17 March 2011

Westpac Institutional Bank

The eye of the storm

Q4 Current account preview: 23/03 10:45am NZT

- **We expect New Zealand's annual current account deficit narrowed in the December quarter to 2.4% of GDP, led by an improving trade balance.**
- **Export volumes posted a solid improvement from a drought impacted Q3, while import volume growth was more modest.**
- **December quarter CAD relatively is unpolluted by one-off reinsurance flows, but these will dominate in Q1.**

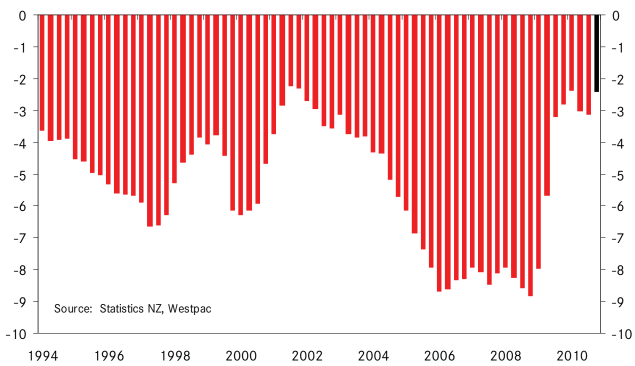
It has been difficult to get a clear picture of the underlying drivers of New Zealand's current account over the last couple of years, with the waters muddied by various one-off events. Reinsurance flows and large tax settlements by banks have all obscured the fundamental picture. While the December quarter will be free of these distortions, this clarity won't last long. Reinsurance flows following Christchurch's second devastating earthquake could even catapult the current account balance into surplus over this year.

In the December quarter, the trade surplus is expected to widen further, getting within a whisker of the historic highs achieved in June. Agricultural export volumes in particular will rebound from a drought affected Q3. Export price improvements will be more muted, despite skyrocketing global commodity prices late in 2010. Softer dairy prices in the quarter – the delayed impact of contracts signed mid-year when dairy prices were temporarily lower – will at least partially offset higher prices elsewhere.

We expect to see a small improvement in the services deficit. Visitor arrivals have been gradually improving over the course of 2010, although spending per person has remained soft.

The investment income deficit –the most unpredictable component of the current account with few reliable indicators – is expected to widen slightly in Q4. We've assumed earnings of overseas owned firms rebounded slightly in the quarter after a particularly weak Q3. This is consistent with anecdotes

Current Account as % of GDP



Current Account Components ($million)

	Dec-09	Mar-10	Jun	Sep	Dec(f)
Goods Balance s.a.	300	918	1,176	835	1,140
Services Balance s.a.	69	-46	-92	-159	-75
Investment Inc Bal	-3,173	-2,303	-2,849	-2,268	-2,530
Transfers Balance	41	167	-122	1,653	-60
Current Account Bal s.a.	-2,791	-1,307	-1,923	35	-1,530
CAB Annual total	-5,205	-4,459	-5,708	-5,933	-4,625
Annual CAB, % of GDP	-2.8	-2.4	-3.0	-3.1	-2.4

of the economy gradually gaining some momentum in late 2010/early 2011 before it was kneecapped by the devastating Christchurch quake.

The transfers balance will temporarily revert to more "normal" levels in the December quarter. While reinsurance flows relating to September's quake will drop out of the quarterly totals (the reinsurance flows are attributed to the quarter in which the event occurred), Statistics New Zealand's initial estimate that these would generate a $1.7bn inflow could well be revised. Any revisions will in turn impact the headline measure which is reported as an annual total. While sizable, September's reinsurance flows will be dwarfed by flows in response to February's even more destructive quake which could be in the order of $10 billion.

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

Market Implications

Should Wednesday's current account data post a small narrowing of the current account deficit it is unlikely to garner significant market reaction. Markets remain focused on the catastrophic earthquakes in Christchurch and more recently Japan, and this data predates both of these events. As noted, they will however have a significant impact on future current account outturns.

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