



## New Zealand Current Account Balance

2 April 2009

### Executive Summary - Commentary

#### “External Deficit Dissected: Victims of our own success?”

Asia-Pacific Risk Management Limited (“APRM”) recently conducted a detailed analysis as to what makes up our Current Account deficit and what are the trends of those individual component parts.

Our conclusions from that analysis and forecast of how that deficit number should track over the next 12 to 24 months are markedly different to the current mainstream economic viewpoint on this important economic measure. Most economic forecasting groups predict the Current Account deficit to remain around existing wide levels.

Based on strong historical correlations between the Investment Income deficit and general business profitability levels in New Zealand and international interest rates, APRM projects the Current Account deficit to reduce from the current 8.9% of GDP to near 5.5% of GDP over the next 12 months. If this projection proves to be accurate, this should be good news for the credit rating agencies as they consider whether to downgrade New Zealand’s sovereign rating due to the dual deficit problem (growing Government budget deficit alongside the large Current Account deficit)

The following analysis highlights a stark and structural reality that the largest and dominating contribution to the increase in the Current Account deficit over the last five years has been the increased profitability of overseas-owned companies operating in New Zealand. The profits and dividends are owed to the foreign owners (e.g. the Australian owned banks) and therefore increase the liabilities side of the external accounts. As the economic recession in New Zealand significantly reduces company profitability, those liabilities to overseas owners will also decrease.

APRM projects the overall deficit to reduce from NZ\$16.0 billion at 31 December 2008 to NZ\$10.5 billion by the end of 2009. The Investment Income balance ( comprising “direct”, “portfolio” and “other”) to reduce by NZ\$3.0 billion over the next 12 months, from NZ\$13.6 billion to NZ\$10.6 billion. Concurrently, the trade (import/export) balance to improve by NZ\$3.4 billion, moving from a NZ\$2.4 billion deficit to a NZ\$1.0 billion surplus due to weaker imports and stronger growth in exports. The services balance, incorporating mainly reduced receipts from tourists, is forecast to deteriorate from a present deficit of NZ\$1 billion to NZ\$1.7 billion.

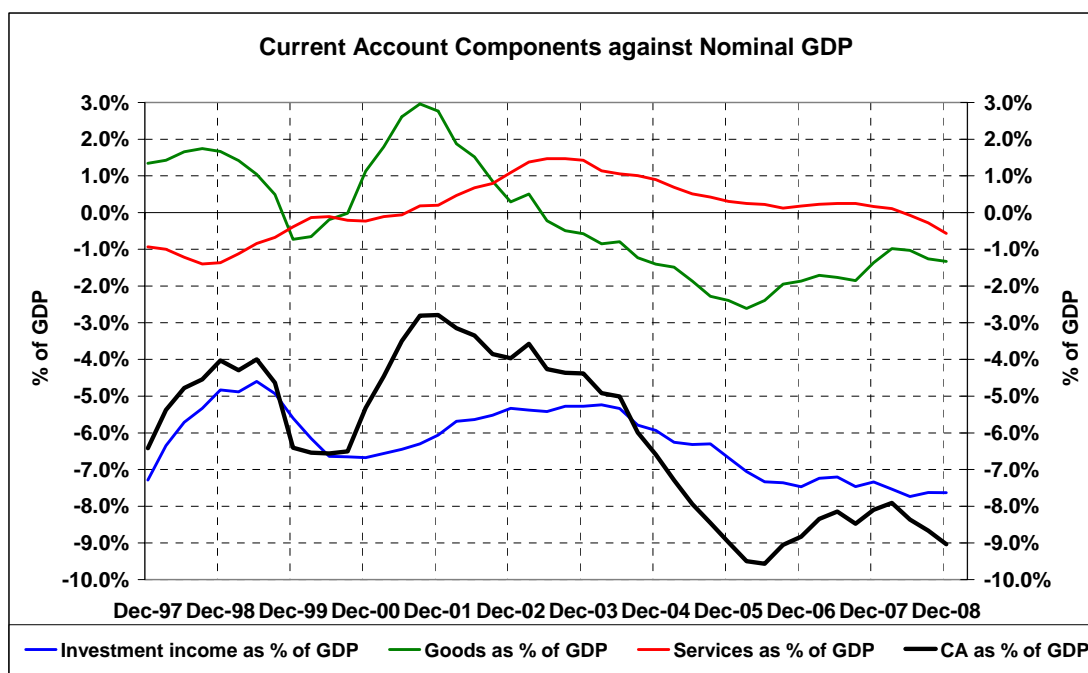
Substantial reductions in global interest rates over the last 12 months will reduce the interest amounts paid and owed to foreign lenders from New Zealand domiciled banks. APRM’s estimation is that the interest bill paid offshore could decrease by up to NZ\$1.5 billion this year.

The anticipated significant changes in company profitability and global interest rates produce a forecast of a material decrease in our Current Account deficit in 2009.

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## Introduction

**The New Zealand Current Account deficit is predominantly a deficit on Investment Income.** These are investment flows to overseas-owners of companies operating in New Zealand in the form of dividend payments on profits, and interest payments to foreign lenders from New Zealand domiciled banks and corporates.

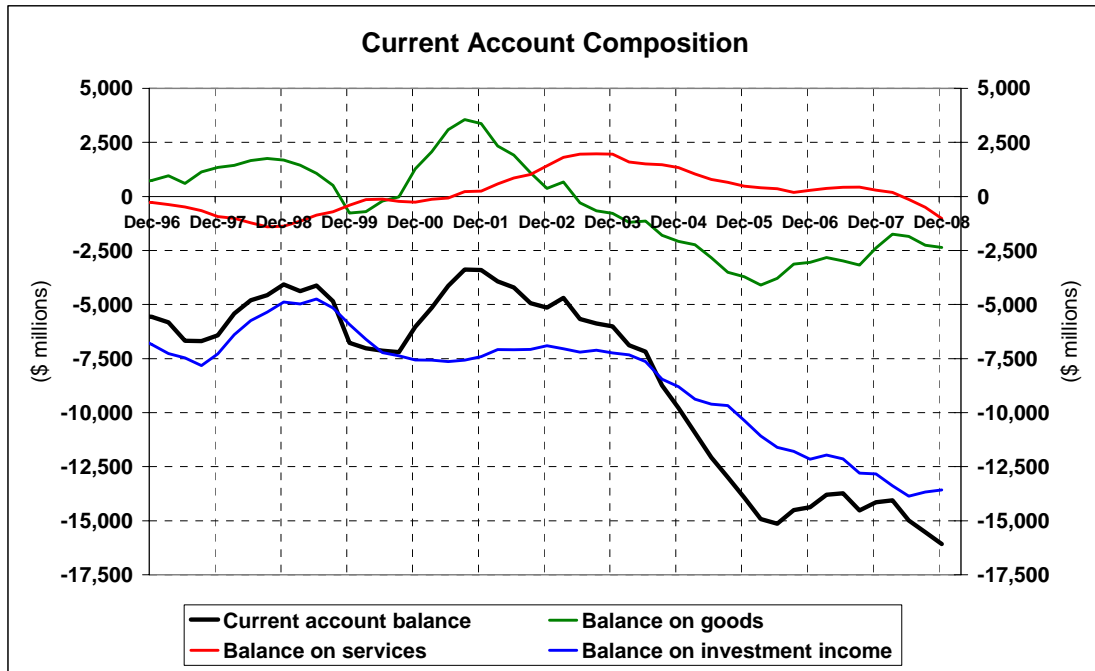


**The Investment Income balance for the 2008 year was in deficit to -7.6% of (nominal) gross domestic product.**

**The Goods balance for the 2008 year was in deficit to -1.3% of gross domestic product.** The Goods balance is the difference between merchandise exports and merchandise imports (also known as the balance on visibles).

**The Services balance for the 2008 year was in deficit to -0.6% of gross domestic product.** The Services deficit is the difference between what foreigners spend on New Zealand services (e.g. tourism) and what New Zealanders spend on foreign services (also known as the balance on invisibles).

The Current Transfers balance (not shown) for the 2008 year was in surplus to 0.5% of gross domestic product. Current Transfers include gifts and grants and transfers made by migrants as they move country.



It appears the Goods balance is in the process of moving back to 0% to modestly positive. This is due to the weaker NZD currency value and relatively firm food export commodity prices with demand for these essential products New Zealand exports seen as better maintained than many of the non essential products New Zealand imports.

The balance on Services (predominantly tourism) appears set for a period of running in deficit as international tourism slows amidst the weakening global economy; this follows a lengthy period of having been in surplus. One caveat to this pessimism is that historical analysis shows that when the global and Australian economies are weaker Australian tourists have a greater propensity to travel to New Zealand (than further afield).

**Collectively, it appears likely the combined Goods and Services balances will not be significantly different from zero over coming years - that is the total Current Account deficit will continue to be driven predominantly by the Investment Income balance.** [For the 2008 year the Investment Income deficit contributed five-sixths of the overall Current Account deficit].

**If the balance on Investment Income deficit is reduced to approximately 4% to 5% of GDP then the overall Current Account deficit will likely be no worse than 5% to 6% of GDP. Relative to the existing level of close to 9% of GDP such a Current Account deficit is likely to be seen as more sustainable and therefore unlikely to elicit strong concern around the need for a weaker NZD and/or higher long-term New Zealand interest rates (i.e. reducing the threat of a credit rating downgrade) as has permeated in recent years.**

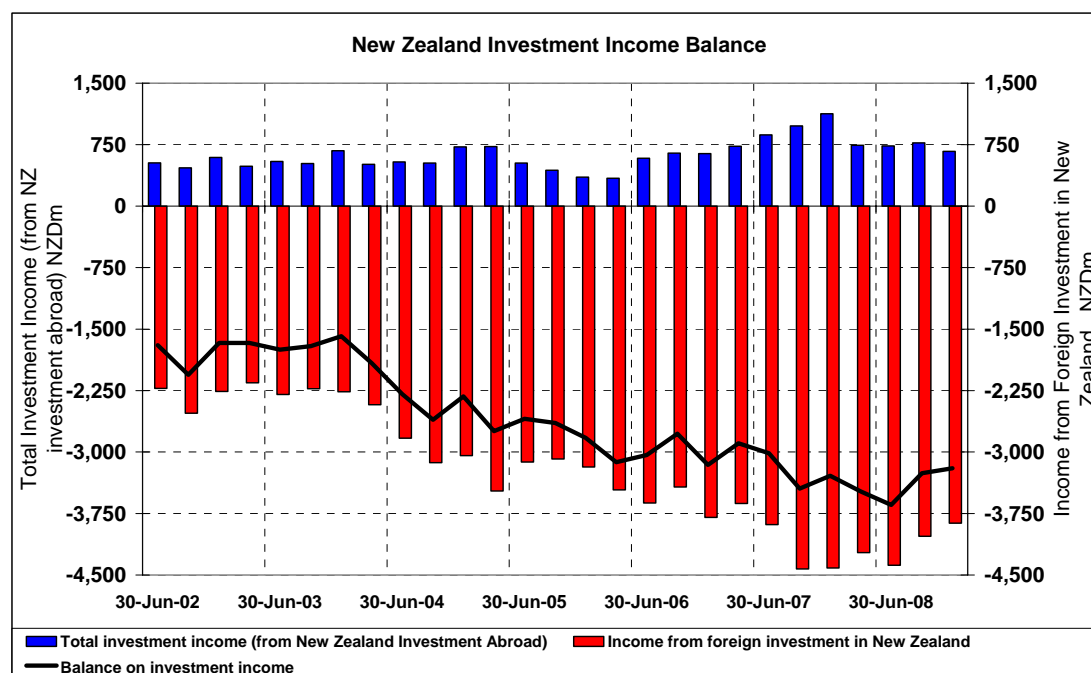
The remainder of this document will consider the sources of the Investment Income deficit since June 2002. The close to seven years of data available spans the latest previous period of expansion for the New Zealand economy and can be useful to form conclusions regarding the likely extent of a narrowing in the Investment Income deficit over coming years.

## Balance on Investment Income

The Balance on Investment Income is defined as:-

Total Investment Income from New Zealand Investment abroad less Total Investment Income from foreign Investment in New Zealand.

This balance has been perpetually in deficit for the last seven years due to the high structural degree of foreign ownership of New Zealand companies and New Zealand indebtedness to foreign lenders. The strong profitability of overseas-owned companies operating in New Zealand in recent years and progressively higher international (i.e. US) interest rates over most of the recent period have been contributing cyclical factors to the widening of the Investment Income deficit.



Note: quarterly data shown above

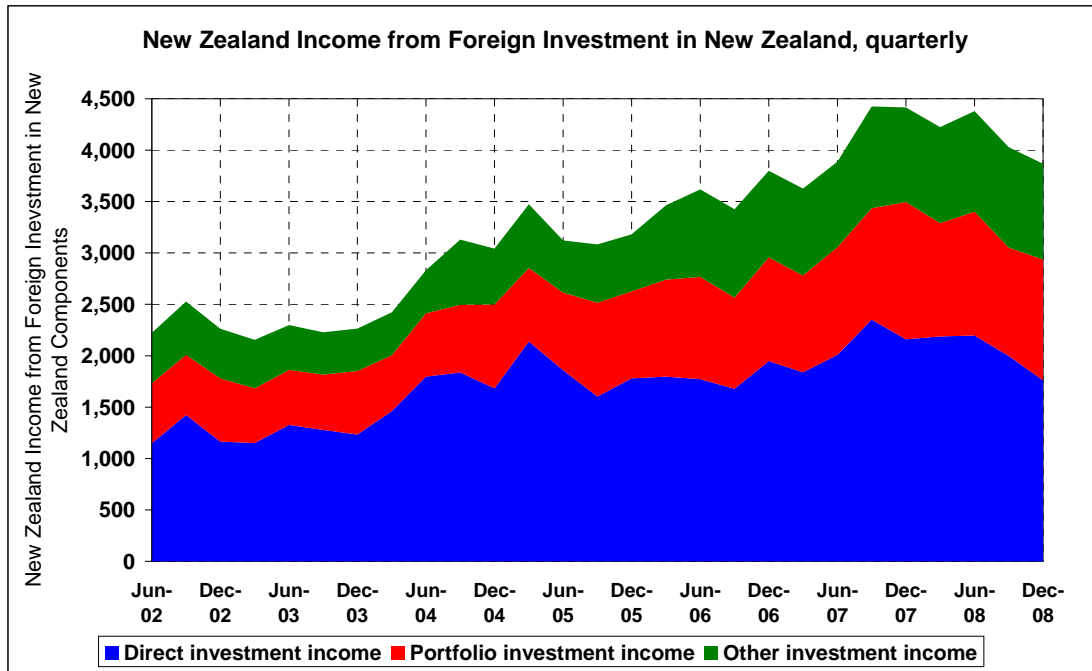
Income from Foreign Investment in New Zealand is defined as:-

Direct Investment Income (where the direct investor owns 10% or more of ordinary shares) plus Portfolio Investment Income (where ownership is less than 10%) plus 'Other' Investment Income (trade credits, loans, deposits and other instruments).

Direct Investment Income refers to the income to foreign owners of private New Zealand companies or dividends to material owners of larger New Zealand companies.

Portfolio Investment Income refers to the dividend income to less material owners of larger New Zealand companies.

There is some evidence that these investment income outflows (quarterly data below) have passed their peaks of late 2007 to early 2008.



Assuming a reasonably stable structural element to the stock of overseas-owned companies operating in New Zealand, then the income outflows on those holdings is linked to the profitability of performance of those companies.

In cyclical terms, periods of a strengthening New Zealand economy leads to greater profitability therefore greater dividend outflows and a wider investment income deficit.

In annual terms direct investment income has fallen 8.4% from its peak (NZD750m), portfolio investment income has fallen by 4.0% (NZD750m) and 'other' investment income is largely unchanged.

	Direct Investment Income	Portfolio Investment Income	Other Investment Income
Peak (June 2008)	NZD8,900m	NZD4,725m	NZD3,825m
Current (Dec 2008)	NZD8,150m	NZD4,535m	NZD3,815m
% from peak	-8.4%	-4.0%	-0.2%

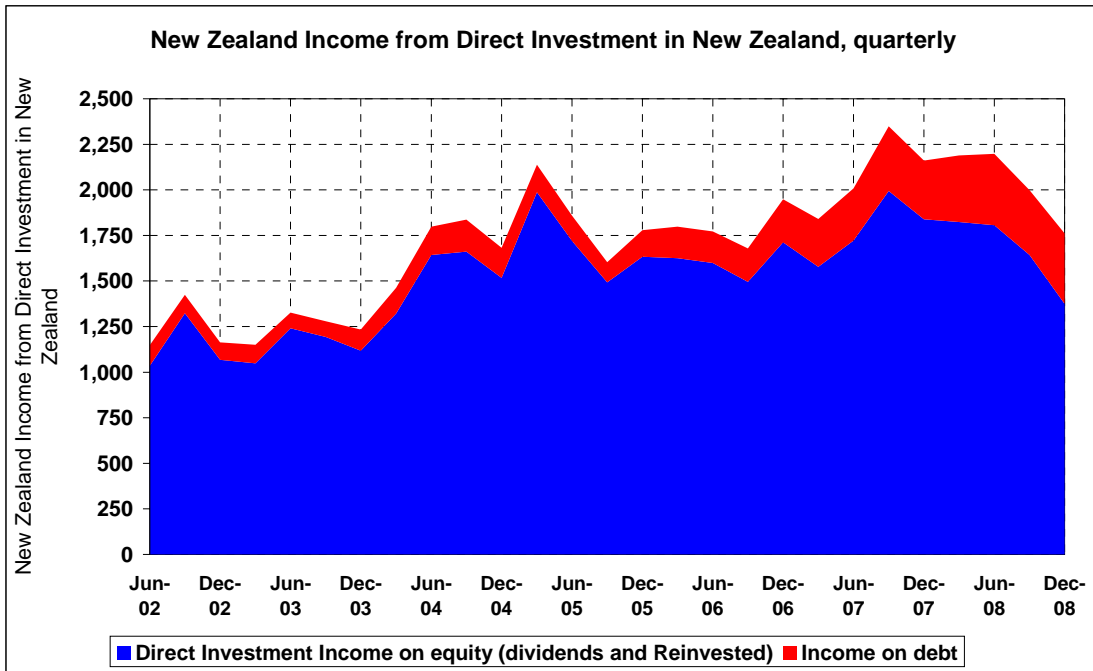
***Direct Investment Income***

Direct Investment Income is defined as:-

Direct Investment Income on equity plus Direct Investment Income on debt.

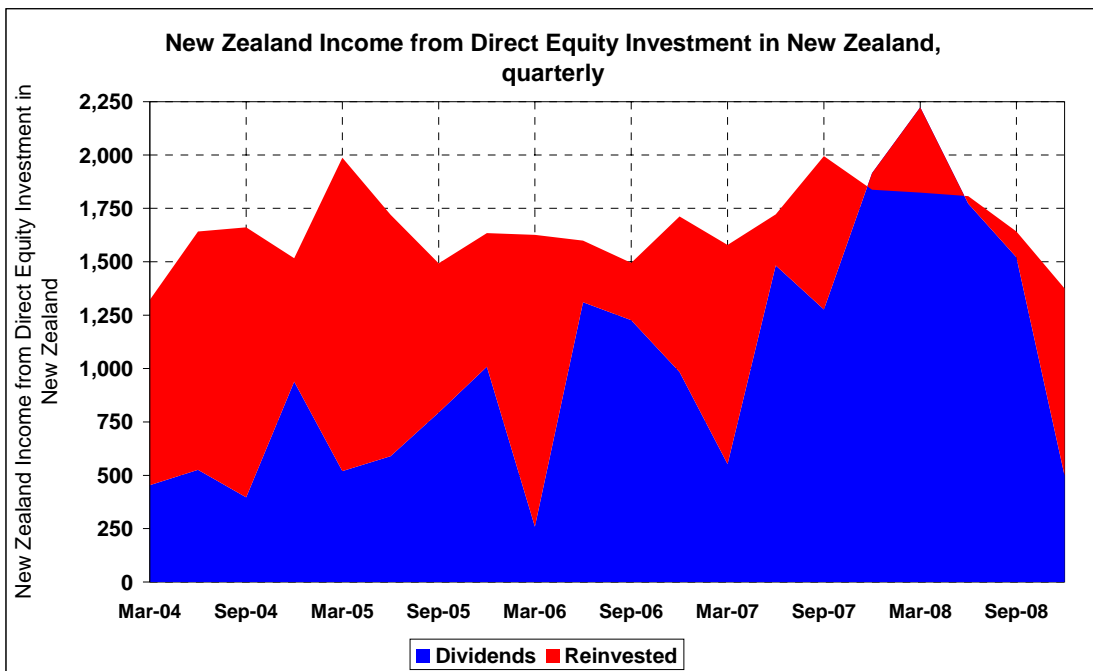
Direct Investment Income on equity has weakened quite sharply from the June 2008 peak as overseas-owned companies operating in New Zealand have turned less profitable.

Direct Investment Income on debt increased over 2006 and 2007 (as US / global interest rates increased) and has been stable over 2008. Direct Investment Income on debt is likely to reduce over 2009 as a reflection of lower lending rates; whilst lending margins have increased this has been super-ceded by the extent of reductions in base rates as central banks (such as the US Federal Reserve) have slashed key overnight interest rates to close to zero.



Direct Investment Income on equity:-

Direct Investment Income on equity can be paid out to foreign material owners of New Zealand companies as dividends or re-invested. December 2008 quarter figures showed a movement towards re-investment, but will need further signs of this occurring in coming quarters to confirm.

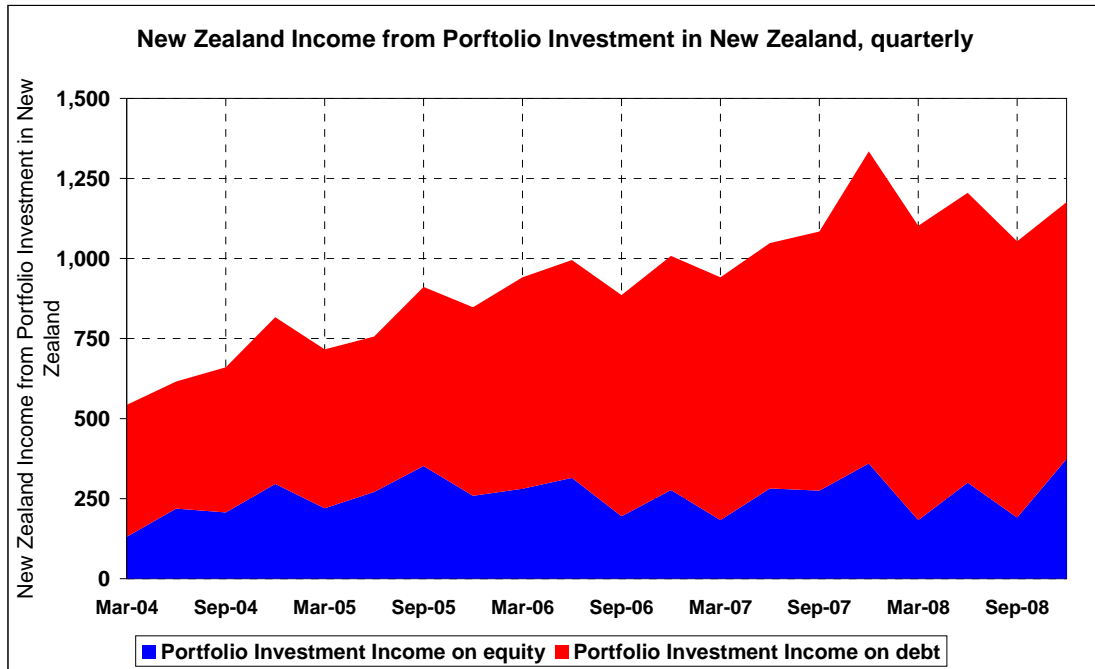


## Portfolio Investment Income

Portfolio Investment Income in New Zealand is defined as:-

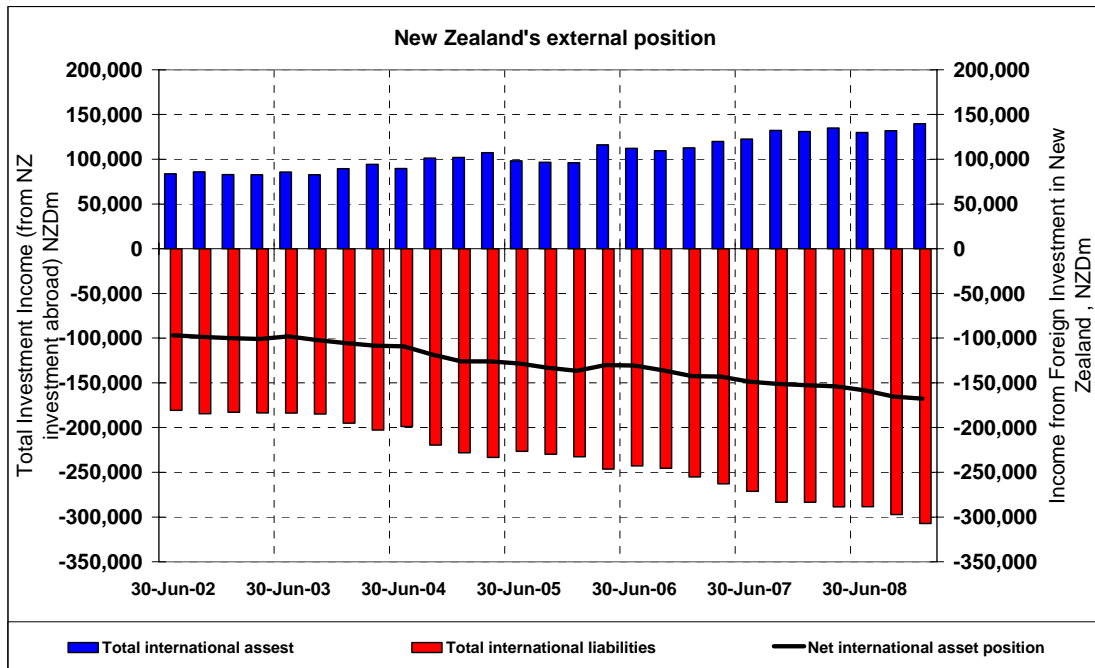
Portfolio Investment Income on equity plus Portfolio Investment Income on debt.

Unlike direct investment income, portfolio investment income earned in New Zealand is predominantly through debt (not equity). This is in the form of interest payments by New Zealand based banks and corporates to foreign lenders.



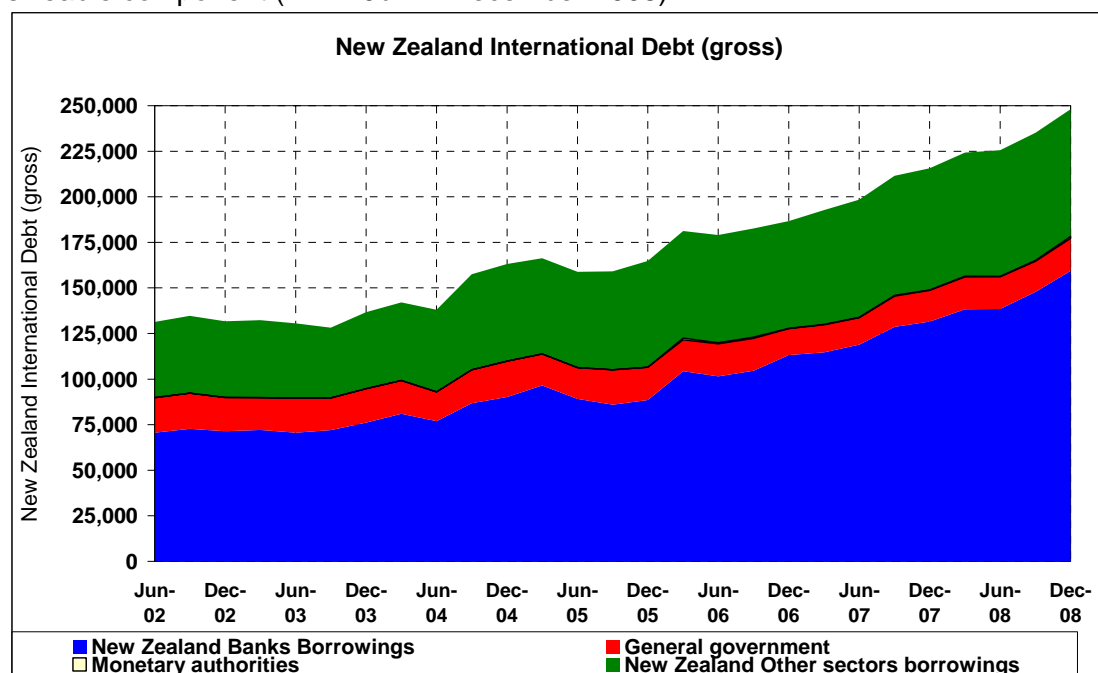
## New Zealand's External Debt Position

New Zealand has at least twice as many international liabilities as international assets contributing to the structural nature of the New Zealand Current Account deficit in that the stock of New Zealand assets owned by foreigners (i.e. international liabilities) is far greater than the stock of foreign assets owned by New Zealanders (i.e. international assets).



Note: data above is a 'stock', i.e. cumulative, not quarterly data

International liabilities of New Zealand are predominantly borrowings, i.e. debt, (as opposed to equity). New Zealand external debt is primarily held within the banks (NZD160bn in December 2008), although 'other' sectors borrowings is also a sizeable component (NZD70bn in December 2008).



## Summary

New Zealand's Balance of Payments Current Account deficit is primarily a deficit on Investment Income. The direct (greater than 10% ownership holding) Investment Income deficit is predominantly in the form of equity and has historically been in the form of dividends on profits being paid to overseas owners. The Portfolio Investment Income deficit is predominantly in debt (bonds and notes) representing lenders to New Zealand banks and corporates (where this lending is not classified to direct investment, or reserve assets). The 'Other' Investment income deficit is also a significant contribution to the New Zealand Current Account deficit.

The following table summarises New Zealand's Current Account deficit for 2008 (in red are the 'problem areas'). This is a table of the net positions for each component, e.g. the balance on Goods of -NZD2,360m represents NZD43,830m exports and 46,170m imports. This net approach simplifies the materiality of the balance (i.e. the deficit on Investment Income is though significantly greater dividend and interest outflows over dividend and interest inflows).

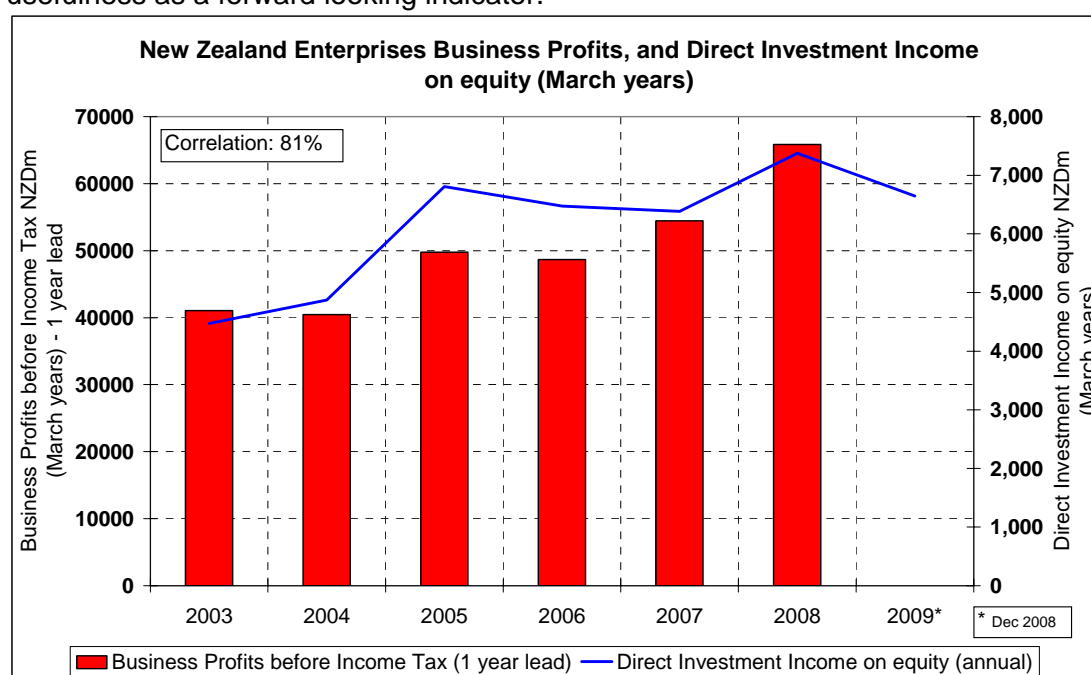
	Balance (NZDm)	% of GDP
<b>Current Account Balance</b>	<b>-16,073</b>	<b>-8.9%</b>
- Balance on Goods	-2,360	-1.3%
- Balance on Services	-1,013	-0.6%
- Balance on Transfers	883	+0.5%
- Balance on Income	-13,582	-7.6%
<b>- Direct Investment</b>	<b>-7,945</b>	<b>-4.5%</b>
- Equity	-6,430	-3.7%
- Debt	-1,595	-0.9%
<b>- Portfolio Investment</b>	<b>-2,543</b>	<b>-1.4%</b>
- Equity	-206	-0.1%
- Debt	-2,337	-1.3%
<b>- Other Investment</b>	<b>-3,095</b>	<b>-1.7%</b>

The following table summarises the net external debt position of New Zealand as at December 2008. This table documents both gross assets and gross liabilities:-

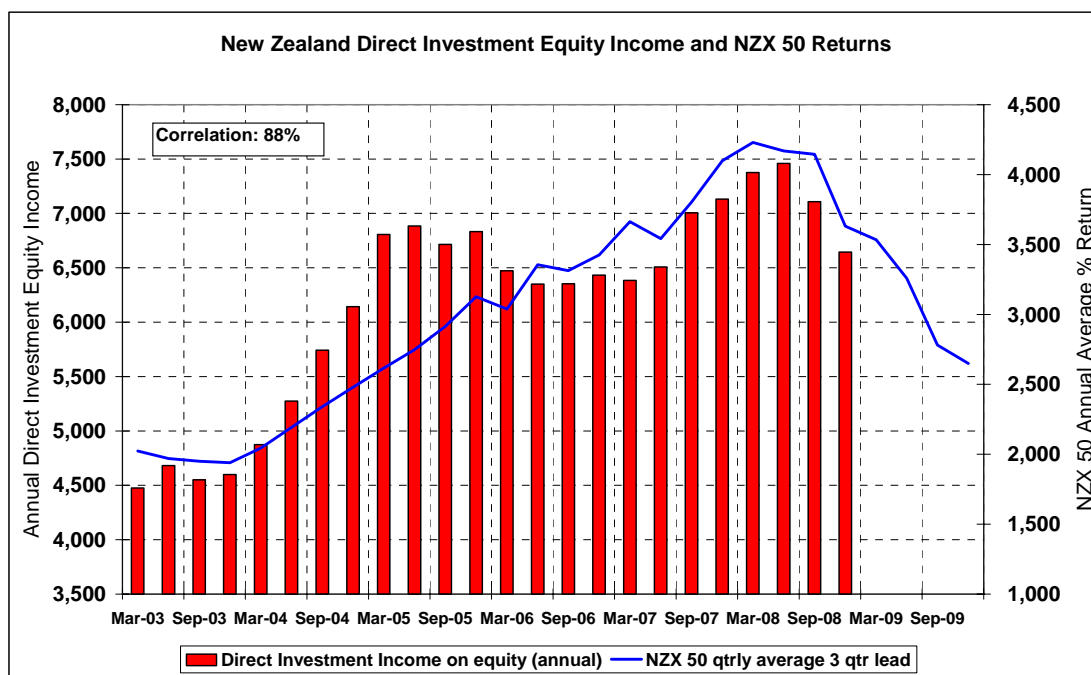
	Balance (NZDm)	% of NZ GDP
<b>Assets</b>	<b>139,589</b>	<b>77.6%</b>
- Equity	47,869	26.6%
- Lending	91,720	51.0%
- Banks	38,943	21.7%
- General Government	9,357	5.2%
- Monetary Authorities	16,035	8.9%
- Other Sectors	27,385	15.2%
<b>Liabilities</b>	<b>307,291</b>	<b>-170.9%</b>
- Equity	59,275	-33.0%
- Borrowing	248,015	-137.9%
- Banks	159,380	-88.6%
- General Government	17,799	-9.9%
- Monetary Authorities	1,062	-0.6%
- Other Sectors	69,775	-38.8%
<b>Balance</b>	<b>-167,702</b>	<b>-93.52</b>
- Equity	-11,406	-6.2%
- Borrowing	-156,296	-86.9%
- Banks	-120,437	-67.0%
- General Government	-8,442	-4.7%
- Monetary Authorities	-14,973	+8.3%
- Other Sectors	-42,390	-23.6%

## Implications

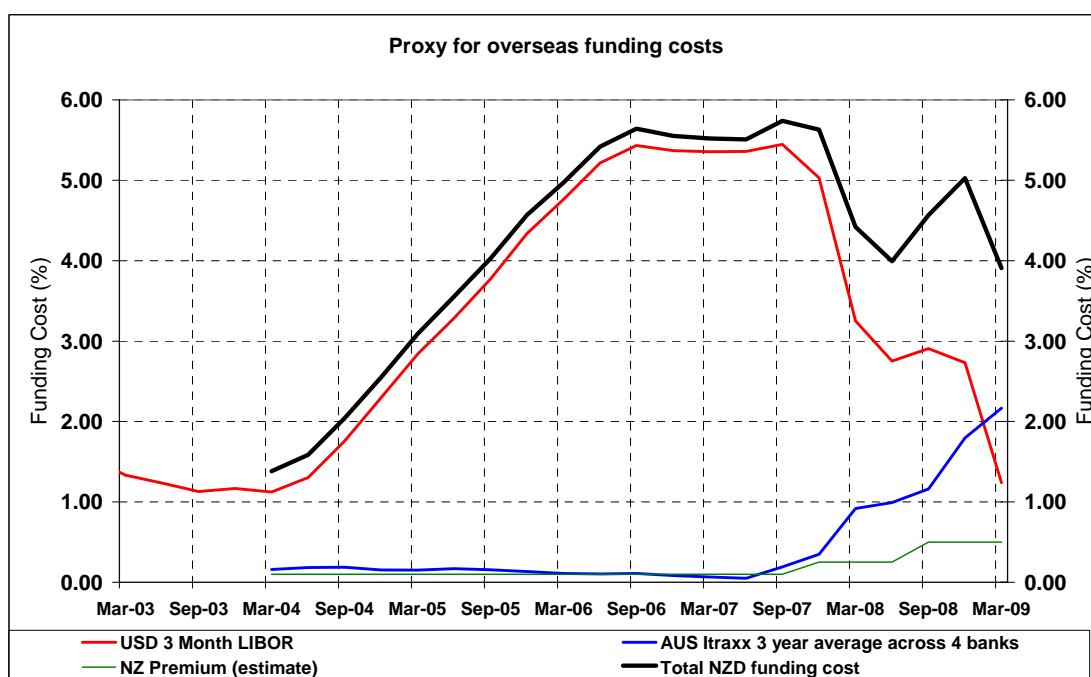
New Zealand's Current Account deficit is a function of the Investment Income deficit on direct equity investment, portfolio debt investment and other investments. The size of the direct investment income deficit on equity can be related to the Statistics New Zealand released New Zealand Enterprise Survey's measure of the total business profits before Income Tax (with this measure leading the direct investment income deficit on equity by one year). The New Zealand Enterprise Survey data is outdated (nominal March years but depends on the industry), with only modest usefulness as a forward looking indicator.



The chart below proxies an indicator for direct equity investment income outflows based on the (average) quarterly level of the New Zealand equity market (leading by 3 quarters). This relationship is based on the belief that information in equity prices has some relevance to future earnings expectations. Whilst a proxy for business profitability, this relationship has some usefulness in terms of a forward looking indicator for the size of the direct investment equity income deficits, and suggests a weakening towards an annual NZD5.5bn deficit over the next calendar year from NZD6.65bn currently (and the peak of NZD7.5bn in the year to June 2008).

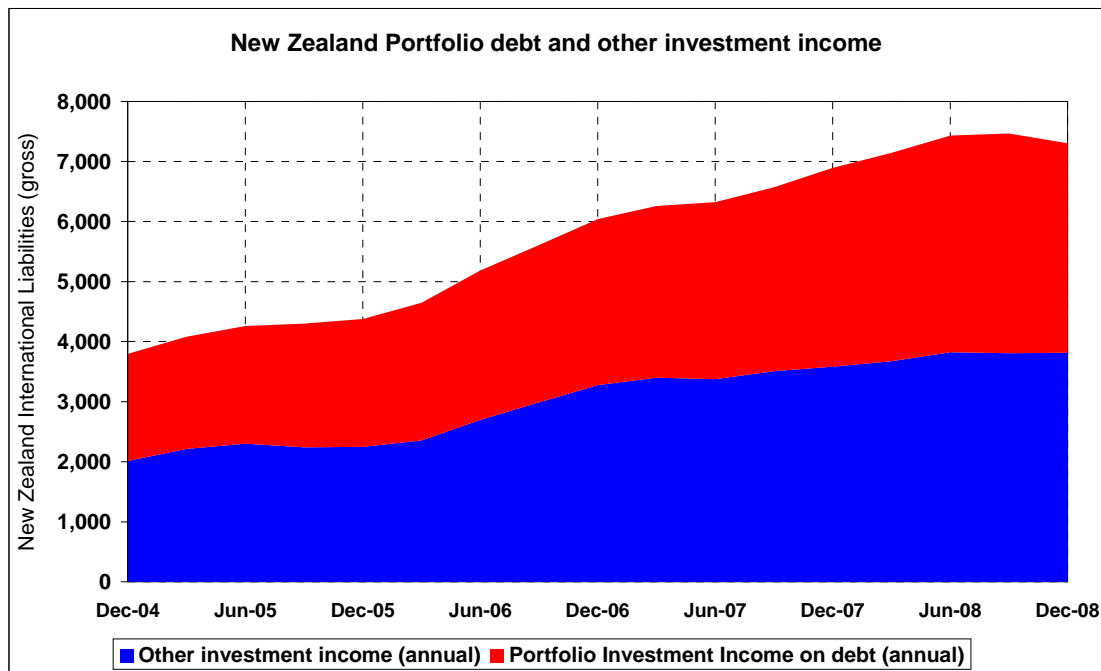


The chart below proxies an indicator for portfolio debt investment and other investments based on the USD 3 Month LIBOR interest rate + Australian Bank Credit Margins + a premium for NZ Bank Risk relative to Australia.

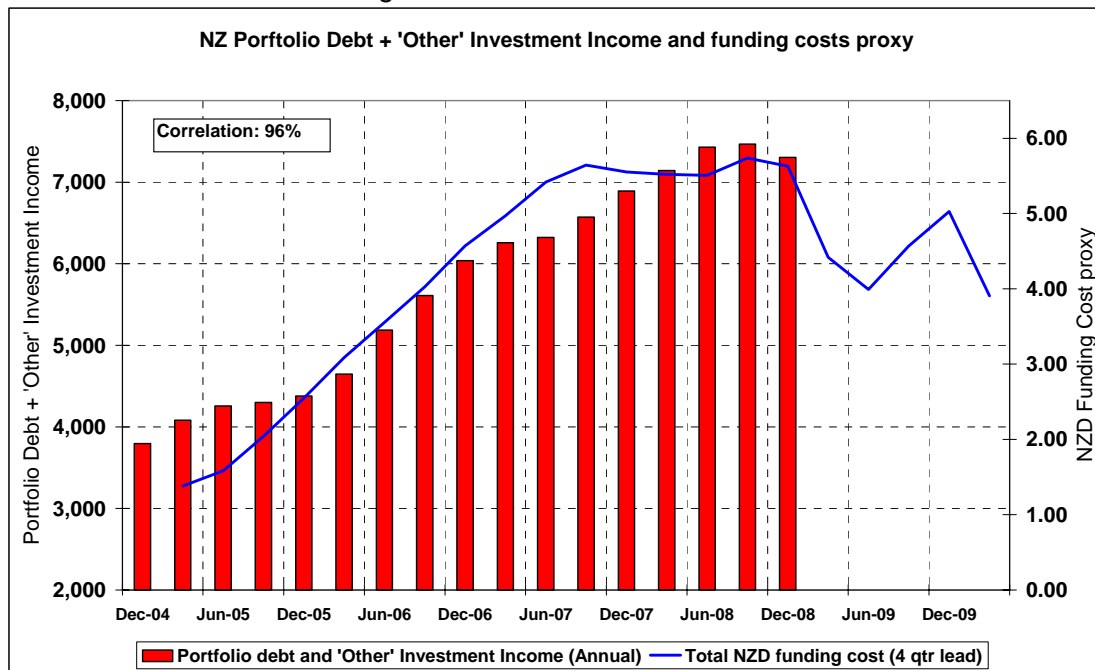


Note: Proxy for funding costs above is on a pre-hedged basis

The following chart shows that combined income from foreign investment in New Zealand for portfolio investment (debt) and other investment income has risen from NZD3.8bn in the year to December 2004 to a peak of NZD7.4bn in the year to September 2008, and currently NZD7.3bn in the year to December 2008.



Combining the two above charts to give a proxy for NZD funding costs against New Zealand portfolio debt and 'other' investment income indicates that over 2009 the combined cost may reduce from the current NZD7.3bn to somewhere in the NZD5.5bn to NZD5.75bn range.



Note: Proxy for funding costs above is on a pre-hedged basis

Summarising the projections from above and presenting on a net balance basis:-

	Balance 2008 (NZDm)	Balance 2009 (NZDm)
<b>Current Account Balance</b>	<b>-16,073</b>	<b>-10,470</b>
- Balance on Goods	-2,360	1,000
- Balance on Services	-1,013	-1,750
- Balance on Transfers	883	880
- Balance on Income	-13,582	-10,600
<b>- Direct Investment</b>	<b>-7,945</b>	<b>-6,500</b>
- Equity	-6,430	-5,000
- Debt	-1,595	-1,500
<b>- Portfolio Investment</b>	<b>-2,543</b>	<b>-2,000</b>
- Equity	-206	-200
- Debt	-2,337	-1,800
<b>- Other Investment</b>	<b>-3,095</b>	<b>-2,100</b>

## Conclusion

The New Zealand Current Account deficit may contract from the existing NZD16.1bn to NZD10.5bn over 2009. This would represent a narrowing in the Current Account deficit as from -8.9% of GDP to around -5.7% of GDP over 2009 (or lower).

A deficit of this size may be unlikely to cause undue concern to the ratings agencies and/or financial markets relative to the existing size of the Current Account deficit. New Zealand has a Current Account deficit for structural reasons being foreign ownership of New Zealand companies (i.e. outflow of profits through dividends) and borrowings from offshore (i.e. outflow of interest payments to those foreign lenders).

Recent years of strong profitability of overseas-owned companies operating in New Zealand and rising international interest rates has impacted cyclically on a wider Current Account deficit. Those cyclical factors have now reversed and are likely to lead to a period of a narrower Current Account deficit over the current year and to an extent beyond.

The analysis has focussed on the Investment income deficit that comprises the vast majority of the New Zealand Current Account deficit, and has assumed some relatively conservative assumptions for the balances on traded Goods, Services (tourism) and Transfers (including inward wealth flows of immigrants). Any potential for exports to strengthen, imports to weaken, tourism to be stronger (e.g. from Australia) and inward migration to pick up relative to expectations will further support a narrowing Current Account deficit in the immediate and near future.

A NZD/USD exchange sustainably below 0.5000 that is based on ongoing fears of the external indebtedness of New Zealand / deterioration of Current Account deficit outflows does not appear justified based on the projected path of the Current Account deficit over the next 12+ months due to a cyclical improvement in the factors determining the outflows.

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