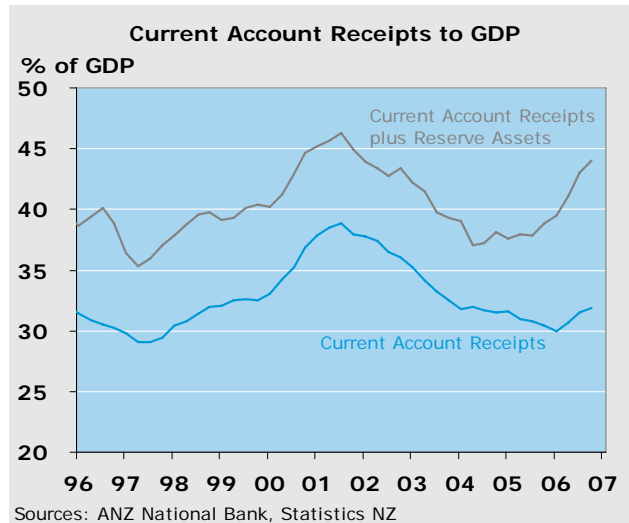
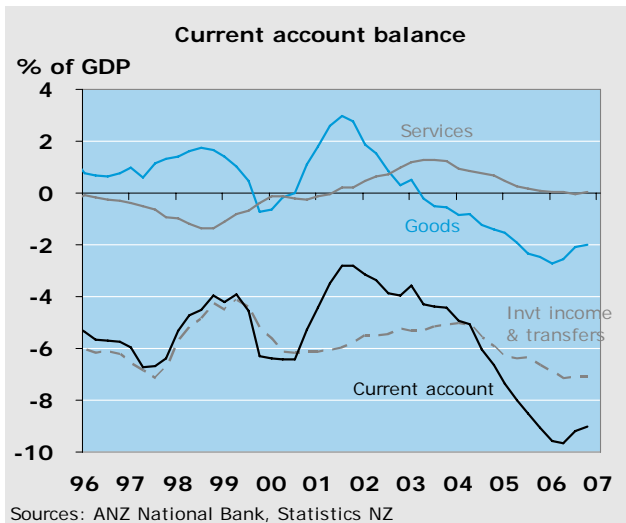


## BALANCE OF PAYMENTS – DECEMBER QUARTER 2006

### Key points

- The annual current account deficit came in as we had expected at 9.0 percent of GDP (slightly better than market expectations of a 9.1 percent deficit). This is an improvement on the 9.2 percent deficit recorded in the previous quarter.
- However, the composition was slightly different with a slightly better than expected goods and services balance offset by a larger than expected investment income deficit.
- Higher direct investment (mainly in the banking sector) and portfolio income earned by foreign investors contributed to the larger investment income deficit.
- We continue to see a gradual improvement in the current account deficit over the quarters ahead, but it will be a slow hard grind given where the currency is.
- There is limited monetary policy implication from today's data. Our view for tomorrow's Q4 GDP, which we expect to print at 1.0 percent, is unchanged.

NZ\$ million	Dec 2006 quarter	Year to Dec 2006	Year to Dec 2005
Goods Balance	-1,273	-3,229	-3,829
Services Balance	209	91	116
Investment Income Balance	-3,125	-12,097	-10,753
Transfers Balance	260	788	536
<b>Current Account Balance</b>	<b>-3,929</b>	<b>-14,447</b>	<b>-13,931</b>



- **The annual current account deficit improved to 9.0 percent of GDP from 9.2 percent in the previous quarter.** An improvement in the goods and services balance accounted for the small reduction in the annual current account deficit. However, on a seasonally adjusted basis, the current account deficit widened by \$329 million in the quarter. This was largely due to higher earnings by foreign investors on their New Zealand investments, which increased by \$385 million in the quarter to \$3,777 million. This is a similar level to the June quarter result and is largely attributed to increased earnings in the banking sector. The income New Zealand earned on its investments overseas was largely unchanged from the September quarter at \$653 million.
- **A larger than expected investment income deficit offset improvements in the goods and services balances.** The quarterly current account deficit, at -\$3,929 million, was in line with our expectations (-\$3,954 million), but the composition was slightly different with a larger than expected investment income deficit. The goods and services balances were slightly better than we were expecting, largely due to lower imports – a result of conceptual BOP adjustments – with exports in line with expectations. The lower import values were also partly a result of the largest fall in merchandise import prices since the March 2001 quarter, falling 6.0 percent in the December quarter due to a 20.8 percent fall

in petroleum and petroleum products prices. The annual services balance rebounded in the December quarter to record a surplus after recording a deficit in the September quarter – the first annual deficit since March 2001.

- **New Zealand's net international liabilities rose by \$5.8 billion in the quarter.** The stock of foreign investment in New Zealand reached \$247.0 billion in the December quarter, while the stock of New Zealand investment abroad rose to \$103.8 billion. This saw New Zealand's net international liabilities increase to \$143.2 billion (89 percent of GDP) and \$11.8 billion above the December 2005 level.

## **Assessment**

**Although New Zealand's annual current account deficit has improved from a peak of 9.7 percent of GDP in the June 2006 quarter to 9.0 percent in the December quarter, it is still at an unsustainable level.** The fact that the deficit is at least moving in the right direction, and most of this improvement has come from the goods balance side, is mildly comforting. The strong rise in New Zealand's main export commodity prices has more than offset the rise in the NZD, and will continue to increase the value of primary exports over the first half of this year if maintained. However, the high level of the NZD will weigh on manufactured exporters and the services sector. The services trade balance, which is dominated by tourism, is barely in surplus. But it is encouraging nonetheless, that despite the level of the NZD, visitor arrivals have continued to trend up over the past year, and the amount they are spending per day has increased – though this has been offset somewhat by a reduction in the average number of days they spend in the country.

**The current account deficit is symptomatic of the imbalances facing the economy.** Two years of slowing growth have so far failed to make a material dent on the deficit. A high currency and continued strong appetite for debt accumulation has kept the current account deficit high. The net investment income deficit now stands at 89 percent of GDP, implying a greater proportion of income is needed to service the growing debt level. This points to the investment income deficit, currently at 7.1 percent of GDP, remaining sticky at those levels and signals a possible structural change towards a higher deficit.

**The investment income deficit looks to diverge from the corporate profitability cycle.** We had anticipated an improvement in the investment income deficit given the squeeze on profits facing corporate New Zealand. However, the fact that the net investment income deficit is predominantly made up of debt (87 percent) point to the investment income deficit being less sensitive to the corporate profit cycle than first thought and influenced more by changes in interest rates. With global interest rates set to rise and domestic interest rates set to stay at high levels for some time, a material improvement in the investment income deficit is not likely over the coming quarters. Part of the investment income story is as much about poor returns from New Zealand investment abroad as opposed to income accruing to foreign investors in New Zealand. The return earned by foreigners on their New Zealand assets continues to outstrip the returns by New Zealand owned foreign assets by a wide margin (1.6 percent in the quarter versus 0.7 percent).

**Despite the large current account deficit, credit rating agencies will remain unconcerned.** The fiscal position remains one of the best in the developed world, and the fact that the deficit is showing improvements over the past two quarters will be viewed favourably. The other ratios which rating agencies monitor, such as the current account receipts to GDP ratio, similarly show improvements. If the Reserve Assets are included, the ratio shows an even bigger improvement. Despite this, the external imbalance remains a key source of vulnerability for the New Zealand economy, which the Reserve Bank is seeking to address by slowing domestic demand (particularly the housing market).

## **Financial market implications**

**From a financial market perspective, the NZD initially gained around 20 basis points to 0.7120 before settling back down to its pre-release level of 0.7100. Given that it was only slightly better than market expectations and there are few implications for Q4 GDP, we are not reading too much into it.**

**There are limited monetary policy implications from the current account number.** The Reserve Bank will continue to keep interest rates high for some time to get the rebalancing in growth away from domestic demand towards the external sector, which will help reduce the current account deficit. While we expect the current account deficit to gradually improve over the coming quarters on the back of a declining investment income balance, any improvement will be a slow hard grind as the high level of the NZD continues to act as a drag on exports while resilient domestic demand keep imports at elevated levels.

**Today's release does not alter our expectation for Q4 GDP due tomorrow.** The goods and services balances confirm our expectation that the net external sector will be a huge drag on growth in Q4. Our estimate of 1.0 percent growth for Q4 GDP is similar to the Reserve Bank's forecast and market consensus estimates. We see upside risk to the GDP number, which will bias the currency and rates market upwards.

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