The Treasury

Budget 2011 Information Release

Release Document

June 2011

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Date: 23 February 2011 MC-1-5

To: Minister of Finance

22 FEBRUARY CANTERBURY EARTHQUAKE: POTENTIAL FISCAL IMPACTS

DRAFT

This note sets out some initial thinking on the fiscal impacts of the earthquake and the implications for fiscal strategy. Further analysis and advice will follow over the next few days and weeks.

Fiscal costs

Based on our experience from the September 2010 earthquake, we can expect to incur costs in the following areas:

Type	**Comment**	**Estimate for 4 September quake ($m)**
EQC	Net expense incurred (after reinsurance) Further damage arising from later aftershocks (after the reinsurance period)	$1,500 $50
Local infrastructure – excluding roads (e.g. sewerage, water and stopbanks)	[4]	
Local infrastructure – roads		
Funding for land remedial work		$146
Government support initiatives		$120
Government infrastructure (schools, hospitals, housing and state highways)	Net expense (after insurance)	$50
Total		[4]

The **EQC impact** (the largest component of cost from the previous earthquake) will not impact net debt, assuming EQC has sufficient assets and reinsurance in place to cover their obligations. If they choose to cash-up their DMO issuances, this will not impact net debt if DMO is able to reissue the debt. This is because net debt is a core Crown measure. Therefore, given that EQC sits outside the core Crown segment, it does not matter whether EQC or some other entity holds the debt.

EQC insurance payouts, net of reinsurance, will be an expense to EQC and so increase the total Crown operating deficit and decrease net worth.

In terms of **local infrastructure** (ie. water supply, sewage, storm water, river beds and banks, but excluding local council operational assets):

- Government current policy is to reimburse 60% of eligible local infrastructure costs.
- Costs for 4 September 2010 have not yet been estimated (and not recognised in the Government's accounts or HYEFU 2010, other than noted as a fiscal risk).
- The 22 February quake is expected to increase this cost. **[4]**

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- Any Government reimbursement cost would increase the operating deficit and net debt.

In terms of **Crown-owned economic infrastructure** assets:

- **Roads:** NZTA has a contingency to undertake emergency works and fund a share of local road repairs, but in the event that this contingency is not sufficient reprioritisation will need to occur across the National Land Transport Programme (NLTP), or additional funding will need to be sourced.
- **Rail**: Based on reports of reasonably contained damage to the rail network and the experience from the September earthquake, we would expect KiwiRail to be able to cover its direct costs from insurance and its event contingency without recourse to the equity capital previously provided for the Turnaround Plan, or to additional Crown support. However, as in September, there is likely to be a revenue impact over the short- to medium term which may affect timing and delivery of the Turnaround Plan.
- **Christchurch Airport**: Airside infrastructure is undamaged, but there is some cosmetic damage to the terminals and in particular to the new International Terminal currently under construction. Unlikely that shareholder support will be required, but may have an impact on activity and on revenue.

We may see some **additional areas of cost** arising from this latest quake:

- Unlike the earthquake of 4 September where there were no fatalities and relatively minor injuries, the latest earthquake will have a significant impact on ACC. ACC covers injury related costs: treatment (including DHB-related costs and counselling), rehabilitation, and weekly compensation. These costs are likely to fall the most heavily on the levied accounts, principally the Work and Earners' Accounts, and therefore won't have an impact on the operating balance.
- In terms of the Non-Earner's Account, which is funded through appropriations, the impact is unknown but at this point we do not think it will have an impact on Budget 2011 due to the sizeable under-spend that is expected. We will have an indication of the size of the under-spend on Friday, although this may be subject to revision because of the earthquake.
- In terms of the levied accounts, the latest ACC results to 31 December 2011 show a significant improvement in the solvency of the Accounts with sizeable (pre-valuation) under-spends projected in the Work, Earner's and Motor Vehicle

accounts. Given the current position of the Accounts, and with ACC's current funding policy allowing it to smooth levies over a long time horizon, there is likely to be capacity to absorb any impact on levies over the next few years. Significant changes in factors outside ACC's control (changes in discount rates, economic factors, etc), could of course change the situation

- Defence force assistance…

Managing the impact on your fiscal strategy

Higher take-up of existing social assistance programmes (eg. unemployment benefits) will be treated as a revision to forecast expenses. Some of these will be within the new amount for "in-year" revisions.

Previous advice was that that new forms of assistance be targeted, timely, and temporary.

Previous advice was to quarantine any earthquake funding over and above the amount in the contingency and treat as a one-off emergency expense outside the allowances for new spending.

The contingencies are running low:

- $51m remaining in general contingency across the forecast period (2010/11 overspent by $167m) but further calls expected for non-earthquake items.

- $94m remaining in emerging priorities contingency across the forecast period (2010/11 overspent by $3m).

Options for managing the costs associated with additional assistance are:

- Quarantine earthquake costs and treat as one-off emergency expense outside the operating and capital allowances for new spending as part of the Budget (ie. treat separately to Budget 2011).

- Cover earthquake costs as part of the allowances for new capital and operating spending in Budget 2011. This could be managed in two ways:

  Offsetting new costs with savings elsewhere through Budget 2011 (there are a number of savings options that have previously been identified), or

  Using part of the existing allowance for new spending to cover the costs. For example, could use the currently unallocated money put aside for in-year revisions ($160m pa) and/or part of Budget 2011 contingency for new spending after the Budget (ie. reduce the size of the contingency).

In addition to the "direct" fiscal costs identified above there will be fiscal impacts resulting from the economic impacts of the earthquake (eg. tax revenue implications).

Macro implications and policy response

Our thinking in the HYEFU on the impacts of the September earthquake was that:

- Damage was probably around $5 billion of which $3.25b was assumed to be residential, $0.75b commercial premises, and $ 1b infrastructure.

- September quarter GDP was probably adversely affected by the earthquake by around 0.2% to 0.4%. Beyond this activity was expected to be boosted by rebuilding activity. Real GDP growth was estimated to be 0.4% higher over the year to March 2012.

Prior to yesterday's event, our thinking around the impact of the September earthquake was that recovery activity was going to be slower than we anticipated. Overall damage was likely to still in the $5 billion range but based on EQC claims numbers residential damage was going to exceed the $3.25b estimate.

Yesterday's earthquake means that the overall impacts are going to be larger:

- Simulation results predict over $5b in damage from an event similar to that which occurred yesterday but there are reasons to believe that the actual impact will be (perhaps significantly) larger. The same simulation approach estimated $4b of damage resulting from the September quake so this would suggest that damage may again exceed such an estimate. In addition, estimates of the loss of life from this simulation appear to be considerably on the low side.
- The recovery from yesterday's event will be slower with a larger negative impact on GDP likely over the next few quarters given the extent of disruption caused.
- More commercial assets and infrastructure appear to have been damaged and as a result the amount of capital and therefore production is likely to be lower for a sustained period of time.
- It is hard to envisage the fiscal costs being any less than the >$2b estimate for the September event. In addition there will be larger levels of expenditure associated with search and rescue, ACC, hospital treatment and accommodation than was the case with the September event.
- In the absence of reduced expenditure elsewhere or increases to revenue, this event will have a significant adverse impact on the overall state of the Crown's finances. This will compound a weaker underlying outlook (ie. prior to yesterday's events) for the economy more generally than was envisaged when the HYEFU was published.

In terms of fiscal strategy:

- HYEFU forecast a zero operating balance (before gains and losses) in 2014/15 and a more material surplus in 2015/16.

- The $10b of fiscal savings being considered by Ministers reduces the peak in the debt path and brings forward the surplus.

- The more sluggish economic outlook between 2010 HYEFU and 2011 BEFU suggests a more active fiscal strategy.

- On its own, the likely EQC impact of the latest quake will push the 2010/11 operating deficit above 6% of GDP and shift out the year in which surplus is achieved. So achieving the fiscal strategy becomes more challenging.

- Sticking to the $10b of fiscal savings may now mean that the return to surplus does not occur before 2015/16. Net debt may peak at 30% of GDP of higher.

- The key trade-off is between looking through the event and its likely one-off effects, or placing more weight on fiscal credibility and ensuring the early return to fiscal surplus.

- In terms of temporary revenue raising options:

  - Following the Queensland floods, total Government expenditure on reconstruction is expected to be A$5.6 billion, funded by A$2.8 billion in spending cuts elsewhere, A$1 billion in delayed infrastructure spending and A$1.8 billion raised by a levy on taxable income.
  - The levy apples at a rate of 0.5% on all taxable income between A$50,000 and A$100,000, and at a rate of 1% on taxable income over A$100,000 for the 11/12 year only. Recipients of Disaster Relief Payments (related to floods) are exempt.

- In New Zealand:

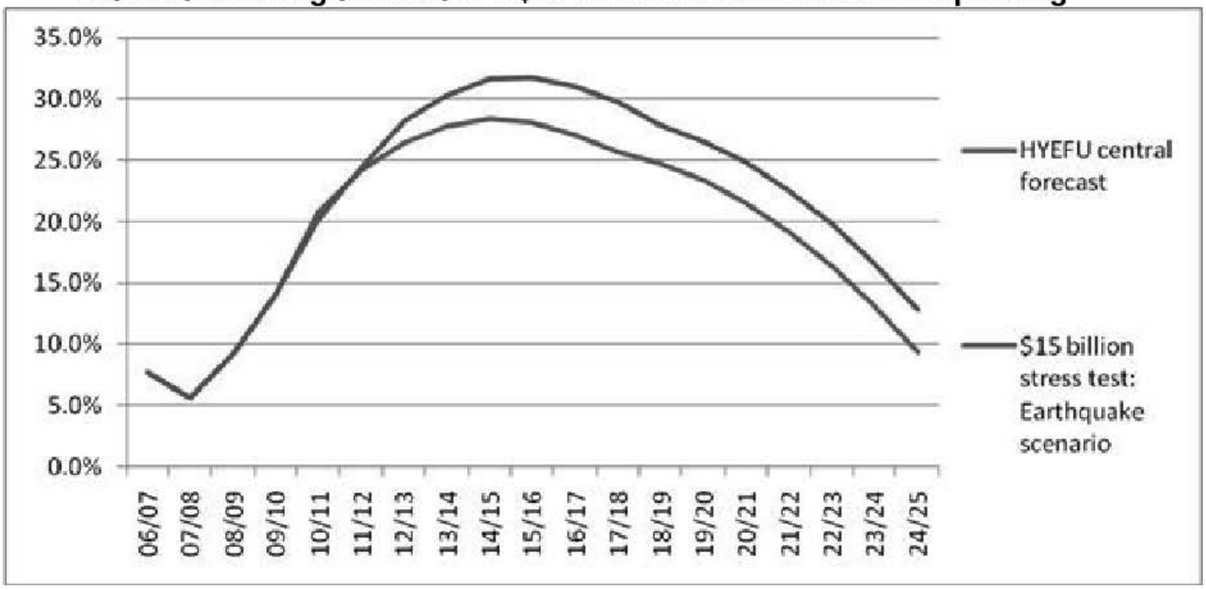
  - Administratively, a levy could be applied in much the same way as the ACC levy currently works.
  - To raise significant revenue, a levy would most likely have to be applied at a higher rate and/or a lower starting income threshold than the Australian example; a similar 0.5%/1.0% levy applied at income levels of $48,000 and $70,000 would only raise roughly $250m in one year. A flat 1% levy on *all* taxable income would raise roughly $1.2 billion.
  - While raising marginal tax rates is not ideal (and would undo some of the recent tax cuts), a small credibly time-limited change is unlikely to have significant labour supply effects. One way to minimise the effect of higher marginal tax rates would be to lower the rate and maintain the levy for more than one year (i.e. spread out the cost to the taxpayer).

ANNEX 1

Treasury has previously completed a stress test of the balance sheet that included a hypothetical earthquake. The key features of that stress test were:

- The assumed $15 billion fiscal cost (over and above EQC payouts) leads to a level shift in net debt, which largely follows a parallel trajectory.
- Growth over a reasonable timeframe was assumed to be largely unaffected, although the earthquake region experiences a strong increase in investment spending over the short term.
- While net debt peaks at a higher level, the debt track still drops below 20% by the end of the forecast horizon.
- A significant change in trend growth, for instance if capital is not replaced, represents a more significant risk.

Net debt following the cost of a $15 billion one-off increase in spending



ANNEX 2

Currency Markets

- NZDUSD – has weakened 1.5 cents since the quake. Initial reaction was approximately 1 cent. The USD has strengthened against major currencies overnight so some of the move in NZDUSD is related to this.

- NZDAUD – has weakened approximately 1 cent since the earthquake.

Interest Rates

- Short end interest rates have rallied strongly since the earthquake reflecting the likelihood that RBNZ may cut the OCR and that any future rate hikes will be pushed out. There has also been some talk of an emergency RBNZ rate cut occurring before the next scheduled meeting.

- 3 Month Bank Bill rates moved from 3.20% before the quake to 3% currently.

- 1 Year Swap rates have moved from 3.35% before the quake to 3.05% currently

- Longer term interest rates have not moved as significantly. 10 year swap rates have rallied by 10 points to 5.33% (from 5.43%).

- Government bond rates have reacted in line with moves in swaps. Short bonds (sub 1 year) have rallied 25 points, with the Nov 11 bond yielding 3%. Long term bonds have not rallied as much as swaps. The May 21 bond has only rallied 3 basis points, this smaller decrease likely reflects expectations of increase government borrowing going forward.

Financial Systems

- There does not appear to be significant damage to financial infrastructure or to the payments and settlement systems. This is largely due to the absence of core payment infrastructure in the South Island. There are issues with ATMS given the need for electricity.

Credit Markets and Rating

- Market commentary regarding the effect on the fiscal position and the credit rating has been measured.

- NZ 5 Year CDS have widened approximately 5 basis points

The rating agencies have been fielding numerous media enquiries about the impact of the quake on the rating.

Fitch gave the following response yesterday:

Fitch Ratings is unlikely to cut New Zealand's AA-plus rating over a powerful earthquake that struck the nation's second-largest city of Christchurch on Tuesday, a spokesman at the ratings agency said.

"The earthquake is not likely in itself to trigger negative action," the spokesman said. "It will have economic consequences as the government moves to repair damage, but costs will not likely drive ratings changes," he added.

S&P's line on enquiries has been to say that it is too soon to comment or make an assessment. Nevertheless, Kyran Curry was quoted yesterday as follows:

International credit rating agency Standard & Poor's says it's too early to assess the impact of today's Christchurch earthquake.

Melbourne-based ratings analyst Kyran Curry told BusinessDesk the quake was likely to have a negative impact on the government's finances as occurred after the September quake.

S&P currently has New Zealand on a AA+ rating, with a negative outlook, though this is strongly based on the country's external position.

Curry said that though there's no good place or time for an earthquake, the fact it has taken place in Christchurch as opposed to Wellington or Auckland means the banking and financial infrastructure will continue to function.

He said it will take at least a couple of days to provide any kind of assessment.

Moody's: *Moody's Investors Service says that it currently sees no reason to reconsider its Aaa rating of the New Zealand government following Tuesday's tragic earthquake in the city of Christchurch, and even though it is very likely to result in another one-time rise in government debt.*