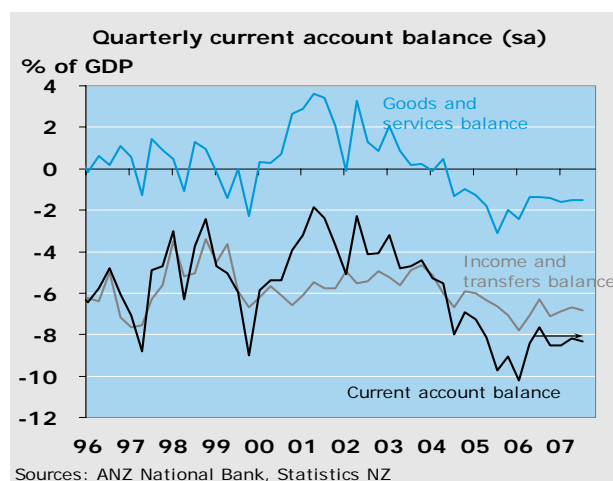


BALANCE OF PAYMENTS – SEPTEMBER 2007 QUARTER

Key points

- The annual current account deficit widened to 8.3 percent of GDP in the September quarter, in line with market expectations.
- The seasonally adjusted quarterly deficit also widened, despite the positive benefit coming from a surging terms of trade.
- A larger investment income deficit drove much of the deterioration in the quarter.
- We still expect higher commodity prices to lead to an improvement in the goods balance over coming quarters, but this will be offset by the cost of servicing NZ's high net debt position.
- There are limited monetary policy implications from today's release. The focus is firmly on Q3 GDP tomorrow.

	Goods Balance \$m	Services Balance \$m	Invt. & Trsf. Balance \$m	CAB \$m	Annual CAB as % of GDP
Sep-05	-2100	-496	-2583	-5179	-8.1
Dec-05	-1306	163	-2739	-3882	-8.6
Mar-06	-557	967	-3096	-2686	-9.3
Jun-06	169	-207	-2802	-2840	-9.2
Sep-06	-1436	-625	-2562	-4623	-8.8
Dec-06	-1222	281	-2915	-3856	-8.6
Mar-07	-342	1052	-2916	-2206	-8.2
Jun-07	21	-161	-2858	-2998	-8.1
Sep-07	-1620	-566	-2988	-5174	-8.3
ANZ	-	-	-	-4,870	-8.2
<i>Market</i>	-	-	-	<i>-4,910</i>	<i>-8.3</i>



- **The annual current account deficit, as a percentage of GDP, deteriorated for the first time in six quarters.** The annual current account deficit increased to 8.3 percent of GDP in the September quarter, from 8.1 percent in the June quarter. This was in line with market expectations. A larger annual investment income deficit drove the majority of the deterioration. For the quarter, the investment income deficit widened by \$203 million, due to an increase in income accruing to foreign investment in New Zealand (\$180 million) and a decrease in income earned from New Zealand investment abroad (-\$23 million).
- **The quarterly seasonally adjusted and trend current account deficits also deteriorated.** The seasonally adjusted current account deficit was \$3,628 million in the September quarter, up from a \$3,508 million deficit recorded in the June quarter. Again, a larger investment income deficit drove the widening in the seasonally adjusted deficit, with the goods and services balance effectively flat. We had expected a small improvement in the seasonally adjusted current account deficit. A smaller services balance (with lower than expected services exports and higher services imports), along with the larger investment income deficit look to be the reasons behind the unexpected decrease.
- **New Zealand's net international liabilities rose by \$2.3 billion in the quarter to \$151.1 billion, equivalent to 89 percent of GDP.** New Zealand's sizeable and growing external liabilities represent the continual running of large current account deficits. Debt makes up the clear majority of New Zealand's net international liabilities (\$133.3 billion or 88.2 percent of the total), and the increase in interest rates since early this year makes servicing that debt more expensive.

Assessment

Despite the terms of trade boom, New Zealand's current account deficit deteriorated in the quarter. Although the deterioration in the current account deficit was reasonably small (8.3 percent from a revised 8.1

percent in the June quarter) it comes at a time when New Zealand's terms of trade are at three-decade highs. We note that both the seasonally adjusted and trend deficits also deteriorated in the quarter. Dairy prices have surged and this impact is now beginning to feed through in NZ's trade statistics, yet the seasonally adjusted goods and services deficit was effectively unchanged in the quarter.

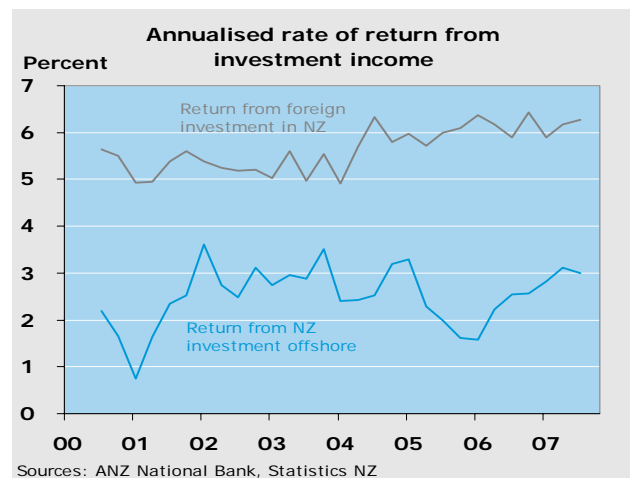
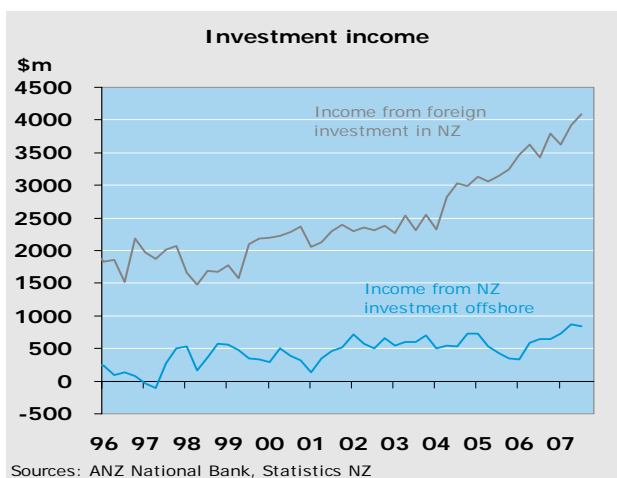
One can't go past a persistently high NZD (despite being largely unchanged in the September quarter) that is weighing on pockets of the export sector reducing competitiveness overseas, as well as making imports relatively more affordable. A substantial improvement in the current account deficit is unlikely to occur in the absence of a lower NZD. However, the largest contribution to the deterioration in the current account deficit in the quarter came from increased profits accruing to foreign owned firms operating in NZ. Although firms making profits is unquestionably positive, it does weigh on the current account given the extent of foreign ownership in NZ. While the investment income deficit is due to offshore investors owning more assets in NZ compared to NZ owned assets offshore, it is also the fact that foreign owned firms in NZ continue to make higher returns on investment compared to NZ owned firms offshore.

We expect the current account to slowly improve, although it will be a very slow grind. Further dairy-related terms of trade improvements are expected over coming quarters and this should help to reduce the overall current account deficit. Slowing import demand – as the housing market and consumer spending continue to moderate – is also expected to contribute to an improving external imbalance. However, the extent of NZ's stock of net foreign liabilities (which is predominately made up of debt) means that debt servicing costs for the country will remain at high levels and limit any major improvement in the current account deficit.

The extent of NZ's external imbalances leaves it vulnerable. In the current global environment where risk is being re-priced and credit is becoming more expensive, NZ's large external deficit leaves it vulnerable to a change in investor sentiment. A lack of local savings means NZ has to look offshore to fund its investment needs. Rating agencies are likely to continue to voice concern at the size of the current account deficit. However, with a Government that continues to record strong operating surpluses (which we again received confirmation of earlier this week), these concerns are likely to be mitigated for now.

Softer net services exports pose downside risks to our expenditure GDP estimate. Although visitor arrivals were flat over the September quarter, Statistics NZ reported that the daily expenditure per visitor fell. This should weigh on the services export volumes in the GDP accounts and suggests a larger detraction than we initially envisaged. We expect the net export sector to shave 0.3 percentage points off Q3 expenditure GDP growth. We note that Statistics NZ has made historical revisions to the current account deficit as a percentage of GDP figures. It appears these revisions are due to a higher level of nominal GDP, which we suspect could be due to revisions in the GDP deflator as opposed to any changes to the real GDP growth rates.

There are limited monetary policy implications from today's release. While the Reserve Bank wants to see growth rebalance away from domestic demand towards the external sector, and today's current account balance shows that to still be some way away, the Reserve Bank's predominant concern at the moment is on inflation. Tomorrow's Q3 GDP print will be the Reserve Bank's (and the market's) main focus.



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