Research
Economy Watch

19 June 2024

Narrowing But Large

- **Current account deficit narrowing, but large**
- **Imports stronger than expected, on adjustments**
- **More volatility to consider for Q1 GDP tomorrow**
- **Large deficit, weak growth on rating agency watch**
- **RBNZ Conway talks inflation**

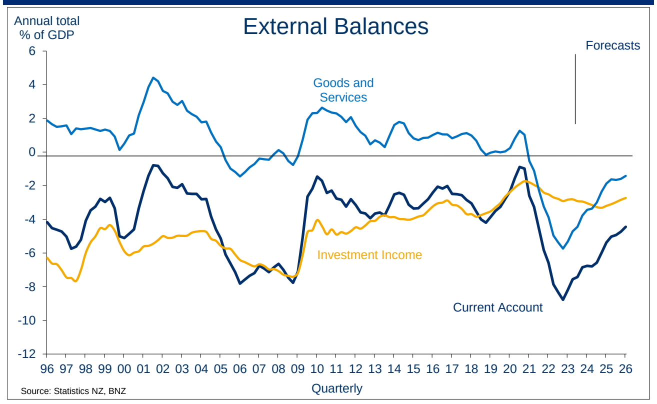
The current account deficit stood at the equivalent of 6.8% of GDP in the year to March 2024. This matched market expectations, although was a little larger than the 6.6% we anticipated.

The annual deficit is still a touch narrower than the 6.9% reading in the previous quarter and is meaningfully smaller than the 8.8% it peaked at in 2022. The deficit is smaller than it was, but it is still relatively large. We suspect that combined with weak economic growth, the deficit will remain on the radars of rating agencies.

We should note a deficit in and of itself is not necessarily a bad thing. In part, it depends on what the funds are used for and what return is achieved over time. But a large and persistent deficit can increase vulnerability and risk.

Today's figures suggest some slowing in the narrowing progress. Our forecasts show some stickiness next quarter too, before narrowing continues. We see the annual deficit around 6% for this calendar year and dipping below 5% in 2025.

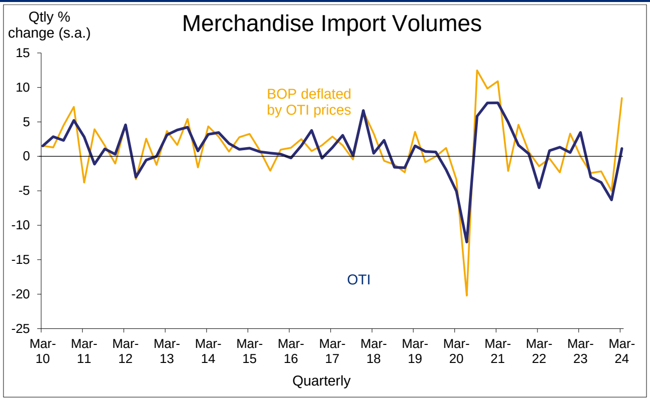
Narrowing, slowly



For us, the main difference to expectations came through imports of goods. The underlying import figures matched the trade figures already published, but there are always adjustments made for balance of payments purposes (often to do with the difference between when change of ownership happens and when something crosses the border). This quarter the adjustment (upwards) was the largest ever, enlarging imports.

This may well flow through to Q1 GDP figures tomorrow. If so, mechanistically, this might lead one to think there is downside risk to Q1 GDP tomorrow. But we are reluctant to draw that conclusion, as if imports are indeed stronger than we had built in for tomorrow's GDP release, there is also likely to be some offsetting influence in things like inventory and investment.

Bigger imports than indicated by trade figures



Indeed, one could argue that a somewhat larger current account deficit than we were expecting might suggest some upside to our -0.1% pick for Q1 GDP tomorrow. The thinking being that a larger deficit is akin to there being either a bit less national saving or more investment compared to what we had thought, on a nominal basis.

In any case, trying to estimate quarterly real GDP outcomes off nominal trade figures is fraught with danger and even more so when things are so volatile. We will stick with the production indicators for GDP that suggests a weak outcome. We have -0.1% on the board for Q1 GDP, albeit that it is close to round up to flat. Today's data just emphasise the degree of noise.

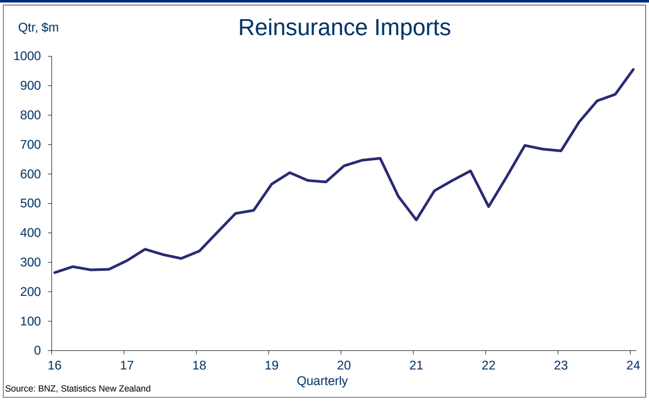
Looking across the major balances within the current account reveals clear narrowing in both the goods and services deficits (even with the upside surprise on good imports, they were still down 4.4% on a year ago). We anticipate further narrowing in both.

The goods deficit is expected to narrow as imports continue to track below year earlier levels reflecting soft domestic demand, while exports show modest growth supported by higher commodity prices in 2024 compared with 2023.

The annual services deficit shrank to $3.1b in the year to March 2024, down from a peak of $9.4b reached 18 months prior. This deficit is expected to narrow overtime as inbound visitor spending is expected to continue to recoup ground lost during the pandemic, although that recovery is slowing. International visitor spending in Q1 was up nearly 14% on a year ago. But the lift in the quarter itself was not as much as usually occurs in the first quarter of the year such that it declined on a seasonally adjusted basis. This is as we expected, and we think exports of services will show a sharp negative in tomorrow's GDP figures.

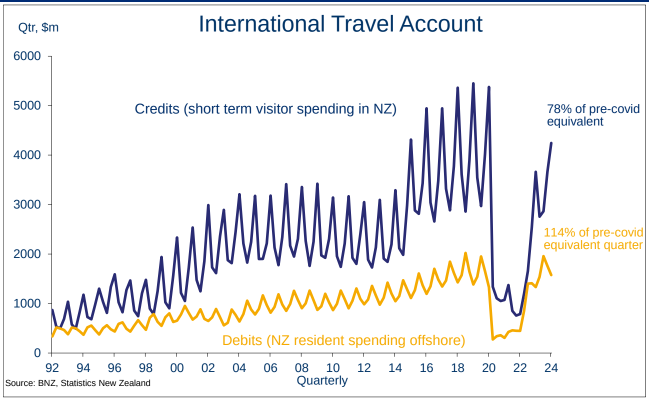
We don't see the services trade balance returning to surplus any time soon. Some of this relates to international tourism taking time to get back to pre-pandemic levels. But there are other factors on the import side too, like transportation (including international freight rates) and reinsurance components to keep monitoring with upward pressures of late. Reinsurance imports for the year to March 2024 were valued at $3.45b, up 30% or $1.3b from a year earlier.

Reinsurance costs rising



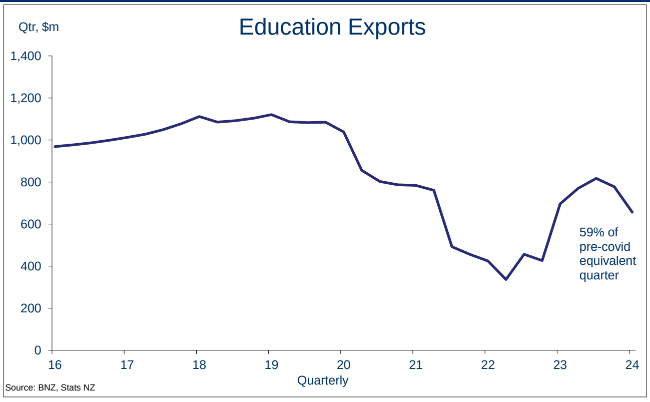
Back to visitor spending. In Q1 itself, it was up about 14% on a year earlier. That looks strong but it is still growth off a compromised base. Spending in the quarter was around 78% of the equivalent quarter pre-covid, on a nominal basis. That represents a significant hole compared to pre-pandemic levels.

The ins and outs of visitor spending



Education exports are a part of visitor spending. These softened in Q1. And the level remains significantly below pre-covid norms. Education export receipts – think foreign student spending in NZ – were only 59% of pre-covid levels for the quarter. That is a hefty hole in pre-covid revenue making its presence felt across various components of the economy exposed to such revenue.

Lower education

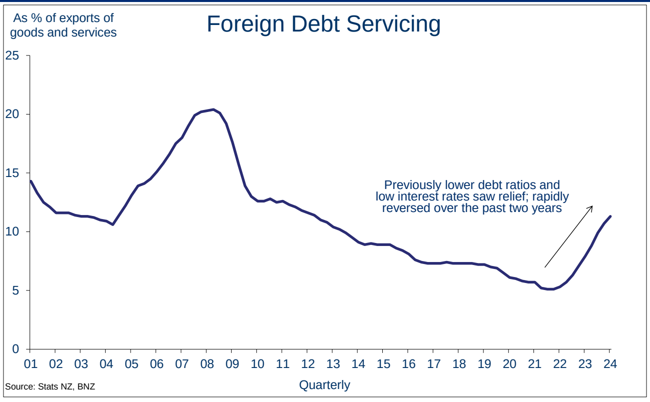


In contrast to total visitor spending in NZ, NZer's spending offshore has remained above pre-covid levels, at least on a nominal basis. NZer's spending offshore in Q1 was about 18% higher than a year ago and 114% of the equivalent quarter pre-covid.

Beyond the details, to the extent that a narrowing overall current account deficit represents a broader rebalance of supply and demand in the economy, it might be viewed favourably by the RBNZ. However, the current account deficit did not narrow as much as the 6.4% of GDP that the Bank published in its May MPS. Not that the Bank targets the external balance. But its policy rate does have influence on domestic savings and investment – the difference between which defines the current account balance.

Higher interest rates are lifting debt servicing costs which add to the nation's investment income deficit. Foreign debt servicing as a share of exports of goods and services has pushed out to 11.3% in Q1, from 10.7% in Q4, and 7.9% a year ago. This remains a headwind for the investment income balance and to the economy. Change in saving and investment behaviour takes time.

Debt servicing costs higher



Speaking of the Reserve Bank, its Chief Economist, Paul Conway, gave a speech today titled 'The road back to 2% inflation' while the Bank also released accompanying research. There was a lot to take in.

Our initial takeaways were that the Bank still has some reservations with annual inflation being above the target band. The summary noted there are 'some remaining challenges in bringing inflation sustainably back to target, with some risks and uncertainties attached.' The risks were two sided. But the tone felt a touch dovish relative to what it might have been. There was a general welcoming of declines in inflation expectations.

The Bank said 'Our recent research highlights that emerging spare capacity in the economy will feed through into lower domestically generated inflation.' Going on to note that 'Lower inflation expectations of firms and households will help reinforce the slowdown in inflation, with less pressure to raise prices and demand higher wages. As inflation continues to fall, businesses will be less able to make large price increases, which will help lower inflation persistence'.

Granted, that could be read as broadly in line with the prevailing view. But there is a sense that it is occurring which is helpful in itself. "Good progress" is being made. Things like lower food price inflation were mentioned as reassuring and gratifying.

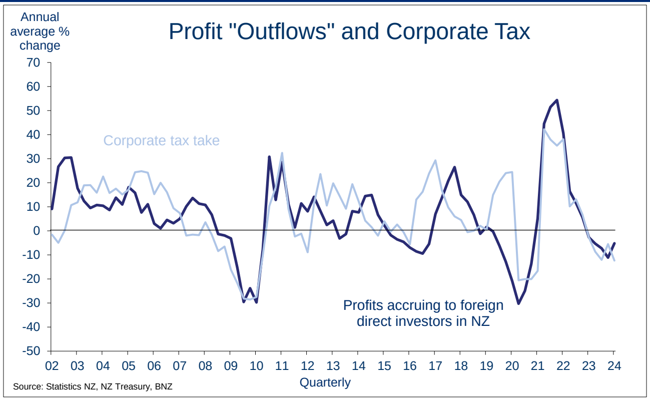
Regards upside risks, the extent to which broad momentum in domestic inflation continues was cited as the key one. 'Partially offset by the potential for a quicker fall in inflation expectations and a more rapid passthrough of weaker demand to prices.'

Importantly, there seems an open-mindedness to the speed of which the various processes involved might play out.

Ultimately, the Chief Economist said that 'Overall, a period of restrictive policy is necessary to give us confidence that inflation will return to target over a reasonable timeframe'. That doesn't tie the RBNZ to any particular action – the speech was never going to – and as the Chief Economist said 'the economy is evolving rapidly'. We think it is evolving in a disinflationary manner a bit faster than the Bank has included in its forecasts. We continue to see the first rate cut in February, but the recent incoming data suggest the risk of an early move has increased.

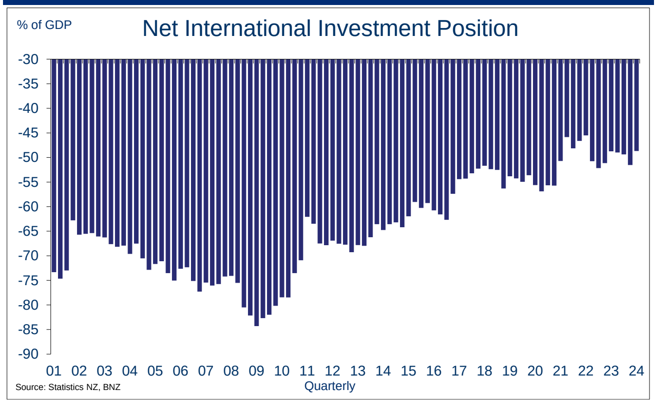
Back to today's Balance of Payments data, profit outflows to foreign direct investors in NZ fell in Q1 and remain well back from recent peaks. It is not a good look for GDP although there is hardly a one for one relationship in that regard. But it is indicative of downward pressure on profitability more generally. That has been a challenge for many and is also a challenge for the fiscal accounts. Lower profitability has seen the corporate tax take come under pressure.

Profit outflows and



A large current account deficit adds to NZ's international investment liability. However, the latter reduced as a share of GDP in Q1 to 48.7% of GDP (from 51.5% in Q4) reflecting NZ's international assets increasing by more than its liabilities. The lift in assets was driven by a combination of strong global equity markets and a lower NZD.

Net liability position smaller in Q1, on revaluations



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