export values as a share of GDP, meaning that we could afford our imports and service our debts without sacrificing too much in lifestyle terms.

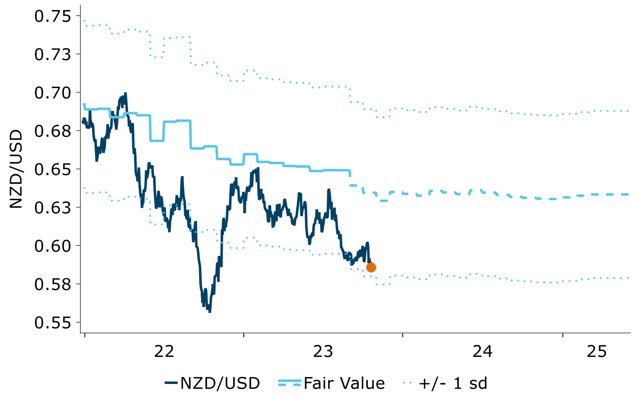
A bad news story would be if import flows continued to grow faster than export receipts to the point that discipline was imposed upon us via the long-term level of the real New Zealand dollar exchange rate. Figure 12 shows just how wide the NZD's trading range against the USD has been in the past 30 years. ANZ's view is that the fair value of the NZD/USD exchange rate over the next couple of years is a touch above 0.60, taking it back to levels prevailing in the 1990s. The risk is that the longer-term fair value for the exchange rate ends up adjusting closer toward 0.50 to reset our burgeoning trade balance. If this occurs, New Zealand consumers would be poorer as the cost of imports would higher – your cash is worth less. But that would help exporters and fix our trade balance.

Figure 12. NZD/USD



Source: Bloomberg, Macrobond, ANZ Research

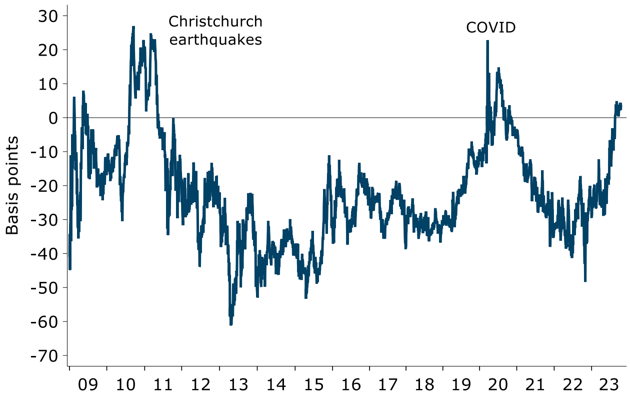
Figure 13. NZD/USD and ANZ's fair value estimate



Source: Bloomberg, Macrobond, ANZ Research

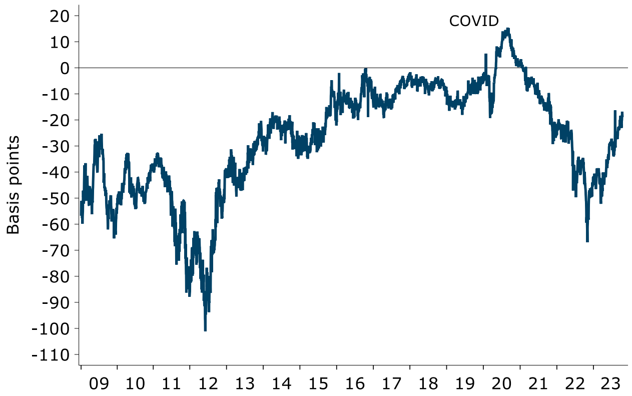
This type of adjustment could be quite abrupt, forced on us through higher than-otherwise interest rates as markets and lenders demand a higher premium for the risk of lending to such an imbalanced economy. We are starting to see some evidence consistent with this – it is no longer purely a hypothetical. We note, for example, that the New Zealand Government is now having to pay a much larger premium relative to inter-bank swap rates than previously when issuing government debt (figure 14). This may be because markets are becoming increasingly concerned about the structure of the New Zealand economy, the enormous trade and current deficits and therefore the sustainability of the Crown accounts. Currently the NZ Government pays a premium of +5bp over inter-bank swaps, well above the post-GFC norm of around -35bp. The premium is at levels that have only been seen during the GFC, Christchurch earthquakes and COVID, when New Zealand was undergoing acute economic stress.

Figure 14. New Zealand asset swap spreads



Source: Bloomberg, Macrobond, ANZ Research

Figure 15. Australian asset swap spreads



Source: Bloomberg, Macrobond, ANZ Research

Conclusion

NZ has a large external imbalance. Some is temporary and coming right – albeit not painlessly as we collectively 'cool our jets', reducing import demand. But unfortunately, continuing to grow export values at the rate we have in recent years looks challenging. China struggles, environmental constraints and deglobalisation are all counting against us. There are tailwinds as well – the relative price of food has been rising and is likely to continue to do so. And while our external balance is a black mark against our name, we have many other structural assets: a robust democracy, strong institutions and rule of law, food security, and plenty of land and water.

But at the same time, we have to keep it real in terms of adjusting when our national income changes, as running up debt can only ever be a short-term fix. We tried it in 1972 when the UK joined the European Community, overnight excluding much of our exports from their markets. NZ became instantly poorer but spent the next couple of decades trying to pretend it wasn't, which didn't go well. The bottom line is, 'something's gotta give', as the saying goes. We can either be the collective architects of that change or we can wait for changes to be imposed on us by foreign creditors and financial markets.

Meet the team

We welcome your questions and feedback. Click here for more information about our team.

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