

Incoming

Q3 current account deficit widens to 3.1% of GDP

- The current account deficit widened slightly to 3.1% of GDP in the year to September.
- The quarterly balance was dominated by a \$1.7bn 'inflow', reflecting expected claims on foreign reinsurers after the Canterbury earthquake.
- A lower trade surplus for the quarter was counteracted by a smaller outflow from earnings of overseas-owned firms.

The September quarter balance of payments turned out largely in line with our expectations. The quarter was dominated by a large inflow from overseas reinsurance firms, arising from the Canterbury earthquake in September, leading to a rare current account surplus of \$35m in seasonally adjusted terms. But the underlying picture is one of a modest widening in the deficit as the economy recovers.

In seasonally adjusted terms, the goods balance narrowed in the September quarter but remained comfortably in surplus. A 3% improvement in the terms of trade wasn't enough to counteract a sharp fall in export volumes, a delayed consequence of the autumn drought. Import volumes continue to rise as domestic demand picks up, with a particularly sharp rise in imports of plant and equipment in Q3.

The investment income deficit was smaller than we assumed, mostly due to a drop in the earnings of overseas-owned firms. This is always the biggest source of uncertainty in our forecasts, since there are no timely indicators for this (for non-banks at least – bank earnings are disclosed each quarter). Non-bank earnings had sprung back surprisingly quickly in the last year – almost back to pre-recession levels – which seemed at odds with the state of the broader economy. We'd assumed that earnings growth would flatten out in Q3; instead, there was a sizeable drop from the June quarter highs (Figure 2). While we wouldn't exactly cheer about a fall in profits, it gives us some comfort that the income deficit is not set to blow out as the economy recovers.

The transfers balance included an estimated \$1.7bn inflow from foreign reinsurers, which was well-flagged by Statistics

Figure 1: NZ Balance of Payments

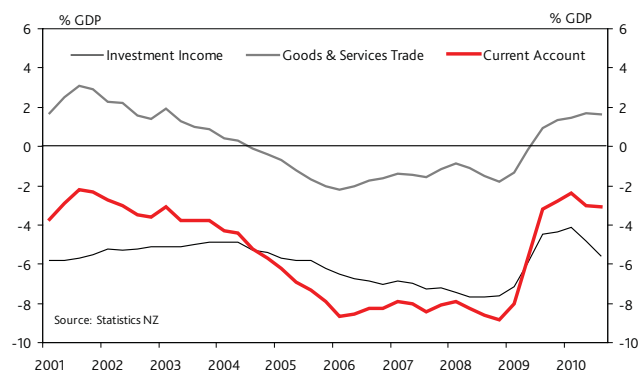
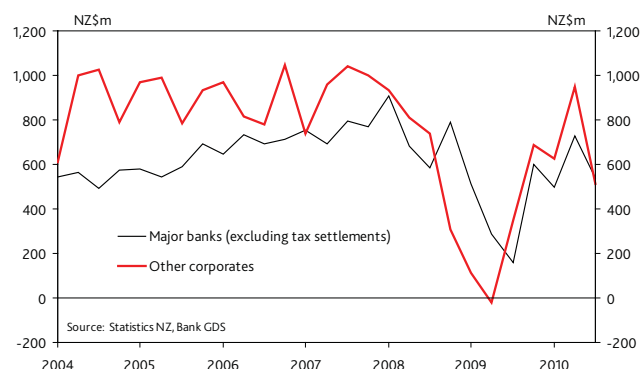


Figure 2: Profits of overseas-owned firms in NZ



Current Account Components (\$million)

	Sep-09	Dec	Mar-10	Jun	Sep
Goods Balance s.a.	667	301	917	1,176	835
Services Balance s.a.	93	68	-46	-92	-159
Investment Inc Bal	-738	-3,201	-2,346	-2,885	-2,294
Transfers Balance	101	41	167	-121	1,653
Current Account Bal s.a.	124	-2,791	-1,308	-1,922	35
CAB Annual total	-5,946	-5,204	-4,458	-5,707	-5,930
Annual CAB, % of GDP	-3.2	-2.8	-2.4	-3.0	-3.1

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NZ. The balance of payments is prepared on an accrual basis, so this inflow is applied to the period in which it was incurred, rather than when it will actually be paid. Since the final value of insurance claims won't be known for some time, this figure will be revised (most likely up) in future BOP releases.

Market implications

No reaction in the NZ dollar or interest rates. The deficit was narrower than the median market forecast of 3.4% of GDP – but then, positive surprises on the current account haven't garnered much of a market response in recent times. It's well recognised that the deficit is near a cyclical low point after the relatively deep economic downturn in 2008-09. The real point of interest is how far the deficit will widen again in the next few years, as the economy returns to its potential.

Interestingly, there are two clear camps emerging. On one hand, the Treasury and some credit rating agencies are projecting the deficit to head towards 7% of GDP, similar to the unsustainably large deficits of the previous decade. On the other hand, the RBNZ and many private sector forecasters (including us) suggest that the deficit will settle around more sustainable levels of 4-5% of GDP. What's more, the point of disagreement seems to be not the trade balance, but investment income – that is, how much the cost of New Zealand's external funding will rise from today's relatively low starting point.

To the extent that today's release provides any insight, it slightly favours the 'sustainable deficits' camp. To us, the risk was for a continuation of the rapid rise in the investment income deficit over the previous year; instead, the upward trend seems to be slowing (though admittedly the data is very choppy).

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