Thursday 4 May 2023

focus

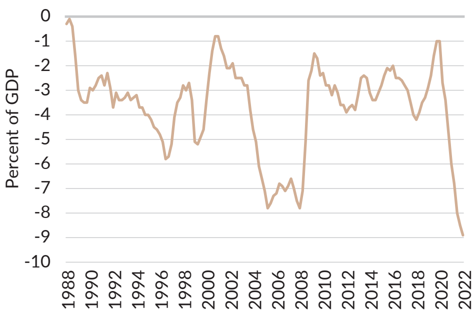
Cracks in the Kiwi Nest Egg

New Zealand recorded its largest ever current account deficit over 2022. The current account is the balance between what we as a country earn and what we spend. In fact, over the 35-year period that we have been measuring the current account we've only had deficits — we are a net (and increasing) borrower from the rest of the world. In the short-term this isn't much of an issue — overseas investors remain happy to lend us money or buy our assets. Over the long-term, however, it does pose economic risks to the country and is another reason why diversifying investments beyond New Zealand is a good idea.

FORSYTH BARR

...We consistently spend more than we earn....

WE CONSISTENTLY SPEND MORE THAN WE EARN: NEW ZEALAND'S CURRENT ACCOUNT



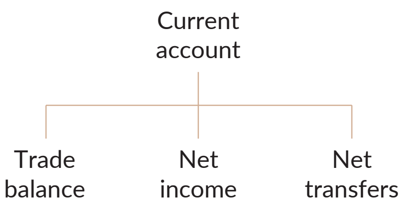
Source: Statistics NZ, Forsyth Barr analysis

What exactly is the 'current account'?

When we talk about the 'current account', it is a bit like your own current or cheque account. Money goes in (wages, pensions, dividend and interest income) and money comes out (shopping, bills, trips) and ideally the balance doesn't go too far into negative territory!

A country's current account is made up of three components as follows:

CURRENT ACCOUNT BREAKDOWN



The sum of all the goods and services that we as a country buy from overseas (e.g. new cars, Netflix subscriptions) is an outflow from our account while the things we sell to foreigners (e.g. dairy exports, services to international tourists) puts money back in. Combined, they make up our trade balance.

The current account also includes income earned from our investments overseas (such as dividends on overseas shares) less the income we pay to foreigners on their New Zealand assets. The three components can be summarised as:

Trade balance: The value of our exports of goods and services less the value of our imports of goods and services.

Net income: The income from offshore investments net of incomes paid to foreign investors.

Transfers: The difference between aid, gifts, grants, and other transfers received from abroad and those paid to other countries.

How low can you go?

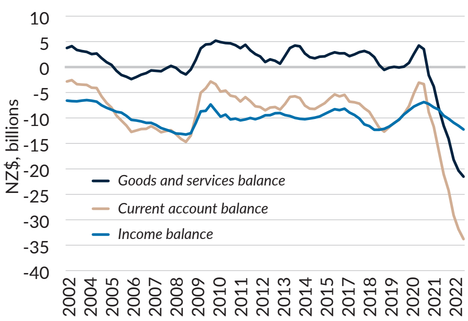
Through 2022 our current account deficit totalled $33.8 billion, or 8.9% of GDP. This is the largest annual current account deficit on record. Previously, the worst deficit we had seen was 7.8% in late 2008. There are several factors as to why it has widened:

...Compared to many of our other trading partners we still, however, have quite a large deficit...

The major reason is, since 2020 our demand for imported goods and services (for example buying cars, televisions, and iPhones) has picked up at a faster pace than our exports have, while higher oil prices have pushed up the cost of energy imports, with both causing our trade balance to worsen. Declining commodity prices and the recent hit to horticultural production from Cyclone Gabrielle won't help this in the near-term, although tourist arrivals picking up should provide some offset.

Our net income balance has also deteriorated as the return on New Zealand assets earned by offshore investors has been higher than the returns we have received from our investments offshore. This is in part due to our relatively higher interest rates compared to other major economies.

CURRENT ACCOUNT COMPOSITION (NZ$, BILLIONS)

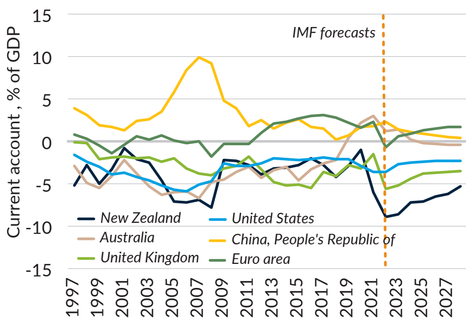


Source: Statistics NZ, Forsyth Barr analysis

How do we stack up internationally?

Looking back through recent history major developed economies have typically run current account deficits, while emerging markets have run surpluses. Compared to many of our other trading partners we still, however, have quite a large deficit. New Zealand and Australia have historically run current account deficits of around 5% for several decades without any ill effects. But higher commodity prices have helped the current account deficit in Australia turn positive during the past five years and it is now around +2.3%.

NEW ZEALAND TYPICALLY RUNS A BIGGER DEFICIT RELATIVE TO ITS PEERS: CURRENT ACCOUNT DEFICITS BY COUNTRY



Source: IMF, Forsyth Barr analysis

...Borrowing from offshore is not necessarily a bad thing....

How is the deficit funded?

So how can we keep running current account deficits year after year?

The current account is one component of our wider balance of payments (BoP) with the rest of the world. When our current account is in deficit it means part of our spending is being funded by either borrowing from overseas or selling assets to offshore investors. For years foreign capital has been used to plug the gap between our spending and our savings

Borrowing from offshore is not necessarily a bad thing. A current account deficit can be a sign of a growing economy, with businesses and consumers having the resources to import more goods and services. If we're borrowing to invest in productive assets that will produce higher future incomes it can be a net long-term positive. Conversely, however, if we're borrowing to buy flashier cars or take more expensive holidays then ultimately rising debt and less assets will mean we're poorer as a country.

Is a deficit something to worry about?

In the short-term, a current account deficit typically isn't a big deal. We do expect to see some reduction in the deficit over the next couple of years as tourism continues to pick up and local spending declines. For now, other countries seem happy to keep lending New Zealand money to finance spending, provided we keep repaying our debt on time.

Over the longer-term, however, these imbalances are likely to remain. New Zealand is a small economy, prone to geological and weather events, whose exports are concentrated in agriculture and tourism. The risk of running ongoing deficits and allowing debt to build up could be a painful left-field event that devalues the NZ dollar and raises borrowing costs. Furthermore, continuing to sell more assets to offshore investors than we buy steadily reduces the country's future income which ultimately impacts our ability to provide the quality of services we desire, including things such as healthcare, education, and infrastructure.

Don't keep all your eggs in the New Zealand basket

New Zealand is a small open economy and vulnerable to international events, domestic shocks, and changing foreign investor preferences. Whilst not an obvious immediate concern, greater financial or economic imbalances magnify the risks of potential future shocks down the road.

...New Zealand is a relatively small and concentrated basket...

Most New Zealanders earn their income locally and have the majority of their wealth at home — their house, maybe a bach, possibly a farm. If the country was hit by a major economic shock potentially the income from and value of all New Zealand assets would be impacted. If the NZ dollar fell significantly it would mean, all-else-equal, our spending power on offshore goods and services would be markedly reduced.

This is one key reason to maintain a well-diversified portfolio including outside New Zealand. Diversification aligns to the old adage of not putting all your eggs in one basket. And New Zealand is a relatively small and concentrated basket. By spreading our investments across multiple countries and sectors we reduce the chance of unforeseen events materially hurting our portfolio.

Having a well-defined investment strategy and sticking to it is an important part of protecting and growing your wealth.

Zoe Wallis
Investment Strategist

If at any time you want to discuss investment options and opportunities, your Forsyth Barr Investment Adviser is available to provide you advice and assistance.

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