

Economic Review

New Zealand

25 June 2009

Balance of Payments – March 2009 quarter

Key points

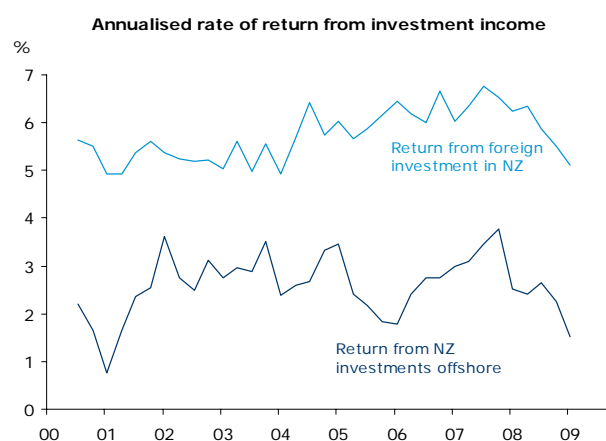
- > The current account deficit improved in the March quarter, courtesy of a sharp drop in imports.
- > The size of external imbalances still leaves the economy vulnerable, with the net international investment position nearing 100 percent of GDP.
- > Further sustained improvement in the current account requires a better export performance, with the global backdrop and recent NZD appreciation remaining key headwinds.
- > There are no monetary policy implications from the data. However, there does look to be some upside risk to our expectation of a 1 percent contraction in March quarter GDP to be released tomorrow, due to a stronger contribution from net exports.

Assessment

The current account deficit narrowed in the March quarter, although to a lesser degree than expected. In seasonally adjusted terms the quarterly deficit fell by \$1,042 million to \$2,682 million. This is the smallest seasonally adjusted deficit since December 2004. A significant improvement in the goods balance, driven by a sharp fall in imports, was the key driver of the smaller deficit. The seasonally adjusted goods balance rose to \$863 million and is in fact the first time a goods surplus has been recorded since March 2003. Offsetting this, to a degree, was a still large investment income deficit. While foreign firms operating in NZ recorded lower profits, a marked drop in the returns of NZ investors offshore saw the investment income deficit remain broadly unchanged from the previous quarter. In annual terms, the current account deficit improved from 9.0 percent of GDP to 8.5 percent, which is still large by international (and historical) standards.

Investment income deficit continues to dominate. The investment income deficit remains large at 7.1 percent of GDP, and has not shown as much of an improvement as we would have thought given the challenging domestic profit environment. Certainly, the investment income debit side has fallen, and is down 15 percent from its September 2007 peak. However, NZ owned firms or interests operating offshore have seen an even larger decline in earnings, with the investment income credit side down 58 percent from the late 2007 peak. Looking at the returns being generated, foreign investors continue to enjoy a far higher rate of return (though this has declined in the past few quarters) on their NZ assets compared to the returns from NZ investment offshore (annualised rate of 5.1 percent compared to just 1.5 percent). Should such a

divergence in performance continue to persist, the investment income deficit will continue to remain large.

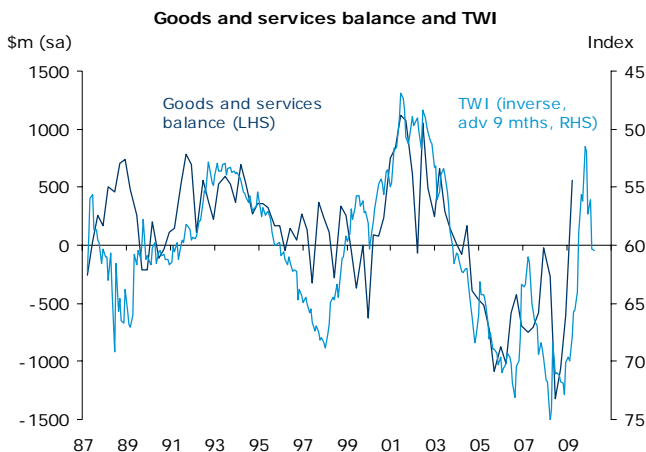


Sources: ANZ National, Statistics NZ

	Goods Balance \$m	Services Balance \$m	Inv. & Trsf. Balance \$m	Current Account Balance \$m	Annual CAB as % of GDP
Mar-07	-342	1,032	-2,960	-2,270	-8.3
Jun-07	21	-192	-2,984	-3,155	-8.3
Sep-07	-1,631	-649	-3,186	-5,466	-8.7
Dec-07	-428	97	-3,150	-3,481	-8.2
Mar-08	294	932	-3,335	-2,109	-8.0
Jun-08	-79	-518	-3,328	-3,925	-8.4
Sep-08	-2,046	-1,008	-2,959	-6,013	-8.7
Dec-08	-496	-451	-3,114	-4,061	-9.0
Mar-09	1,322	687	-3,256	-1,247	-8.5
ANZ	-	-	-	-890	-8.3
Market	-	-	-	-1,065	-8.4

A current account improvement does look like it could be a slow grind. While we shouldn't lose sight of the fact that the current account has started to improve, which is an encouraging sign in the first place, the fact that it did not improve as much as expected in the quarter is disappointing. While weakness in domestic demand will see ongoing weakness in imports, we cannot continue

to rely on this to improve the external position. There is a limit to how far imports can fall. A sustained turnaround in the external position will need to come from an improvement in export performance, either via volumes or prices and preferably both. However, the weak global backdrop, dairy subsidies affecting global prices and the recent appreciation in the NZD are doing the tradable sector no favours. Should the currency remain elevated for some time, the recent improvement in the goods and services balance will prove to be temporary, resulting in a very drawn out current account adjustment process.

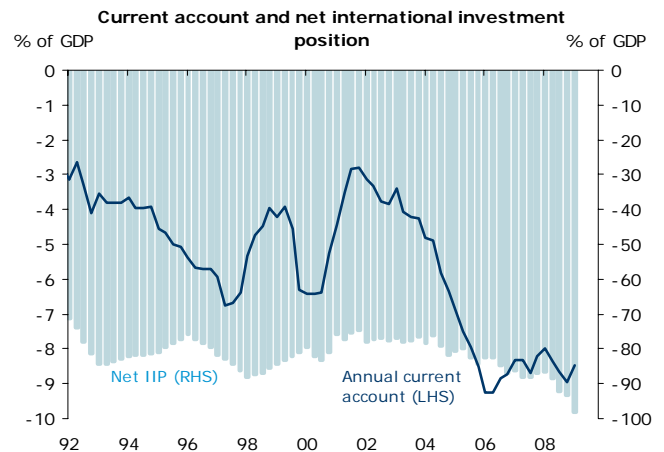


Sources: ANZ National, Statistics NZ

Nevertheless, a current account deficit adjustment remains a key theme driving our economic outlook. The economy cannot expect to recover and grow in a sustained fashion until there is further improvement in a number of structural areas. A smaller current account deficit is a key component of the structural adjustment the economy needs to go through. This will ensure that de-leveraging remains a dominant driver and is also a critical component driving our currency expectations. A lower NZD is a prerequisite to getting the external imbalances down.

External vulnerabilities will still be watched closely by rating agencies. While the imminent threat of a credit rating downgrade looks to have eased following an improvement to the medium-term fiscal outlook, we suspect that rating agencies will still be watching developments in NZ closely given our external vulnerabilities. With the stock of net international liabilities sitting at 98.3 percent of GDP (up from 93.2 percent in the December

quarter), the current account deficit needs to get to around 4 to 5 percent of GDP to start stabilising and hopefully make inroads in reducing this stock of net liabilities.



Sources: ANZ National, Statistics NZ

We now see some upside risk to our March quarter GDP pick due to the composition of exports and imports. The services balance, in particular, was better than we had envisaged. Despite visitor arrivals falling by 1.5 percent over the quarter, Statistics NZ report that the average expenditure per person was higher. Net exports now look like they will make a bigger positive contribution to growth than initially thought – over 2 percentage points by our estimates. Of course, consumption and investment will contract, and the wildcard is always how much of an inventory rundown occurred during the quarter. There tends also to be a mis-match at times between the expenditure and production GDP measures, with the latter being the headline number most focused on. We could still get a situation where the expenditure measure fares much better, but the production measure shows a far larger contraction. Nonetheless, the risk is to the upside of our -1.0 percent bottom of consensus call for tomorrow's GDP release.

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