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Westpac InstitutionalBank

Tax very much

Q3 Current account preview: 22/12 10:45am NZT

- **We estimate that the current account deficit narrowed to 3.5% of GDP in the year to September.**
- **Bank tax provisions will flatter the balance even more so than in the June quarter – but their significance shouldn't be overplayed.**
- **The narrowing in the deficit continues to be driven by the cyclical factors of lower import spending and lower returns to foreign investment in New Zealand.**

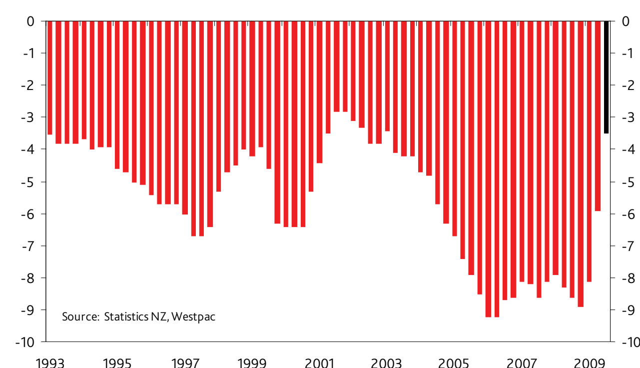
New Zealand's stubbornly large current account deficit (CAD) has had a dramatic makeover in 2009, in large part due to the lagged effects of a prolonged recession. From a reported peak of 9% of GDP (before revisions) at the end of last year, the annual deficit had shrunk to 5.9% of GDP by June. We estimate that another large contraction in the September quarter took the annual deficit down to 3.5% of GDP, which would be the lowest since March 2003.[1]

Details

The goods balance recorded a smaller surplus (seasonally adjusted) than in the last two quarters. Prices for dairy exports fell further (the recent surge in contract prices probably won't be reflected in shipment prices until next year), but volumes remained strong. There was a pickup in imports of cars, and of intermediate goods such as fertiliser and steel, where inventories are likely to have been run down to very low levels.

It's worth considering New Zealand's recent trade performance, in light of claims by some policymakers and analysts that the recovery must be led by exports rather than consumption. The terms of trade, published last week, showed that export volumes are up 9% on a year ago – a stunning result in the midst of a global recession. What's more, Kiwis have been able to do much of their belt-tightening via imports, with volumes down 14% on a year earlier. Net exports were a huge positive for the New Zealand economy during the recession; it's reasonable to expect consumption to pick up the baton during the recovery.

[1] Note that revisions to the National Accounts, which will be incorporated in next week's data releases, have added several billion dollars to the level of nominal GDP. This reduces the CAD to GDP ratio by 0.2% at its peak, and 0.1% in the latest quarter.



Current Account Components ($million)

	Sep-08	Dec	Mar–09	Jun	Sep(f)
Goods Balance s.a.	-820	-76	822	822	200
Services Balance s.a.	-223	-435	-240	-78	220
Investment Inc Bal	-3,390	-3,256	-2,781	-1,600	-820
Transfers Balance	357	163	54	287	130
Current Account Bal s.a.	-4,076	-3,608	-2,120	-612	-270
CAB Annual total	–15,437	-15,969	-14,569	-10,614	-6,510
Annual CAB, % of GDP	-8.4	-8.7	-7.9	-5.7	-3.5

We estimate that the seasonally-adjusted services balance turned positive again, the first time since December 2007. Tourism earnings are still down on a year ago but have noticeably improved in recent months. On the imports side, New Zealanders have been taking fewer overseas trips, and transport costs are down on last year due to weaker import volumes and lower fuel prices.

The investment income deficit will have narrowed further, as interest payments on overseas debt fell and the recession ate into the profits of overseas-owned firms in New Zealand. But the most significant impact on the income deficit will have come from some major one-off items.

Tax provisions

In the June quarter, BNZ reported a $661m provision for tax on structured finance transactions that were entered between

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2000 and 2005, after the High Court ruled in favour of the IRD in July. This type of item is recorded in the balance of payments at the point when it is recognised in a firm's financial statements (which is not necessarily when the tax is paid), and resulted in a sharp drop in income on foreign equity investment in Q2.

Tax provisions will be an even bigger feature for the Q3 accounts. Westpac made a $918m provision after a separate High Court ruling against them. The other two major banks haven't had their day in court, but ASB provisioned for the full $208m liability and ANZ set aside $240m (their maximum liability was last estimated at $409m) in their Q3 statements. That gives a total of $1,366m – more than double the BNZ tax provision.

The dollar amounts involved in these tax provisions are large, but their significance to the CAD can easily be overstated. The BNZ tax provision was widely cited as the reason behind the 'surprise' narrowing in the CAD in June. But it was equivalent to just 0.36% of GDP; most forecasts of the deficit overshot by 1 to 2 percentage points. (We factored in the tax provision and were still too high by 0.7%). Similarly, the tax provisions in Q3 add up to 0.73% of GDP – only a third of the estimated narrowing in the deficit for that quarter.

The remaining two-thirds come from the same factors that have been driving the CAD lower for the last year: weaker import demand, lower interest rates on overseas debt, and lower profits for overseas-owned firms. The latter two are likely to be a feature for several more quarters, given the fairly long lag before they began to have a downward effect on the deficit. However, imports are now beginning to turn higher as demand recovers and firms rebuild inventories.

Market implications

We suspect our forecast of a deficit of 3.5% of GDP will be at the lower end of the range of market forecasts, though the spread is likely to be narrower than last time – forecasters won't be caught out twice by banks' tax provisions. The RBNZ forecast a deficit of 4.0% in the December *Monetary Policy Statement*. The market is familiar by now with the factors that have driven the CAD lower, so an outturn on our forecast would probably only prompt a small rise in the New Zealand dollar.

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