

As good as it gets

Q1 current account deficit narrows to 2.4% of GDP

- The annual current account deficit is likely to have bottomed at 2.4% of GDP.
- The trade balance has improved substantially in recent quarters. Export volumes have grown strongly, while imports remain well down on pre-recession levels.
- As the economy recovers, we expect the deficit to settle at a sustainable 4-5% of GDP.

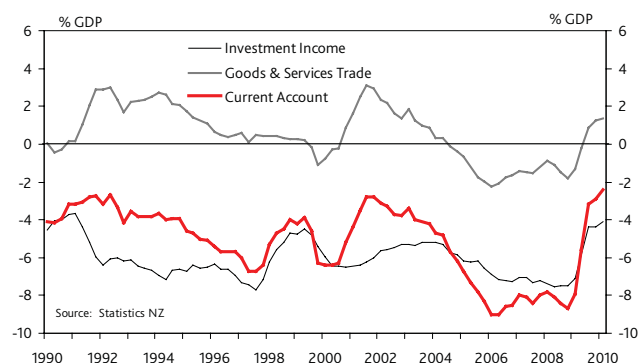
The annual current account deficit (CAD) narrowed to 2.4% of GDP in the March quarter, right in line with our expectations, from an unrevised 2.9% in Q4. This is the smallest annual deficit since September 1989 – though as it was back then, this represents a relatively low point in the cycle in the wake of a sharp slowdown in the economy.

In seasonally adjusted terms, the goods balance rose to a healthy \$919m – not quite the record high that we were anticipating, as we were thwarted by conceptual adjustments to the trade flows (largely differences in timing that will balance out over time). According to the terms of trade, export prices rose by 10.3% for the quarter, reflecting the sharp rebound in dairy prices that began last year, while import prices rose by 4.1%. Volumes on both sides of the ledger grew by about 3%, though from very different starting points: exports have continued to grow steadily, while imports are still a long way from recouping their 19% decline during the recession.

The services balance of -\$146m (s.a.) was below our forecast, due to lower than expected tourism earnings. While short-term visitor numbers were up about 5% on last year, the average spend per person appears to have fallen. This probably reflects a change in the composition of arrivals – the most significant growth has been from Australia, where a trip to NZ is likely to represent a casual visit than a major journey.

As usual with the current account, several wrongs make a right, and our downside surprises on trade were offset by a smaller than expected investment income deficit. Income earned on New Zealand's overseas investments rose to \$684m, about

Figure 1: NZ Balance of Payments



Current Account Components (\$million)

	Mar-09	Jun	Sep	Dec	Mar-10
Goods Balance s.a.	738	775	657	295	919
Services Balance s.a.	-237	-64	22	-24	-146
Investment Inc Bal	-2,781	-1,366	-743	-3,254	-2,265
Transfers Balance	54	288	101	73	170
Current Account Bal s.a.	-2,198	-409	62	-2,919	-1,291
CAB Annual total	-14,569	-10,371	-5,896	-5,314	-4,457
Annual CAB, % of GDP	-7.9	-5.6	-3.2	-2.9	-2.4

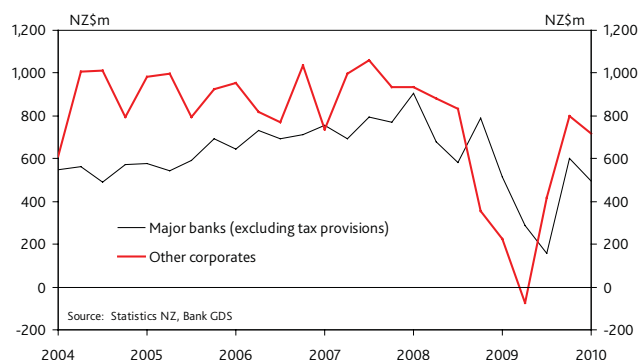
\$100m more than we expected. However, this series is choppy and unpredictable, as is still well down on the \$1.13bn peak reached in Q4 2007, just before the global crisis.

On the debit side, profits earned by overseas-owned firms in New Zealand moderated in Q1. This component was astoundingly strong when it was originally published for the December quarter, almost returning to pre-recession levels (excluding banks). We didn't think this would be maintained, and in a way it wasn't: \$145m was shaved off the Q4 estimate, leaving the Q4 and Q1 figures at similar levels (Figure 2). The turnaround in company profits has now been sustained for three quarters, putting another positive spin on New Zealand's recovery even as it adds to our external deficit.

For further information, questions or comments contact Brendan O'Donovan, telephone (04) 470 8250, email brendan_odonovan@westpac.co.nz

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Figure 2: Profits of overseas-owned firms in NZ



The net international investment position (IIP) improved slightly, from -90.6% to -88.9% of GDP, mostly due to valuation adjustments. The mark-to-market values of derivative contracts, which blew out as a result of the sharp drop in interest rates during the global financial crisis, have been steadily easing back in recent quarters. And the rise in world share markets from December to March worked in our favour (for listed equities, at least, New Zealand's net position is positive).

The net IIP ratio is still ugly by developed nation standards, and any improvement from here will be a hard slog. Since New Zealand is likely to continue running current account deficits, which will need to be funded from overseas, the dollar value of our net liabilities will keep rising. So the only real way to reduce the ratio is for the bottom line (nominal GDP) to grow faster than the top line (liabilities). As a rough guideline, if nominal GDP grows at 5% a year (let's say 2.5% real growth, 2.5% inflation), then the current account deficit would have to be maintained at less than 5% of GDP in order to reduce the IIP ratio. We think that's actually achievable, but it would still only mean a gradual rate of improvement.

As a side issue, the current account-to-GDP ratios provided by Stats NZ imply that nominal GDP was about 0.5% higher than we've assumed for Q1. However, that will probably come through in the price deflator, rather than the real GDP figure that will hit the headlines tomorrow. As such, we've left our GDP forecast unchanged at 0.7% growth.

Market implications

There was no reaction in the NZ dollar or interest rates. While the deficit was smaller than the median forecast of 2.7% of GDP, the market is aware of the wide margin of error around forecasts for this series.

The annual deficit has probably bottomed out; the challenge from here on is to identify how far it will widen as the economy recovers. We're becoming more confident that there has been a step-change in New Zealand's trade performance compared to the last cycle. Strong demand from developing Asia (particularly China) will continue to support export prices and volumes, and we expect to see more frequent trade surpluses in coming years. While the investment income deficit will remain large, this should still be enough to see the overall deficit settle into

a range of 4-5% of GDP, compared to the 8-9% peaks of last decade.

Our view is substantially different to the more ominous statements coming from some official circles. For instance, the RBNZ sees the deficit widening to more than 7% of GDP by early 2013. Its projections assume a collapse in the terms of trade from next year, which would see the trade balance return to a deficit of 1.8% – not far from the nadir of -2.2% seen in the last cycle. That seems to suggest a very dim view of China's place in the global economy.

At another extreme, the IMF's recent Article IV report predicted a widening in the deficit to 8% of GDP by 2013, not through the trade balance – which is expected to remain in surplus – but through a blowout in the investment income deficit to an unprecedented 9% of GDP. Our calculations show that to achieve this, the 'price' of our external funding – the interest rates paid on overseas debt, and the return on equity for foreign-owned firms – would have to be sustained above 9%, a rate unseen even at the peak of the last cycle. That's not impossible, but it's a very extreme assumption to have as your central view.

Brendan O'Donovan, Chief Economist, Ph: (64-4) 470 8250

Michael Gordon, Markets Economist, Ph: (64-4) 381 1412