

As bad as it gets?

Q4 Current account preview: 26/3 10:45am NZT

- We estimate that the current account deficit (CAD) widened slightly to 8.7% of GDP at the end of 2008.
- Weaker import demand and lower overseas interest payments drove an improvement in the underlying trend.
- The widening of the deficit in recent years was a direct reflection of the booming domestic economy. Now that this has gone into reverse, the deficit is set to shrink substantially.

The gradual improvement in New Zealand's CAD that began in 2006 has stalled in recent quarters, as a number of factors have worked against it – surging oil prices, rising interest costs, and a hit to agricultural exports due to drought. While all of these factors had gone into reverse by Q4 last year, the deficit is likely to have widened further on an annual basis – we expect it to clock in at 8.7% of GDP¹. We think this will mark the peak in the deficit, though, as the global recession forces a correction of some of the long-running imbalances in the New Zealand economy.

Goods and services

We expect the goods balance to record a larger deficit compared to a year ago, which was flattered by a surge in both prices and volumes for dairy exports and the peak in output from the Tui oil field. For the quarter, a 12% fall in the New Zealand dollar more than offset the weakness in world prices for many of our export commodities, leaving export values slightly higher in seasonally adjusted terms. Imports were down in Q4, due to a sharp fall in world oil prices and plunging car imports (down 27%).

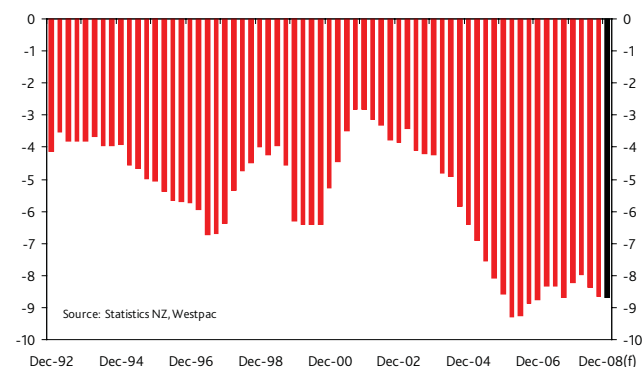
The services balance is expected to head further into the red. The tourism sector has been hit by a drop in visitor numbers as the global recession has deepened, and has yet to see much relief from the weaker currency as businesses tend to price in New Zealand dollars. The lower NZD has, however, inflated the cost of imported services (mostly transport and travel).

¹ Last week's terms of trade figures suggest that goods imports for Q3 will be revised lower, though we are awaiting confirmation of this. Without this revision, our CAD forecast would be 8.8% of GDP.

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Current Account as % of GDP



Current Account Components (\$million)

	Dec-07	Mar-08	Jun	Sep	Dec(f)
Goods Balance s.a.	-26	-191	-1,079	-898	-290
Services Balance s.a.	-10	2	-217	-237	-400
Investment Inc Bal	-3,289	-3,482	-3,644	-3,248	-2,860
Transfers Balance	139	147	315	286	290
Current Account Bal s.a.	-3,188	-3,510	-4,650	-4,079	-3,260
CAB Annual total	-14,372	-14,211	-14,982	-15,509	-15,450
Annual CAB, % of GDP	-8.2	-8.0	-8.4	-8.6	-8.7

Investment income

The investment income balance has long been the largest component of the CAD. The main components are the interest payments on New Zealand's relatively large overseas debt burden, and the profits earned by foreign-owned companies – both of which have reflected the strength of domestic demand, and the need for the RBNZ to maintain relatively high interest rates, in recent years. As the economy slows, a reversal in these components is a core part of our view that the CAD will narrow over the next year.

While we can't be as confident about how much of this adjustment will happen in any given quarter, we have assumed a substantial fall for Q4. Interest rates fell particularly sharply as the RBNZ slashed the cash rate by 250 basis points; even after allowing for the growing risk premium charged in international

money markets, New Zealand's overseas interest bill is set to shrink significantly.

Looking ahead

We expect that Q4 will mark the widest point in the deficit (as a percentage of GDP). The improvement over this year may appear modest at first, but will accelerate as some of the large quarterly deficits from last year drop out of the annual calculations. We expect the deficit to narrow to 6% of GDP by year-end.

A global recession may seem an unlikely catalyst for an improvement in the CAD, given the obvious impact on demand and prices for our exports. But this is only a part of the story. A current account deficit ultimately reflects a country's willingness to live beyond its current means. For most of this decade we have seen strong global growth and easy access to credit, which encouraged New Zealanders to borrow and spend. In these more chastened times, consumers and businesses are scaling back their spending ambitions relative to their income, and the CAD will naturally correct. And history shows that this adjustment can be quite dramatic:

- The early 1990s recession saw the deficit narrow from 4.1% to 2.7% of GDP as import demand sagged;
- During the Asian crisis in 1997-98 the deficit narrowed from 6.7% to 3.9%, as a sharp fall in interest rates reduced the outflow of interest payments; and
- The dot-com collapse in 2000-01 saw the deficit shrink from 6.4% to 2.8% as the NZD fell to record lows, driving a substantial improvement in the trade balance.

It's worth considering that in the current recession, all three of these drivers have been put into play.

Market implications

The economic landscape has shifted considerably since the end of last year, and the market may view this data as dated; however, a larger than expected deficit would likely be looked upon less kindly than a smaller one. We see the risks around our forecast as slightly biased towards a larger deficit, as we can only guess at how far interest payments and company profits fell in the quarter.

We should point out that our predicted narrowing in the CAD over this year does not occur in a vacuum. We still believe – as does the RBNZ – that the exchange rate has more work to do to drive this correction. If the recent gains in the NZ dollar are sustained, the burden of adjustment will be placed back on to interest rates.

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