

Current account deficit highlights the RBA's challenge

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Authors:

Katie Dean
Senior Economist
+61 3 9273 1381
Katie.Dean@anz.com

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Key points

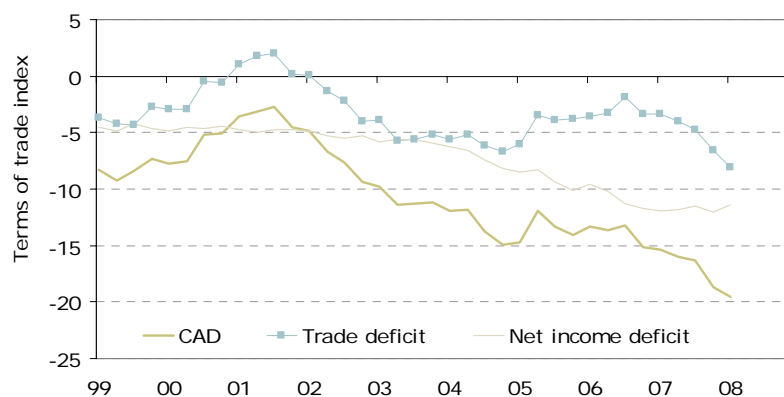
- Today the ABS reported that the **Australia's current account deficit widened, yet again, to hit another record, yet again.** The deficit widened to \$19.5bn in the March quarter, or around 7% of GDP.
- Australia's current account deficit has deteriorated by more than \$4bn in the last year, despite our terms of trade hitting new records. **This is the flipside of an economy that is running above potential and spending significantly beyond its means.**
- We've been burned on this call many times before, but we still believe the CAD will improve from here. Indeed, a booming resources sector means **we could see a trade surplus by year end.**
- **The RBA is content with current policy settings, having decided to keep interest rates on hold today.** However, an enduring terms of trade boom and a likely pick up in export volumes means that **the RBA has to lean harder on the domestic economy to make non-farm GDP growth slow as required.**
- Also today, the ABS reported that **general government spending was solid in the March quarter.** Consumption rose a modest 0.4% but public sector investment was up a strong 5.9%.
- **We expect tomorrow's March quarter GDP figures to print a small positive, of around 0.2%qoq (2.8%yoy).** Market expectations are for a rise of 0.3%.

Balance of Payments - Key Figures

	Mar qtr	Dec qtr	Sep qtr
Current account (Mar qtr) (\$bn)	-19.5	-18.7	-16.3
Balance on goods & services	-8.0	-6.6	-4.8
Balance on net income	-11.4	-12.1	-11.5
Terms of trade (% change)	1.1	1.1	-0.9

Source: ANZ

Trade deficit drives current account shocker



Sources: ABS

Another unenviable record

Could this economy be any more imbalanced? Today the ABS reported that the Australia's current account deficit widened, *yet again*, to hit another record, *yet again*. The deficit printed at \$19.5bn in the March quarter, up from \$18.7bn in the December quarter and from 'just' \$15.4bn in the March quarter of last year. This puts our deficit at around 7% of GDP – the third worst in the developed world (after New Zealand and Spain).

Australia's current account deficit has deteriorated by more than \$4bn in the last year, despite our terms of trade hitting new records. This is the flipside of an economy that has been running above potential and spending significantly beyond its means. No wonder we have inflation!

The widening of the CAD over the last year has been almost entirely due to a deterioration in the trade deficit. This itself can be largely blamed on stronger import volumes. It was the same old story in the March quarter. The trade deficit widened to \$8bn (surprise, another record!), despite an improving terms of trade, as a 3.5% rise in import volumes more than offset a small 0.5% rise in export volumes. To be fair, we can blame the weather for the poor performance of exports. Floods in Queensland saw coal exports drop 8% in the quarter while the ongoing impact of the drought pushed meat exports down 9%.

Trade volumes - Key Figures

	Mar qtr	Dec qtr	Sep qtr
Exports - % quarterly change	0.5	-0.7	2.0
Rural	1.3	0.8	-2.4
Resources	2.7	0.0	0.8
Manufacturing	7.3	-1.2	1.3
Services	-1.0	0.5	1.2
Imports - % quarterly change	1.8	2.1	5.9
Consumption goods	0.3	0.8	5.3
Capital goods	9.3	1.0	3.8
Intermediate & other goods	1.1	3.3	5.9
Services	3.2	2.3	3.4

Source: ABS and ANZ

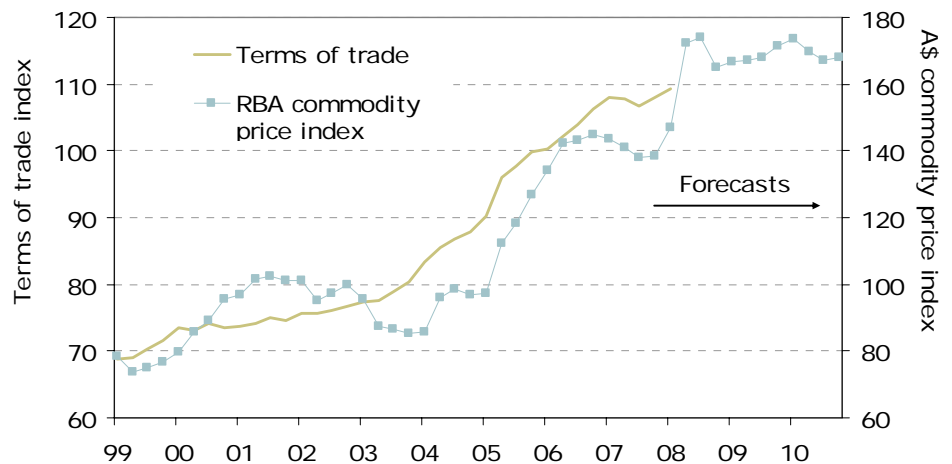
Today's CAD would have been wider if not for the net income deficit, which unexpectedly narrowed slightly to \$11.4bn from \$12.1bn. The main driver of this improvement was a decrease in income debits, led by a notable decrease in payments by Australians on portfolio debt held offshore. This is most likely due to the fall in US interest rates in the March quarter.

Is this the worst?

Many times we have made the call for the CAD to improve, and each time we have been burned. So, understandably, it is with some trepidation that we once again lay out our view that yes, the CAD will improve from here.

The main driver of this forecast improvement will be the terms of trade. As the chart below shows, soaring contract prices for Australia's major coal and iron ore exports should underpin a 20%+ rise in the terms of trade this year. Moreover, the long-awaited pick up in export volumes should occur over the coming months – a number of new major mine expansions have recently hit record capacity and (hopefully) improving weather will allow some rebound in rural exports. Together, this favourable combination of rising volumes and prices could be enough to push our trade balance back into surplus by the end of 2008.

Terms of trade to rise sharply



Source: ABS, RBA and ANZ and ANZ

That said, the improvement in the CAD will not be commensurate with the improvement in the trade balance. This is because the other driver of the CAD, the net income deficit (NID), is likely to deteriorate in the coming year. The NID is determined by net interest payments on foreign debt and dividend payments to foreign holders of Australian equity.

In the March quarter, the ABS reported that Australia's net foreign liabilities remained near record high levels, with a notably sharp rise in net issues of bonds and notes and money market instruments by depository corporations (ie. as banks stepped up offshore funding in the midst of the global credit crisis). Moreover, this new capital was raised at a sharply higher interest rate (reflecting the increased risk premium during the credit turmoil). The combination of a higher stock of debt together with an increased cost of the new portion of this debt stock, means that net interest payments on foreign debt are likely to increase notably in the next 12-18 months, pushing the NID wider.

Also likely to widen the NID in the year ahead is higher dividend payments from our mining sector to foreign shareholders.

Policy implications

The performance of the CAD in itself shouldn't have too many implications for the RBA. But the performance of the components does matter. The terms of trade boom, should it outperform our current forecasts, clearly provides upside risk to profitability and investment, and thus inflation in this capacity-constrained economy over the next 12 months.

Meanwhile, the expected pick up in export volumes in the next few years means that the RBA has to lean harder on the domestic economy to make non-farm GDP growth slow as required. The upshot is that the RBA is fighting powerful global forces. It is questionable whether the current real cash interest rate of around 3% is a big enough weapon.

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Telephone +61 3 9273 6224 Fax +61 3 9273 5711

UNITED KINGDOM by:

Australia and New Zealand Banking Group Limited

ABN 11 005 357 522

40 Bank Street, Canary Wharf, London, E14 5EJ, United Kingdom

Telephone +44 20 3229 2121 Fax +44 20 7378 2378

UNITED STATES OF AMERICA by:

ANZ Securities, Inc. (Member of NASD and SIPC)

6th Floor 1177 Avenue of the Americas

New York, NY 10036, United States of America

Tel: +1 212 801 9160 Fax: +1 212 801 9163

NEW ZEALAND by:

ANZ National Bank Limited

Level 7, 1-9 Victoria Street, Wellington, New Zealand

Telephone +64 4 802 2000

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