The Treasury

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Date: 25 February 2011 MC-1-0

To: Minister of Finance

AIDE MEMOIRE: 22 FEBRUARY CANTERBURY EARTHQUAKE: MACROECONOMIC POLICY ISSUES

Executive summary

The Government's current fiscal objective, given uncertainty in the global economy and domestic vulnerabilities, is to return to surplus no later than 2015/16. The level of uncertainty has now increased on the back of a weakening domestic economy and potential costs associated with the 22 February Canterbury earthquake.

An earlier return to surplus remains highly desirable to mitigate the risk of future shocks and to deal with the cost of population ageing. Prior to Christmas, Budget Ministers indicated that they wanted to reduce debt by $10 billion and return to surplus no later than 30 June 2015. The feasibility and timing of specific targets will remain uncertain for some time. However, you will need to indicate fiscal intentions in the 2011 Fiscal Strategy Report.

Treasury's pre Christmas advice showed that achieving surplus by 2014/15 would require an active fiscal strategy over the next four budgets starting in Budget 2011. Reducing debt by $10 billion would have returned the budget to surplus by 2013/14.

The Prime Minister has indicated the Government plans to reduce the new spending allowance in Budget 2011 even further, to around $800 to $900 million.

The preliminary BEFU tracks, excluding the February earthquake costs, indicate a weaker fiscal position and revenue that is $2 billion lower than was expected at HYEFU. Earthquake costs will make achieving a surplus in 2014/15 more difficult. Net debt will be higher by June 2015 as a result of crisis support, leading to higher debt servicing costs.

Our September advice was to look through EQC and benefit costs (ie, allow debt to rise), but finance any one off (temporary, timely, and targeted) assistance from within the operating and capital allowances. The feasibility of doing this with the current allowances will depend on how much additional spending is required in Canterbury to deal with the February earthquake.

The more the adverse economic and fiscal effects rise above those of last September the more appropriate it will be to phase adjustments over the medium-term and look to a combination of responses (eg, operating, capital, revenues, and debt).

Treasury will provide analysis of the feasibility and advisability of incorporating spending against allowances before the final budget Ministers' meeting in March.

As information improves, Budget Ministers will need to make four key decisions ahead of the FSR:

a. **How much** to spend on earthquake support?

b. **What target**: How quickly can the government return the Budget to surplus?

c. **What is managed within allowances**: To what extent should the government aim to mitigate the impact on debt? Specifically can the costs of temporary, timely, and targeted assistance be included in the operating and capital allowances?

d. **How should savings be timed**: Should savings be phased in slowly to correspond with stimulus provided by rebuilding?

Fiscal strategy and economic outlook before the 22 February earthquake

At HYEFU, the operating balance (before gains and losses) was forecast to return to a small surplus ($39 million) in 2014/15. The surplus would have been more substantial in 2015/16, at $1.4 billion (0.5% of GDP).

The short-term fiscal intention in the 2011 BPS was to return the operating balance (before gains and losses) to surplus as soon as practical and no later than 2015/16, subject to any significant shocks.

In mid-December Budget Ministers discussed fiscal scenarios (based on HYEFU) that returned to operating surplus earlier and reduced borrowing by $10 billion by 2015. Treasury provided a range of options around operating and capital that would achieve a $10 billion debt reduction. The option involving a lower operating allowance in Budget 2011 ($750 million) and zero capital allowances (from Budgets 2012 to 2014) achieves a slightly larger surplus in 2014/15 and reduces debt by $5.3 billion.

The Prime Minister has indicated the Government plans to reduce the new spending allowance in Budget 2011 even further, to around $800 to $900 million. This would involve taking active steps to rein in baselines and reduce debt over coming budgets.

Notwithstanding the uncertainties around how the economy responds initially, over the longer term, the various consolidation options, in combination with wider reforms, will help shift the economy onto a more balanced (in terms of tradables/non-tradables, saving/investment), and higher growth path.

Over the past few weeks Treasury has been developing its preliminary macroeconomic forecasts for BEFU 2011. Although these forecasts have not gone through the complete process, we have used them to provide a base economic and fiscal outlook excluding the effects of the 22 February earthquake. The main features of this base outlook are:

- The economy has been more subdued than expected as households and firms have been more cautious in their spending and investment decisions. As a result, real GDP in 2010 was more subdued than in the HYEFU and the first half of 2011 also looked to be weaker. Despite an expectation of higher export prices flowing through to stronger terms of trade, forecasts of nominal GDP are lower than HYEFU over the forecast period, generating lower tax revenues and higher benefit spending.

- An approximate estimate of the impact from these new economic forecasts is that tax revenue could be $2 billion lower across the forecast horizon. However, recent strong outturns of PAYE and company tax suggest the reduction in tax revenue forecasts may not be this large.

- We have assumed a one-off $500 million of spending on the September 2010 earthquake (that is yet to be recorded).

- On the basis of these factors alone the operating balance (before gains and losses) would be in a deficit of 0.1% of GDP in 2014/15 before returning to a surplus of 0.3% of GDP in 2015/16.

- The deficit is now expected to peak at 6.1% of GDP in 2010/11, compared to the 5.5% forecast at HYEFU.

- Net debt is now expected to rise to 21.6% of GDP in 2010/11 and peak at 29.9% in 2014/15. Across the projection period, the net debt profile is consistently above that in HYEFU.

- There are other fiscal risks that could impact on the fiscal outlook (eg, valuation changes coming through the March Baseline Update).

Clearly this preliminary outlook is now essentially nothing more than a base case/counterfactual. Nonetheless, it indicates that absent the latest earthquake, the task of returning to surplus earlier would have been more challenging than indicated by the pre-Xmas options.

Macroeconomic and fiscal outlook after the 22 February earthquake

Treasury is now in the initial stages of incorporating the effects of the latest earthquake into the preliminary BEFU macroeconomic forecasts. A first cut of these will be available early next week.

The changed macroeconomic outlook will flow through to revenues and the fiscal outlook – what might be termed as the "indirect" fiscal costs of the earthquake. The size and profile of the changes will be influenced by a range of factors:

- The February earthquake will reduce economic output in the March 2011 quarter as businesses are disrupted by the earthquake initially and over coming weeks.

- Economic activity will be weaker in the June 2011 quarter than otherwise would be the case. As businesses re-open, the negative impact is likely to be smaller than in the March quarter. However, there is considerable uncertainty about how quickly activity returns to a new "normal".

- The boost to economic activity due to rebuilding will need to be substantially higher than was envisaged after the September earthquake. Over coming years, the extent to which this represents an additional boost to activity, over and above that anticipated from the September earthquake, will depend on the extent to which additional capacity is available. While it is possible to envisage moderately higher levels of rebuilding in any particular period than was the case prior to the recent earthquake, this is not going to be sufficient to prevent the period of rebuild facing Canterbury being extended by a number of years. This means that the level of economic activity will be boosted by earthquake related construction activity for much longer than previously anticipated.

- While the government faces considerable costs associated with the earthquakes, tax revenues will eventually be boosted for longer than previously anticipated. This will provide some offset to the additional expense incurred. Clearly there is considerable uncertainty associated with any predictions around such revenue.

Economic forecasts incorporating working assumptions around the impact of the most recent earthquake on the economy are currently being developed and will feed into

advice ahead of this year's Budget. Revenue projections based on this economic outlook will provide further information on the fiscal outlook but it needs to be appreciated that any predictions are subject to considerable uncertainty.

Indicative scenarios around direct fiscal costs

The "direct" fiscal costs (eg, EQC, social and business assistance, local infrastructure) of the latest earthquake are extremely difficult to quantify at this very early stage.

The table below shows the effects on key fiscal aggregates of applying three alternative fiscal cost scenarios to the preliminary BEFU forecasts (ie, those excluding the economic effects of the February earthquake). In reality the costs will not be simple multiples of the September 2010 earthquake. For example, the mix between residential and infrastructure will differ and large costs may exhaust some funding avenues that were available to help cover the original earthquake.

In addition to the one-off EQC costs, we have assumed that all other costs are one-off and additional to existing fiscal allowances. Because we have not modelled the economic effects the costs do not include flow on impacts on unemployment and tax revenues.

	Scenario 1 Approx. September EQC = $1.5 bn Other = $0.7 bn	**Scenario 2** September x 2 EQC = $4.5 bn Other = $1.4 bn	**Scenario 3** September x 3 EQC = $5 bn Other =$2.1bn+$3bn
OBEGAL in 2014/15	-$0.5 bn	-$0.7 bn	-$1.0bn
Peak deficit	-7.3% of GDP	-9.2% of GDP	-11.3% of GDP
Peak net debt	30.3% of GDP	30.7% of GDP	32.6% of GDP
Change in finance costs relative to BEFU base in 2014/15	$0.15 bn	$0.40 bn	$0.65 bn

Responding to fiscal costs and the implications for Budget 2011

Our previous advice in September 2010 made a distinction between those fiscal costs to which policy would not adjust (eg, EQC expenses; increased unemployment spending and associated automatic stabilisers) and those to which policy might adjust (eg, timely, targeted and temporary operating initiatives; capital initiatives).

In terms of the "when", there are choices about the extent to which it is possible to meet the costs from Budget 2011 versus phasing them over future Budgets.

The fiscal costs likely to be faced as a result of the earthquake cannot be managed within the existing contingency for between Budget spending (ie, the contingency established in Budget 2010).

Budget Ministers are considering a number of possible savings as part of Budget 2011. Depending on decisions about these savings it may be possible to use the

saved money to meet some of the costs of the earthquake. A clearer picture of savings related to Budget 2011 as well as some of the earthquake related costs should be available for the Budget Ministers meeting on 22 March.

The risk of large costs emerging as a result of the earthquake mean that it is possible that the costs will not be able to be managed within the existing Budget allowances for Budget 2011 or the savings currently being considered for this year's Budget. This would mean absorbing some of the costs from future Budgets. One way to implement this would be to establish an 'Earthquake Contingency' as a share of Budget 2011 and possibly future Budget allowances.

The contingency could then be used to manage the earthquake related costs within future Budgets, with flexibility to adjust the size of the contingency over time. The alternative would be to add the costs on top of existing allowances and then find options to make offsetting savings, or absorb the impact into the fiscal accounts

Implications for the macroeconomic situation and fiscal strategy

The timing of the Christchurch rebuild is now going to be a story for calendar 2012 and beyond. This is the period over which offsetting fiscal changes are likely to be larger – hence the fiscal adjustment occurs outside the period when the economy is at its weakest. Furthermore, the EQC injection will come through as a 'fiscal stimulus' while the economy is weak.

The fiscal strategy evolving around the time of the 2011 BPS and into early-2011 was placing increased emphasis on the importance of achieving an earlier return to surplus and a lower path for debt. This was motivated by: the need to adjust the fiscal/monetary policy mix in favour of lower interest and exchange rates and so shift the economy onto a more balanced and higher growth path; the restoration of a buffer to shocks; and the implications of population ageing.

The uncertainty around the economic and fiscal effects of the 22 February earthquake makes achieving the current fiscal strategy more challenging. If the effects were in the vicinity of the September 2010 earthquake then it would be feasible to look through one-off shocks like EQC and adjust to the other costs within one or two budgets.

However, the more the adverse economic and fiscal effects rise above those of last September the more appropriate it will be to phase adjustments over the medium-term and look to a combination of responses (eg, operating, capital, revenues, and debt).

As more information comes to hand it will be possible to reassess the trade-offs and choices and signal thinking more publicly. Nonetheless, the 2011 Fiscal Strategy Report will be a key part of articulating the various dimensions of the fiscal policy response.

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