NEW ZEALAND’S BALANCE OF PAYMENTS: past, present and future
(an update of the June 1996 paper)

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Executive Summary

- The balance of payments accounts summarise economic transactions between New Zealanders and the rest of the world.

- There are two main sets of accounts - the current account and the capital account. This paper focuses on the current account.

- Current account deficits add to our level of foreign liabilities. Large deficits increase our vulnerability to various economic shocks.

- A major factor determining the appropriate level of deficit is whether it is driven by productive investment.

- Three main periods can be discerned for the current account deficit since 1951: 1951-1974, 1975-1985 and 1986-1998. Deficits in the most recent period are up on the preceding period (as a percentage of GDP), but still down on the first period.

- The current account is made up of merchandise trade and of other payments (called invisibles). Invisibles consist of services, income from foreign investment, and transfers. Fluctuations of the current account balance have largely been driven by changes to the balance of merchandise trade, although a deteriorating invisibles balance has added to the deficit over the last few decades and has been responsible for its dramatic rise over the last two years.

- The current account balance is equal to the difference between New Zealand’s savings and its investment expenditure. Household savings have been steadily declining since 1980, however improvements to the fiscal balance have lifted total savings levels since 1992.

- The terms of trade have had a significant effect on the deficit, especially since 1970.

- The Asian crisis is an important factor dominating the current account in the short-to medium-term. However, our more competitive exchange rate should soon lead to an improving current account balance, albeit slowly.

- Savings and income trends will influence the deficit thereafter. Demographic factors will increase New Zealand’s savings rate over the next couple of decades (as more people enter their high-savings middle-age years) which will have a beneficial effect on the current account deficit over this period.
1. Introduction

New Zealand’s current account deficit has increased considerably over the last year or so and is likely to remain high for a while. A consideration of the balance of payments is therefore timely.

This paper gives a brief account of what the balance of payments is, why it is important and what is an appropriate level for a current account deficit. It also describes trends since 1951 and assesses our prospects over the next few years.

2. Balance of Payments: the different elements

The balance of payments accounts record the economic transactions of New Zealand residents with the rest of the world. They are divided into two major parts: the current account and the capital account. The current account records transactions involving goods, services and investment income, and also includes transfers such as pensions and gifts. The capital account records changes to New Zealand’s total foreign financial assets and liabilities.

In theory, the sum of the current account and capital account balances is equal to zero. If New Zealand imports more than it earns by exporting, it must pay for these imports by either borrowing or by selling assets.

This paper will focus on the current account side of the balance.

The main current account categories are listed in the following table, along with the most recent values for each category (for year ending 31 March 1998; $million):

<table>
<thead>
<tr>
<th>Category</th>
<th>Credits</th>
<th>Debits</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Merchandise Trade</td>
<td>21,490</td>
<td>20,463</td>
<td>1,027</td>
</tr>
<tr>
<td>Invisibles</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>services</td>
<td>6,537</td>
<td>7,677</td>
<td>-1,141</td>
</tr>
<tr>
<td>international income</td>
<td>185</td>
<td>7,921</td>
<td>-7,735</td>
</tr>
<tr>
<td>transfers</td>
<td>2,170</td>
<td>1,396</td>
<td>775</td>
</tr>
<tr>
<td>total invisibles</td>
<td>8,892</td>
<td>16,994</td>
<td>-8,101</td>
</tr>
<tr>
<td>Total Current Account</td>
<td>30,382</td>
<td>37,457</td>
<td>-7,073</td>
</tr>
</tbody>
</table>

(note, credits result in payments to New Zealanders (e.g. exports) and debits payments to foreigners (e.g. imports))

This $7,073 million current account deficit is equal to 7.2% of gross domestic product (GDP) and 25% of New Zealand’s exports of goods and services.

3. Why is the Balance of Payments important?

1 Where “merchandise trade” is the term for the import and export of goods; the main “services” categories are transportation, tourism and insurance; “international investment income” consists of earnings accruing to New Zealand investors on their investments overseas (in the case of credits) and to foreign investors on their investments in New Zealand (in the case of debits); and “transfers” is the term for funds given or received where no offsetting payment is required; for example, foreign aid, gifts and migrants funds.
Because the current account and capital account sum to zero, the current account balance is the mirror image of the capital account balance. Thus, a current account deficit signifies a fall in New Zealanders’ net foreign assets (or an increase in their net foreign liabilities).

What makes the level of the current account deficit especially important for New Zealand is our high level of foreign debt. New Zealand’s total net overseas debt is the highest in the OECD (as a percentage of GDP and of exports) and higher than many third world “problem” countries. It is also well above the levels permissible by the standard rules of thumb used by analysts. High debt levels are expensive because they have to be serviced, often at less-than-preferable terms. They also increase our vulnerability to interest rate and foreign exchange changes and to any fall in confidence in the New Zealand economy.

In addition, large current account deficits increase the risk of economic instability. They must be funded by continuous inflows of foreign capital. If foreign investors lose confidence in the New Zealand economy - for example, they may regard the current account imbalance as symptomatic of deeper problems such as “inappropriate” policy or low rates of savings - then they will reduce their investment in New Zealand. The result would be higher interest rates, a depreciating exchange rate, inflation and recession, especially if the adjustment is sudden.

4. What level of Current Account Balance is ideal?

For the foreseeable future, a current account deficit is inevitable in New Zealand. This is because our savings are insufficient to fund the levels of investment we make in replacing and adding to our capital stock (e.g., buildings, equipment, etc.).

What is an appropriate level of current account deficit depends on several factors:

- **The current level of overseas debt.**

  Adding to already high levels of debt further increases our exposure to interest rate and foreign exchange risk and to the costs of servicing the debt.

- **The extent to which the increase of net foreign liabilities is used for productive investment.**

  Debt and other liabilities have to be serviced. High current account deficits will not be sustainable if the debt is principally used for consumption and non productive purposes.
• The type of debt (or other liability) used to finance the current account deficit (especially its term).

For example, the use of short-term debt increases our exposure to interest rate fluctuations and capital flight.

The first of these factors is an especially limiting one for New Zealand, as was explained in the previous page. The second factor has also been a cause for concern over recent years, with much of the rising debt being driven by household borrowing to purchase housing. Housing is hardly an investment likely to increase the productive capability of the country. The third factor is not as great a problem as it once was.

As the above indicates, the level of current account deficit which is sustainable depends on a complex array of factors. There is no simple, hard and fast rule that can be applied. An article by the Reserve Bank discusses the different factors in more detail. It concludes that, as regards current account sustainability, New Zealand’s strengths outweigh its weaknesses, and “any external correction is unlikely to be of the extremely disruptive variety seen in Mexico in 1994, or the kind East Asian countries are now working through”.

Most definitely, financial markets have marked down the value of the New Zealand dollar over the last year. However, the adjustment has not been sudden, nor has it been dramatically out-of-kilter with that of Australia and other countries closely tied to the crisis Asian economies. The adjustment has also been from levels widely regarded as over-valued, and has coincided with a monetary easing (and its associated weakening currency) which is normal at this stage of an economic cycle.

However, this is not to say that there is room for complacency. Despite the economic strengths mentioned in the Reserve Bank article, the current account deficit is well above that level widely mentioned as the rule-of-thumb for dangerous territory (namely, 5% of GDP). Our high level of debt makes us very vulnerable to any rapid and major change of investor sentiment.

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2 After increasing over most of the period from December 1992 (when the current series began) to March 1997 (from 28% to 37% of total debt), debt with a maturity of less than 90 days now makes up only 28% of total debt. Debt denominated in NZ dollars, which is not so vulnerable to currency fluctuation, has risen from 31% to 54% over the same period.


4 See footnote 10 for a definition of “monetary easing” and its significance.
5. Current Account trends

Graph 1 shows the current account balance as a percentage of gross domestic product (GDP). Three main periods are discernible:

- 1951-1974, characterised by constant fluctuations around an average of -1.4% of GDP

- 1975-1985, where the balance improved from a dramatic low point, only to fall again at the end of the period; the balance was considerably worse over this time, averaging -6.4% of GDP

- 1986-1998, which showed a similar pattern to the previous period; the balance has so far averaged –3.8% of GDP.

Graph 2 shows that, until recently, the current account balance trend has largely been shaped by the merchandise trade balance. Over the second part of this period, a lower balance of invisibles has served to pull down the level of the current account balance, most spectacularly so in the last two years.

Graph 3 shows the balance of invisibles and its three components. It is changes to the balance of international investment income which have primarily determined the shape of the overall invisibles balance over much of the period. Its deterioration has considerably counter-balanced the gradual improvement of the services balance.
Another highlight of the graph is the rise and fall of the balance of transfers in the 1990s. This was mainly caused by changes to the transfer of migrant funds into the country, with these rising and falling in line with migration changes. A worsening of all three components has contributed to the dramatic rise of the invisibles deficit over the last few years.

6. Factors determining the trends

Three key determinants examined in this section are national savings, national investment and the terms of trade. Other factors are also briefly discussed at the end of the section.

First, however, a consideration of savings and investment together.\(^5\) Savings and investment are the major factors determining the trend of the current account balance. The lower the amount that New Zealanders save compared to what we invest, the greater our demand for foreign capital and for foreign goods and services. Indeed, the current account deficit is actually equal to the gap between savings and investment, both in theory and (bar some measurement differences) in practice.\(^6\) The closeness of this relationship is shown by the bottom two lines of graph 4.

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\(^5\) Where “savings” is defined as the amount left from disposable income after subtracting expenditure on consumer products, and “investment” is defined as expenditure on items which generate a flow of benefits over time (such as the plant and machinery in a factory).

\(^6\) This relationship can be derived from the economic equations showing the relationship between basic National Accounts components such as GDP, investment and so on. Similar algebraic computation also shows the current account balance to be equal to the gap between a nation’s earnings and its spending – a concept easier to understand in terms of common sense, as most householders know that if they spend more than they earn, they must borrow the difference or draw from their assets.
Graph 4 also shows the trend of both savings and investment. These are now discussed in turn.

(a) National savings

A nation’s savings are what is left of its disposable income after its final consumption expenditure is subtracted. Savings are thus affected by changes to income and to the amount of this income spent on consumption (or not saved).

A major factor behind changes to a country’s savings rate is the trend of its economic growth. Savings tend to be high during periods of high economic growth, and low during low or negative growth periods. One reason for this is that most people (in households, businesses and governments) are slow to change their spending habits in response to changes of income. Thus strong economic growth during the early seventies kept gross savings high at a rate averaging 26% of GDP from 1971 to 1977. Savings fell considerably during the 1978 recession, plateauing around that level from 1978 to 1989 (with an average of 19%). It fell further during the 1991 and 1992 recession years, and has risen and fallen with the 1990’s economic cycle. This relationship is shown in graph 5.

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7 “Savings” is gross savings, i.e. it also includes consumption of fixed capital (depreciation), and “Investment” not only includes gross fixed capital formation, but also the values of the physical increase of stocks and a figure representing a statistical discrepancy between two ways of calculating GDP. Consumption of fixed capital is fairly constant at around 7%-10%, whereas the value of the physical increase of stocks and the statistical discrepancy are very small.

8 Note that data on savings have high margins of error. This is because savings tends to be calculated as the difference between two far larger figures - income and consumption. Any statistical or other discrepancy in these larger figures will therefore have a substantial impact on the residual, savings.
However, economic growth is not the only factor determining rates of savings. A breakdown of net savings into its sub-components - household, Crown, and other savings⁹ - is given in graph 6. Two points are especially worth noting. First is the exceptional improvement of the Crown’s savings in recent years and its substantial impact on national savings. Second is the constant decline of household savings since 1980. This latter trend has not only been the result of poor economic growth, indeed it has continued to decline despite strong economic growth over recent years. Other factors include: financial deregulation, which has increased households’ access to credit; increased numbers of beneficiaries, who tend to be low savers; consumers (and businesses) catching up on buying things which they had put off during the low growth years of the early 1990s; innovative lending packages; and an increased orientation of banks towards household lending.

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⁹ The “Crown” is defined as the core central government sector. Savings data from the Crown current account is available only from 1987; for years before that in the graph, this savings data is adjusted by changes to the Table 2 adjusted financial (fiscal) balance. Note that “other” includes mainly business retained earnings, local government savings, and a residual item.
(b) Investment

Investment levels in New Zealand also show a strong relationship with the rate of economic growth, as is shown clearly in graph 5.

A further highlight of graph 5 is how low investment now is, as a percentage of GDP, compared with what it was during the 1970s and most of the 1980s. This is despite the strong investment growth that has occurred in recent years. Graph 7 shows that this is due to a significant fall in government investment. Private sector investment is in fact around the highs achieved in the 1970s and 1980s.

Graph 8 shows the type of investment that has occurred. It suggests that one reason for the higher level of private sector investment recently is the growth of residential investment. Investment in residential buildings is the only type of investment that has grown from the mid 1980s. It grew from 4.5% of GDP during the high investment year of 1986, to 5.6% in 1997. By way of comparison, investment in plant, machinery and equipment fell from 14.0% to 10.0%.

(c) Terms of trade

The savings-investment gap is one way of analysing the current account balance trend. It is also worthwhile singling out other factors which impact on the balance. One important factor is the terms of trade.

The terms of trade is an index measuring the volume of merchandise imports that can be exchanged for a fixed volume of exports. It is purely a function of export and...
import prices. These price changes have an immediate effect on the balance of payments - a higher terms of trade means higher earnings for exports relative to what we pay for imports, and hence a reduced current account deficit.

Graph 7 shows the close relationship between the terms of trade and the balance of merchandise trade, especially during the 1970s and 1980s.

(d) Other factors

A significant determinant of import volume changes is our economic growth rate, with high rates of growth resulting in more imports of raw materials and intermediate products for processing in New Zealand. Export volume growth is largely dependent upon the growth of our trading partners. Other factors matter too, for example: exchange rate changes, livestock numbers, local weather patterns, market access, and so on. More recently, factors affecting the invisibles account have had a large impact on the balance of payments. Especially important has been the large increase of foreign direct investment into New Zealand, its profitability, and the associated widening of the imbalance of net international investment income. Migration flows have also had a significant effect.

Additional considerations, especially in the long run, are the mix of goods and services produced and exported by New Zealand and the extent that we develop the appropriate skills and structures to support exports and import substitutes.

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10 Note that the flow of New Zealand investment overseas also increased substantially in the early 1990s but has been affected by poor returns over the last year or so, mainly due to falling prices for forest products.
7. Prospects

Any assessment of New Zealand’s future current account balance needs to differentiate between cyclic, other short- and medium-term factors, and long-term trends.

(a) Cyclic factors:

Strong economic growth tends to cause a marked rise in the level of imports. This results from firms investing more in plant and equipment, from producers requiring a greater flow of intermediate goods for processing, and from consumers spending more. With falling economic growth over the last few years, the growth of imports has fallen and should continue to do so into next year.

The economic cycles of our trading partners are also a factor and impact on the amount we export to them. The effect of the Asian crisis is that economic growth amongst our trading partners will be more subdued both this year and possibly over the next few years. This will also impact on international commodity prices, although these effects should be balanced by a lower exchange rate for New Zealand.

A further cyclic factor is the easing of monetary conditions11, which usually occurs around the bottom of the economic cycle, and the depreciation of the New Zealand dollar associated with this. A lower dollar tends to encourage people to import less and export more.

(b) Other short- and medium-term factors:

Short- and medium-term factors considered here are: the Asian crisis; recent tax cuts and Government spending increases; the mix of monetary conditions; the balance between monetary and fiscal policy; trends in foreign direct investment; and levels of household debt.

At the moment, the factor most dominating economic news is the Asian crisis. This is having a significant impact on our economic growth, both directly and through the effects of greater uncertainty on business and consumer confidence. The result is likely to be lower import growth and possibly reduced export growth as the increased competitiveness of the New Zealand dollar is balanced by lower demand for exports.

Tax cuts and increased government expenditure will also impact on the current account balance. This is likely to be a negative factor, as it will lead to higher expenditure by households than would otherwise have been the case.

11 The term “monetary conditions” refers to the mix of interest rates, exchange rates, and money and credit growth, all of which are affected by a country’s central bank (for us, the Reserve Bank of New Zealand). Easier or looser monetary conditions generally involve lower interest rates, a weaker dollar, and higher growth of money and credit. Monetary policy is said to be easing, loosening or weakening when it is having this effect. Easing monetary policy tends to lead to higher economic growth, although with a lag. Tightening monetary policy has the opposite effect. However, these indicators of monetary conditions can also move at different rates. When talking about the “mix of monetary conditions”, the focus is whether the change of monetary conditions is achieved more by one indicator (e.g. interest rates) or another (e.g. the exchange rate).
The mix of monetary conditions affects trading conditions in the short- to medium-term. Monetary easing over the last few years has been achieved through depreciation of the exchange rate, with short-term interest rates remaining high. The result should be more conducive to improving the balance of merchandise trade, as high interest rates subdue growth in the domestic economy (thereby reducing that sector’s demand for imports) and the lower dollar encourages exports and discourages imports.

Fiscal policy is also likely to impact on the current account balance. The more expansionary fiscal policy is, the tighter monetary policy has to be to counteract inflation. Tight monetary policy, with its associated strong dollar, is not as conducive to export growth as tight fiscal policy.

Foreign direct investment into New Zealand has increased significantly over the last few years and is likely to remain high. Related to this has been the “loss” of income that foreigners have earned from these investments. This is likely to remain at high levels. However, foreign investment’s net effect on the current account deficit is difficult to assess in the medium- to long-run. If it raises general productivity and income-earning ability within the New Zealand economy (for example, through access to finance, technology, markets, etc.), then this may serve to counterbalance the loss of profits. Furthermore, New Zealand investment by foreigners is partially balanced by foreign investment by New Zealanders, although this has recently been afflicted with poor returns.

The level of household debt has also increased substantially over the last few years, and the resulting drop in household saving and rise in household investment (in residential housing) has contributed to the worsening deficit. However, there is a limit to how much this debt can increase. Households are likely to be a less important source of the deficit pressures than they have been in the recent past.

These and the cyclic factors are likely to be fairly evenly balanced over the next year or two, with the Asian crisis dominating events in the short run but the competitive exchange rate and the end of the rapid rise in household borrowing working to improve the deficit as the period progresses. Of course, the Asian situation still involves considerable uncertainty.

(c) Long-term factors:

What are the long-term factors driving exports and imports or, to look at it in a different way, savings and investment?

Increasing diversity has been a striking feature of the export trend. At the beginning of the 1980s, earnings from services (such as transportation, travel and insurance) were equal to 21% of the value of merchandise exports, whereas they are now 31% (down from a high of 35% in March 1996). The volume of non-food manufacture exports grew 180% over the same period, well surpassing that of pastoral and dairy

12 Fiscal policy relates to government expenditure and taxes. It is said to be loosening or expanding if government expenditure is rising or tax rates are falling.
exports (which grew 50%). There has also been a slight diversification away from the main countries we export to: the percentage of exports going to Australia, Japan, the United States and United Kingdom has fallen from 55% at the beginning of 1980 to 52% now, with growth of the Asian markets growing especially.

This increased diversity will lessen the risk of New Zealand’s dependence on only a few commodities and countries. It is also likely to be self-sustaining, with the development of new markets, networks and skills carrying considerable momentum.

One long-term trend affecting imports may be the level of New Zealand’s border protection. However, the figures do not support this in any conclusive way. Imports of goods and services increased as a percentage of GDP from 1989 to 1997 (from 23% to 28%). But this growth also coincided with New Zealand moving from the bottom to the top of an economic growth cycle. Imports are still well down from their high of 37% in 1985. Note, however, that even if there is increased import penetration, this is not necessarily bad for the current account balance. The resulting increased competition and better access to inputs may have positive effects on the economy generally and on exports.

The long-term savings trend is favourable for the next couple of decades, which is likely to have a beneficial impact on our current account balance (as was explained in section 6). Demographic trends are one reason that savings should improve. The 1950s baby boomers are now middle-aged, which is the stage of their life-cycle where people save the most. Another reason is increased uncertainty about state provision and financing of health, education and old-age needs. The more the state pulls out of these areas, the greater is the need for people to save.

The other main factor mentioned in section 6 was investment. While an increased savings-investment gap is equivalent to a worsened current account deficit, investment also provides the basis of future economic growth and increased savings.

8. Conclusion

The current account deficit’s level is important for a high debt country like New Zealand, as large deficits represent further increases to our international liabilities. However, just as important is the make up of the deficit and the reason for the increase. A deficit driven by productive investment is likely to be more sustainable than one based upon surging consumption expenditure.

A country’s current account balance is equal to the gap between its savings and its investment. New Zealand’s household savings rate has shown a disturbing downward trend since 1980. However, since 1992 this has been more than compensated for by increased government savings. The prognosis for savings (and the deficit) over the next couple of decades is for an improvement, driven largely by demographic changes and continuing high levels of savings by governments.
However, the current account deficit is likely to remain high over the next few years, especially because of the Asian crisis, but a more competitive exchange rate should soon begin reversing the recent trend.

The best policies for addressing persistent current account deficits are those which raise national productivity and increase the level of domestic savings available for productive investment.

9. References


