

## Revisions improve net debt position

- Q2 current account deficit widens, with financial impact of earthquakes causing some temporary volatility.
- High dairy and meat prices continue to underpin trade surplus, although outlook less certain.
- Historical current account deficit and net international debt position revised lower due to change in methodology.

The Q1 Current Account deficit was close to market expectations. Seasonally-adjusted, the deficit increased to \$2 billion, from \$1.5 billion in the previous quarter. The increase was underpinned by a wider investment income and transfers deficit, while the goods surplus remained unchanged. The financial impact of the Canterbury earthquakes is currently causing some short-term volatility in the current account. Q1's current account deficit narrowed, as insurance industry losses reduced investment income outflows. Meanwhile, Q2's current account deficit was amplified by reinsurance outflows (specifically, coverage reinstatement premiums). Beyond this, we expect the current account deficit to increase, largely due to a recovery in investment income outflows. Continued trade surpluses are expected to provide some offset, although there is increased uncertainty around the outlook for NZ export commodity prices given the deterioration in the global outlook.

Much of the quarterly movements in the current account were overshadowed by historical revisions. StatsNZ has improved the methodology in estimating investment income inflows and NZ-owned assets offshore. As a result, this has reduced the annual current account balance, and the overall net international debt position.

Q2 current account movements overshadowed by historical revisions.	NZ current account (\$millions)					
	Quarter	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11
Goods & services (s.a.)	921	1,127	606	360	707	657
Investment & transfers (s.a.)	-1,893	-2,734	-2,176	-2,914	-2,241	-2,698
Current Account (s.a.)	-972	-1,607	-1,570	-2,553	-1,534	-2,041
Current Account (unadj)	499	-644	-3,320	-3,322	90	-921
Year ending	-3,587	-4,698	-6,621	-6,787	-7,196	-7,473
% of GDP	-1.9	-2.5	-3.5	-3.5	-3.6	-3.7
International assets	138,441	139,528	149,195	147,324	164,601	162,577
International liabilities	288,786	291,979	298,031	294,497	300,650	302,737
Net Assets	-150,346	-152,451	-148,836	-147,173	-136,049	-140,160
% of GDP	-80.2	-80.5	-77.7	-75.4	-68.7	-70.0

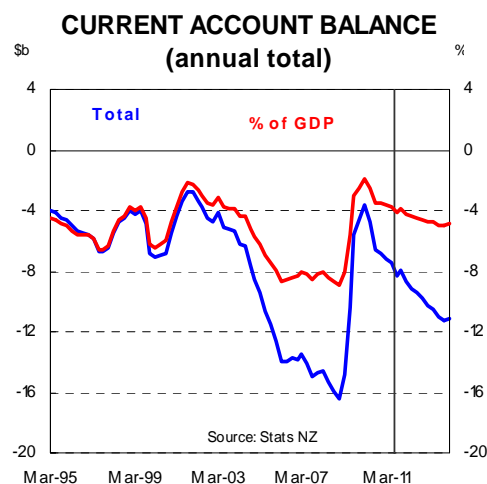
Income deficit expands in Q2 as investment income outflows recover.

### Deficit smaller on insurance industry losses

The current account deficit of \$921 million in the June quarter was reasonably close to expectations. Adjusting for seasonality, the current account deficit increased to \$2 billion in the June quarter, from \$1.5 billion in the previous quarter. The increase was due to a larger income and transfers deficit.

Historical annual deficit revised lower on revisions to methodology.

The annual current account deficit was revised lower, largely due to revisions to StatsNZ methodology. StatsNZ has improved the measurement of income inflows by including updated Inland Revenue data on the receipt and payment of overseas income. As a result, this revision has reduced the income deficit over the past 2 years.



The current account deficit stood at 3.7% of GDP over Q2, up from 3.6% of GDP (revised from 4.2% of GDP).

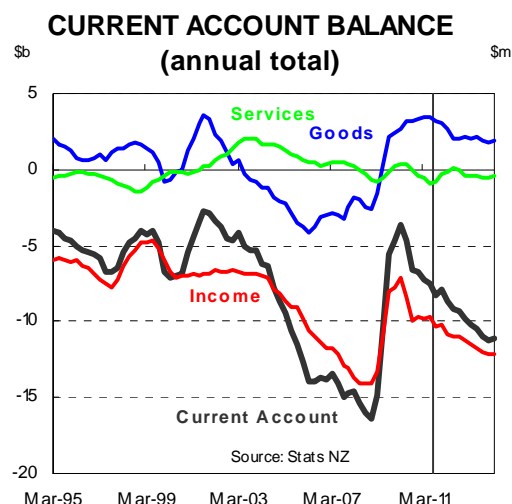
Over Q2, a **strong goods balance** (seasonally-adjusted surplus of \$657 million) partly offset an increase in the income and transfers deficit. The strong goods balance is largely due to strong export prices for dairy and meat.

**Goods balance in surplus on strong meat and dairy prices.**

The NZ Terms of Trade are at a 37-year high, and are expected to remain relatively elevated over the coming year. We expect a high export prices will continue to underpin trade surpluses over the coming year.

**Income deficit expands as income outflow recovers from earthquake-related losses.**

**The increase in the income deficit** is due to a recovery in profitability of foreign-owned NZ companies. In Q1, the income outflow was reduced reflecting the financial impact of the earthquakes on foreign-owned insurance companies. Despite the improvement in Q2, the outflow of investment income remains relatively subdued. This reflects reduced profitability as the NZ economy only gradually recovers from recession. We expect that income outflows will continue to gradually increase over the coming year, reflecting continued recovery in profitability of foreign-owned NZ companies.



Inflows of investment income also increased in Q2 (although was more than offset by the increase in outflows). This was largely due to a recovery in equity losses recorded over the previous quarter.

**Transfers deficit increases on reinsurance premiums following earthquakes.**

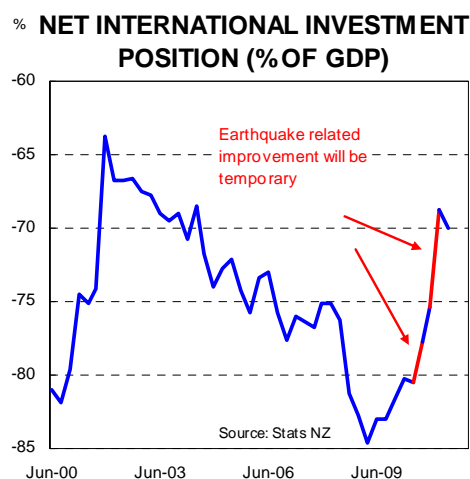
**The transfers balance** was weaker than we had expected, posting a deficit of \$165 million. This was due to an increase in reinsurance premiums paid by insurance companies (\* see footnote below). This was largely due to reinstatement premiums, which is an additional premium paid to reinstate the amount of insurance coverage following claims trigger by the Christchurch earthquakes.

**The services balance** posted a deficit, largely as expected. Exports of services fell due to a fall in travel services. This is a result of fewer international visitor arrivals in the wake of the February earthquake and June's ash cloud travel disruption. Exports of services will recover over the rest of the year, due to the Rugby World Cup tournament. Meanwhile, imports of services increased largely due to more New Zealanders taking holidays overseas. The high NZD has improved affordability of overseas trips. A portion of reinsurance premiums is also allocated of this category.

**International debt position revised lower due to methodology changes.**

**Net International Debt Position**

The net international liabilities position widened in Q2 relative to Q1, to 70.0% of GDP from 68.7%. However, the overall level of the net international debt position is now lower, due to revisions published earlier this week that incorporate additional offshore assets (primarily held by NZ fund managers) as well as student loans owed by former students now living abroad.



**Net debt position increases in Q2, following earthquake related increase in previous quarters.**

The main drivers of the increased net liabilities in the June quarter were a \$2.9 billion decline in overseas equity assets and a \$2 billion increase in overseas equity liabilities. The debt component was flat, with a further decline in banks' net foreign liabilities largely offset by increased net government liabilities (as the amount of government bonds held by foreigners lifted).

Over the previous quarters, the net international debt position has been reduced due to outstanding reinsurance claims arising from the Christchurch earthquakes. We think this will be a temporary feature of the International Investment Position. Stats NZ noted in the March release that "as claims are settled, the value of outstanding claims recorded as an asset in the international investment position falls, with corresponding transactions recorded in the financial accounts".

\* Stats NZ counts about half of an insurance premium as a transfer covering the risk component (effectively the transfer of claim liability to offshore). The other portion is counted as a service, as the foreign insurance provider is still providing a service even in the absence of any actual claims made. Hence, insurance premiums paid to overseas companies are split across the services and transfers components. The split is based on historical domestic claims ratios.

**Net debt position lower than previously estimated.**

**Implications**

The quarterly movements in the June figures were overshadowed by revisions to StatsNZ methodology. The upshot was an improvement in the measurement of NZ-owned assets abroad and investment income inflows. This reduced New Zealand's March quarter net international liability position to 68.7% from 75% as originally published. In addition to this, upward revisions to measured investment income inflows has reduced the annual current account deficit, and is now estimated at 3.6% of GDP (in Q1), from 4.2% previously.

**Financial impact of earthquakes increase volatility in current account**

Meanwhile, the quarterly current account has been thrown about over the past two quarters by the financial impact of the Christchurch earthquakes. Impaired profitability of insurance companies has reduced investment income outflows in Q1. Meanwhile, outflows of transfers and services increased in Q2, due to the payment of insurance reinstatement premiums.

Looking beyond these impacts, the underlying drivers of the current account have been strong goods surpluses due to high export prices, offset by a gradual increase in investment income outflows due to improved profitability of foreign-owned (non-insurance) NZ companies. Over the coming year, gradual improvement in the NZ economy will see investment income outflows continue to increase. This will see the current account deficit increase to just below 5% of GDP.

**Global situation casts some uncertainty on Terms of Trade and goods balance outlook.**

The extent to which investment income outflows are offset by the goods balance depends largely on the outlook for NZ export commodity prices. We expect NZ's Terms of Trade to remain elevated going forward. However, there is more

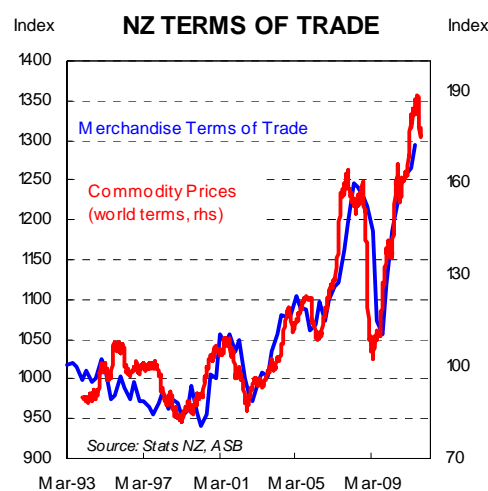
uncertainty than usual on the global outlook, and prospects for NZ exporters.

The prevailing level of the current account, and outlook for only modest expansion, should also give rating agencies some degree of comfort.

**Background to the data**

The balance of payments is a record that summarises all of New Zealand's transactions with the rest of the world. It is made up of the current account and the capital account. The current account records the net balance of tradable goods and services, net investment income received (traditionally negative in New Zealand), and net transfers. The capital account is the aggregate of the capital flows between NZ and the rest of the world.

By definition, the respective balances on the current and capital account are equal, but with an opposite sign. This means that if a country has a current account deficit (which NZ does) then it is spending more than it earns and is borrowing abroad or attracting investment monies to finance this spending.



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