

A nice problem to have

Q4 current account deficit narrows to 2.9% of GDP

- The current account deficit narrowed to 2.9% of GDP in 2009, but was much wider than we or the market expected.
- However, most of the surprise came from a sharp rebound in profits of overseas-owned firms – a very positive sign in the context of an economic recovery.
- The cyclical narrowing in the deficit is nearing an end, and is expected to widen out to around 5% of GDP by the end of next year.

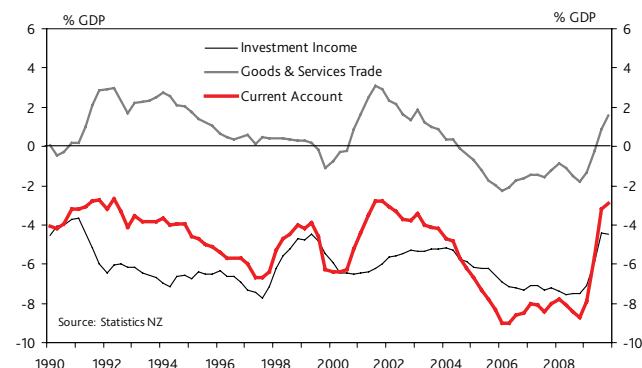
While New Zealand's annual current account deficit (CAD) narrowed further at the end of 2009, the deficit for the December quarter was significantly larger than the market expected, beating even our relatively large forecast by around \$1bn. However, we believe that the reasons for this surprise can be read as either neutral or positive for the economy.

The goods balance remained comfortably positive in seasonally adjusted terms. Export volumes were down only slightly in Q4, and have held their ground remarkably well through the global recession. While export prices are off their peaks, they are set to rise strongly in the first half of 2010 as the rebound in world dairy prices comes through with a lag. Import volumes rose modestly but are still around 20% below their pre-recession peak, and prices were down nearly 6% as a result of the stronger NZ dollar in Q4.

The imports bill was the source of the first major surprise, coming in almost \$500m higher than we expected. The Balance of Payments makes adjustments for, among other things, import shipments that have entered the country but not yet officially changed ownership. In past years this has seen a large deduction from imports in the December quarter; that didn't happen this time. We're not concerned as this is simply a matter of timing – the deductions are typically added back in the following quarter. Put another way, the upward surprise in today's figures suggests that March quarter imports will be around \$500m lower than we would have otherwise thought.

The second major surprise was on the investment income deficit, which surged from a 19-year low of \$743m in September

Figure 1: NZ Balance of Payments



Current Account Components (\$million)

	Dec-08	Mar-09	Jun	Sep	Dec
Goods Balance s.a.	50	804	780	642	237
Services Balance s.a.	-409	-245	-62	16	-17
Investment Inc Bal	-3,256	-2,781	-1,366	-743	-3,399
Transfers Balance	163	54	288	101	69
Current Account Bal s.a.	-3,452	-2,146	-402	39	-3,110
CAB Annual total	-15,969	-14,569	-10,371	-5,896	-5,473
Annual CAB, % of GDP	-8.7	-7.9	-5.6	-3.2	-2.9

to \$3,399m in December. The bulk of this came from profits of overseas-owned firms in New Zealand, which rose from a \$190m loss to a \$2,287m gain. We knew that the market was likely to be surprised by this item, but the actual outturn blew away even our forecasts. This may be seen as 'bad' for the deficit, but we regard it as a very positive sign for the broader economy – it suggests that the business sector is well into recovery mode.

Admittedly, the major Australian-owned banks account for a sizeable share of these profits, and from their quarterly disclosure statements we can see that they did indeed report a rise in profits in Q4, due to a pickup in trading and fee income and a drop in bad loan provisions (Figure 2).¹ There was also a partial reversal of tax provisions relating to structured finance

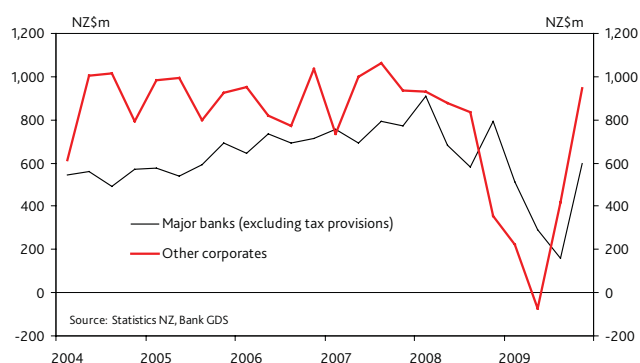
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transactions, adding \$379m to their bottom line, which we have excluded from our calculations (all up, these tax provisions reduced bank profits by \$1.65bn last year).

But as Figure 2 shows, that still implies a massive increase in the profits of other overseas-owned firms to make up the balance – about \$500m higher than we estimated, taking them back to pre-recession levels. Profits can be volatile from one quarter to the next, but the fact that this was the second substantial improvement in a row gives us some comfort that the turnaround is genuine.

Figure 2: Profits of overseas-owned firms in NZ



What's more, nearly two-thirds of profits were reinvested rather than paid out as dividends. This is consistent with the early stages of an economic recovery: with profits on the rise, firms can initially rely on internal capital to fund new projects, before resorting to bank loans and other external sources of capital. As a result, bank credit tends to *lag* the economic recovery – anyone looking to this as a prerequisite for growth is going to miss the party.

Market implications

The NZ dollar fell from 0.7070 to 0.7050 after the release. While the CAD was much larger than the median forecast of 2.0% of GDP, the market reaction may have been tempered by the recognition that much of the surprise was due to the positive factor of stronger company profits (and the fact that this aspect of the CAD is essentially self-funding – if firms weren't making profits, there wouldn't be a deficit to fund).

We have pencilled in a further slight narrowing in the annual deficit in Q1 this year. But from then on it will start to climb again as the economy regains momentum: import demand is rising, company profits are improving, and banks' tax provisions will start to drop out of the annual balance from Q2. We expect the CAD to return to a balance of around 5% of GDP by the end of next year, which we would regard as a sustainable level over the long run.

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¹ Note that in the Balance of Payments, bad loan provisions are treated as a balance sheet item rather than a profit/loss item.