

Balance of Payments – December 2008 quarter

Key points

- > Today's Q4 current account release was largely in line with expectations.
- > External imbalance clearly large and unsustainable, but a peak is likely to have been reached.
- > Improvements will be via a narrower investment income balance, as profits by foreign owned firms are affected by the recession and debt servicing costs on overseas debt reduces.
- > But extent of the current account improvement is dependent on the NZD. Recent sharp gains could prolong the much needed adjustment process.

Assessment

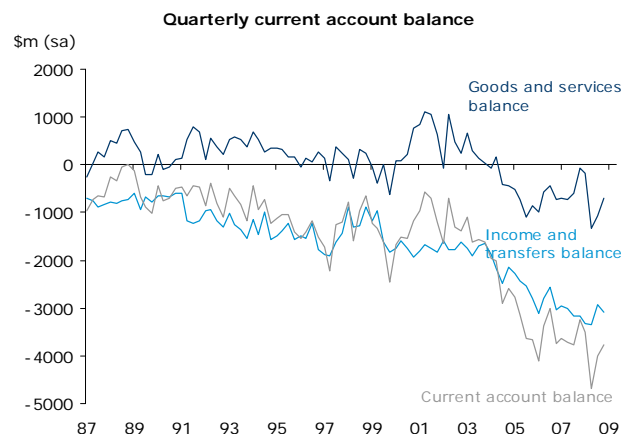
The seasonally adjusted current account deficit improved slightly in the December quarter. A deficit of \$3,772 million was recorded, \$236 million smaller than in the September quarter. The improvement was largely due to an improvement in the goods balance, with exports still benefiting from the lagged impact of high commodity prices, although recent falls in goods imports is also contributing. The investment income balance also improved slightly in the quarter to a deficit of \$3,199 million, \$58 million smaller than in September. Although the income from NZ's investments offshore fell, this was not enough to offset the lower profits being made by foreign firms operating in NZ. Offsetting these improvements slightly was a deterioration in the services balance, with the number of visitor arrivals, and the length of time visitors spent in NZ, impacting on services exports. Nevertheless, this is the second quarter in a row where the quarterly deficit has shown an improvement and suggests that the economy is starting its much needed rebalancing process.

However, a wider annual current account balance shows that there is some way to go yet. While slightly better than market expectations, the annual current account deficit widened to 8.9 percent of GDP, compared with 8.6 percent in the September quarter. This remains one of the largest deficits in the developed world. Considering the credit-centric nature of global events, this leaves NZ in a vulnerable position. Particularly with the government now flagging a larger fiscal deficit than what was contained in their downside forecasts released in December.

But we expect (and hope) that a peak has been reached. A current account deficit adjustment is a key driver of NZ's economic prognosis over the next 12 months as the economy

rebalances from spending towards more export and earnings orientated growth. The fact that the seasonally adjusted deficit has begun to reduce over the past two quarters is an encouraging sign and we expect this theme to continue.

	Goods Balance \$m	Services Balance \$m	Invnt. & Trsf. Balance \$m	Current Account Balance \$m	Annual CAB as % of GDP
Dec-06	-1,221	239	-3,019	-4,001	-8.7
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	-8.6
Dec-08	-529	-421	-3,076	-4,026	-8.9
ANZ	-	-	-	-4,055	-9.0
Market	-	-	-	-4,033	-9.0



Sources: ANZ National, Statistics NZ

However, this improvement is also premised on the belief that the domestic economy will remain weak for a time yet as households de-leverage. A lower currency is also a required component of this adjustment process. It therefore seems strange to hear comments of a pending solid rebound in the housing market (and therefore consumer spending) and also the NZD remaining at

current levels or increasing. These types of outcomes do not sit with the credit and de-leveraging nature of the adjustment the economy requires. And if they were to occur, this will only serve to delay the adjustment process. Although commodity prices are falling and export demand will be affected by the global recession, we expect import demand to fall by more. But the real driver of the current account improvement will be in the investment income balance. Debt servicing costs on our overseas debt will start to reflect lower wholesale interest rates, and profits by foreign owned firms will continue to be affected by the downturn. It will take some time and will be a slow grind, particularly with the large stock of net foreign liabilities (currently sitting at 92.9 percent of GDP), but it is the direction that will be important.

There are limited GDP implications from today's data. At the margin, goods import values were lower than we expected, with \$1,365 million of conceptual adjustments (due to differences between trade and BoP accounts). However, this is likely to be offset by lower than expected services exports. All-in-all, we remain comfortable with our expectations for tomorrow's December quarter GDP release, and are looking for a 1.2 percent quarterly contraction.

The financial account threw up some surprises. By construction, a current account deficit implies that the financial (or capital) account is in surplus. Effectively, the financial account shows how the current account deficit was funded

in the quarter. However, today's data reported that the financial account showed a net outflow of financial capital to the tune of \$2.6 billion, with a divestment of NZ assets abroad of \$7.1 billion being offset by a divestment of foreign investment in NZ of \$9.6 billion. This type of dynamic is not mathematically possible and results in net errors and omissions blowing out to \$6.7 billion. Statistics NZ notes that this is an issue with the financial account (due to coverage and data issues) and hence the numbers should be treated with caution. Nevertheless, and although we are unable to have a lot of confidence in the interpretation, the fact that capital repatriation was a key theme for both NZ and international investors in the quarter, does highlight to us the challenge for a nation like NZ at present who are reliant on foreign capital, when international investors are spoilt for choice. It reinforces to us our bearish views on the NZD.

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- Subject of an adverse finding by a court in any proceeding that has been taken against them in their professional capacity;

- Expelled from or has been prohibited from being a member of a professional body; or
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