

Shaken up

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

- We expect the current account deficit for the year to September to widen slightly to 3.2% of GDP.
- The Q3 trade surplus narrowed in seasonally adjusted terms, as export volumes fell and imports rose.
- The balance will be boosted by a large inflow from foreign reinsurers, to cover the costs of the Canterbury earthquake.

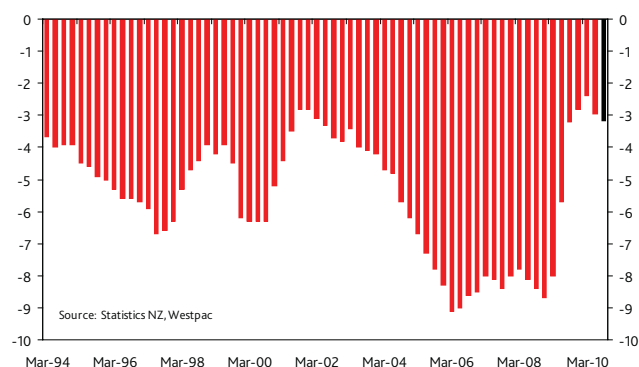
New Zealand's current account deficit (CAD) has been gradually widening over the last year as the economy has hauled its way out of recession. However, this has been obscured at times by some large positive one-off factors, which will again be the case in the September quarter. As a result, we expect the annual deficit to widen only slightly to 3.2% of GDP.

The trade surplus for goods narrowed, in seasonally adjusted terms, in the September quarter. World commodity prices moved further in New Zealand's favour (food up, fuel down), but export volumes fell an estimated 4%, while import volumes rose 3%. The fall in exports was a delayed response to the drought that curtailed the dairying season in Q2; Fonterra maintained the level of sales in Q2 by running down stocks.

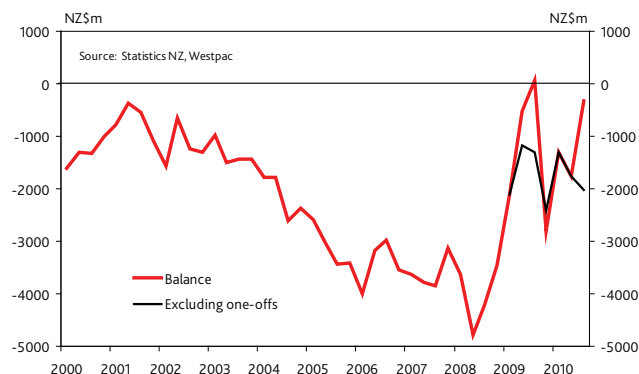
Investment income is the most unpredictable component of the CAD. Profits of overseas-owned firms have rebounded surprisingly quickly over the past year – effectively back to pre-recession levels. We've assumed that this pace will moderate slightly in Q3. Interest costs probably rose, reflecting the lagged impact of higher interest rates earlier in the year.

The most unusual aspect of the Q3 balance will be in transfers. The Canterbury earthquake is now estimated to have caused around \$5.5bn worth of damage. Much of this will be covered by the EQC and private insurers, who in turn are at least partially covered by overseas reinsurers, who in turn are at least partially covered by overseas reinsurers. Since the balance of payments is prepared on an accrual basis, the inflow of reinsurance payments will be counted in the period in which the trigger event occurred, that is, in Q3. But since the final amount won't be known for many months, a 'best guess' is required in the meantime. Statistics NZ has given a figure of \$1.7bn, which will be revised over time as more information becomes available (and could even change by next week's release).

Current Account as % of GDP



Current account balance, quarterly s.a.



Current Account Components (\$million)

	Sep-10	Dec	Mar-10	Jun	Sep(f)
Goods Balance s.a.	595	296	936	1,226	820
Services Balance s.a.	112	64	-55	-76	-160
Investment Inc Bal	-701	-3,173	-2,303	-2,733	-2,640
Transfers Balance	102	41	167	-120	1,690
Current Account Bal s.a.	83	-2,808	-1,254	-1,814	-330
CAB Annual total	-5,946	-5,204	-4,458	-5,600	-6,100
Annual CAB, % of GDP	-3.2	-2.8	-2.4	-3.0	-3.2

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On an annual basis, we expect the CAD to widen from 3.0% to 3.2% of GDP. The reason that the reinsurance inflow won't have much impact on the annual total is that it largely replaces another one-off from a year ago: in Q3 last year, the major banks made almost \$1.37bn of provisions for tax owed on structured finance transactions, which reduced the outflow of investment income. Absent these one-offs, we estimate that the deficit would have widened from 3.5% to 3.9% of GDP.

Market implications

It's well recognised that the dramatic improvement in New Zealand's CAD over last two years was largely the product of an unusually deep economic downturn; a small widening in the deficit at this stage of the economic cycle would be of little concern for markets.

The real test will be how far the deficit widens again as the economy returns to its potential. Market forecasts vary greatly, but the biggest point of difference seems to be not on trade, but on investment income – that is, what will happen to the cost of New Zealand's external liabilities in coming years? Next week's release may shed some light on this matter – we'll be looking for income outflows to start to level out after a sharp rebound in the last year.

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