19 June 2013

Westpac Institutional Bank

Up-down, up-down, down

Q1 Current account deficit at 4.8% of GDP

- **The current account deficit narrowed by 0.2 percentage points to 4.8% of GDP in March 2013 year, in line with our expectations.**
- **The timing of the twin impacts of the drought – lower export volumes next quarter, then higher dairy prices – will mask growing imbalances this year.**
- **From 2014 onwards, imbalances will drive the current account further into deficit.**

The current account deficit gets a free pass this quarter. In fact, with the drought set to take and then give back to the balance over the next two quarters, the free passes may last out the year.

Meanwhile, the underlying growth in the economy is accelerating. The Canterbury rebuild is humming along; households are confident and spending; while manufacturing has had its best month in nine years in May. On the other hand, the export sector is dealing with the volatility associated with the drought and a still over-valued exchange rate.

As such, growth is lop-sided. The export sector leg is shorter than the domestic leg, and the economy is walking with a limp. The economy's limp is set to worsen.

Many businesses will enjoy the improvement in the domestic economy. Equally households will enjoy growing employment and the extra spending power that the high currency affords. Also, markets will continue to look favourably upon New Zealand compared to our international peers as our economy grows while many others stand still.

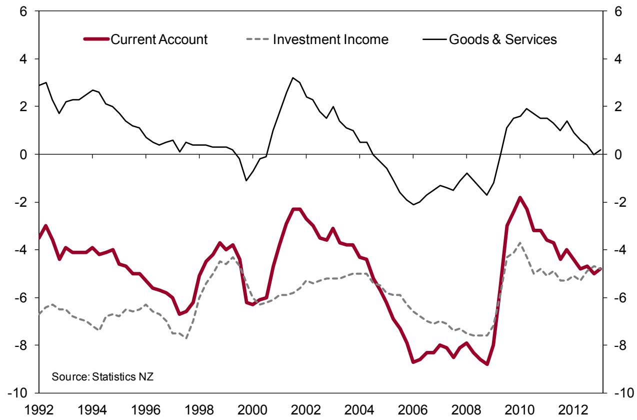
But, the current account deficit is a tell-tale sign of economic imbalances. Other signs are that household debt to income ratio is rising, house prices are continuing to hit new highs, and the exchange rate remaining overvalued. Eventually, New Zealand's 'borrow and spend ways' may get it in trouble.

Detail

The current account deficit narrowed to $2.2bn in seasonally adjusted terms in the March quarter. This was precisely in line with our and the market's forecasts. The detail was also in line with our expectations. Along with the lack of any immediate red flags, market focus quickly switched elsewhere.

As a proportion of GDP, the current account deficit narrowed to 4.8% in the March quarter from 5.0% in December. The deficit now stands around 3 percentage points higher than its recent low of 1.8% in March 2010.

NZ Balance of Payments, as a % of GDP



Current Account Components ($millions)

	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13
Goods balance (s.a.)	149	340	145	395	615
Services balance (s.a.)	-286	-198	-287	-307	-124
Balance on investment income	-2,305	-2,811	-2,213	-2,495	-2,511
Balance on current transfers	-160	-106	-147	-86	-135
Current Account Balance (s.a.)	-2,631	-2,804	-2,521	-2,539	-2,209
Annual Current Account Balance	-9,032	-10,087	-9,861	-10,486	-10,077
Annual CAB, % of GDP	-4.4	-4.8	-4.7	-5.0	-4.8

The seasonally adjusted balance on goods improved to a surplus of $615m, up $220m from the December quarter as the volume of dairy exports rose. The value of imports was largely flat, but this reflected currency strength and weak prices rather than any drop-off in demand. On the services side, the deficit narrowed a touch to $124m mainly as visitors to New Zealand spent more. The deficit on investment income largely tracked sideways for the quarter.

Over the remainder of 2013, we expect volatility associated with drought to drive the current account balance and to mask the underlying story of rising imbalances. Over the last year a fall in the balance has then been followed by an increase. For the pattern to continue, the June quarter balance needs to fall. In this respect the drought will duly oblige as the drought hit to production will flow through lower export volumes next quarter. But the drought is not done yet. The spike in world dairy prices, as a result of the drought, will then flow through to dairy export prices in the September quarter.

Come 2014, the pattern will break and the goods balance will head south. The accelerating Canterbury rebuild will generate demand for imports. Households that are borrowing and spending more will also add to the import bill.

Moreover, we expect the income deficit to also widen over 2014. With domestic growth improving, profits of foreign-owned New Zealand firms should increase. Moreover, as the Reserve Bank moves to cool the economy by raising interest rates next year, interest payments to overseas lenders will increase.

Market reaction

There was no market reaction to the release.

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