The Treasury

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Release Document

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Date: 2 March 2011 MC-1-5-2

THE TREASURY
Kaitohutohu Kaupapa Rawa

To: Minister of Finance

AIDE MEMOIRE: FISCAL POLICY SCENARIOS BASED ON PRELIMINARY NUMBERS RELEASED IN THE MONTHLY ECONOMIC INDICATORS

On Friday 4 March the Treasury will release a copy of the Monthly Economic Indicators (MEI) that will include an estimate of the total cost of the February 22nd earthquake. Our estimate of $15 billion is subject to considerable uncertainty, but represents our best estimate at the time of publication.

You have indicated that you would like to look at options to return net debt to the HYEFU 2010 level by the end of the forecast period and that an earlier return to surplus remains the Government's intention.

We think these objectives are appropriate, notwithstanding the considerable additional uncertainty around the economic outlook that has arisen as a result of the second earthquake:

- The global economy, while improving, remains a source of potential downside risk to the New Zealand economy with the prospect of rising global imbalances, the need for significant structural and fiscal policy change in many developed economies, and continued financial difficulties in the European periphery.

- Given New Zealand's high net international liability position the economy remains highly exposed to any negative change in investor sentiment, whether as part of a global shock or a New Zealand specific event.

- The second Christchurch earthquake has further eroded the fiscal buffer. Standard and Poor's, put New Zealand's sovereign credit rating onto negative outlook in December. A fiscal outlook weaker than the HYEFU would increase the possibility of the sovereign rating being cut. Markets will also likely interpret an earlier return to surplus as positive signal with regards to sustainability over the medium term.

There are also broader macro management reasons for keeping with an earlier return to operating surplus. While we now expect the economy to be more subdued over the coming year, the February earthquake will eventually lead to a larger boost to domestic demand and bottom line GDP growth as reconstruction takes place. This will inevitably result in more inflation pressure than previously. Any hit to potential growth from damage to buildings and firms will go in the same direction. By fiscal policy leaning more firmly against domestic demand pressures when they eventuate, monetary policy will need to do less work, allowing interest rates to stay lower for longer and taking pressure off the exchange rate. This mix would be more conducive to tradable sector output growth.

This note provides an initial assessment of the impact of the earthquake on key fiscal aggregates together with the savings proposals presented to you at Fiscal Issues on the 28th February. The scenarios below suggest a return to surplus in 2014/15 is feasible, but that keeping net debt to the same as in HYEFU in 2014/15 would likely require more work or a stronger economy.

Economic assumptions

The draft MEI, which accompanies this report, provides a more detailed summary of the current state of the economy and the impact of the earthquake. For the purposes of this report, the headline message is that even prior to the quake, the economy, notwithstanding historically high export prices, was more subdued than expected at HYEFU as households and firms continue to be more cautious in their investment and spending decisions. This was expected to persist over the forecast period leading to lower GDP and tax revenue.

The February quake is a further significant shock to the economy. Beyond the terrible loss of life, it will cast a large shadow over the economy for much of the forecast period. It will mean weaker growth over the short term, if not actual contractions in activity, but stronger growth and/or inflation over the medium term. Disrupted business activity, confidence effects, and a delay in rebuilding in Canterbury getting underway will mean GDP looks more subdued in the first half of 2011. As construction gets firmly underway there will be a substantial boost to activity. As a result, growth could be very strong in 2012/13. The net result is that nominal GDP is still expected to be lower in 2014/15 than at HYEFU. An early estimate of the tax is that this reduction could reduce government revenue by $3.4 billion over five years. A firmer estimate will be provided with the preliminary BEFU forecasts when they are finalised.

Table one: key economic summary statistics underpinning the MEI
Annual average % change (March years) and % change from HYEFU *(in brackets)*

	2010 (actual)	**2011**	**2012**	**2013**	**2014**	**2015**
GDP	-0.5 *(0.0)*	0.8 *(-1.3)*	1.9 *(-1.5)*	4.2 *(1.3)*	2.9 *(0.2)*	3.0 *(0.2)*
CPI	2.0 *(0.0)*	4.6 *(0.1)*	2.7 *(-0.2)*	2.4 *(-0.2)*	2.5 *(0.3)*	2.5 *(0.5)*
Unemployment	6.0 *(0.0)*	6.6 *(0.5)*	5.6 *(0.4)*	4.8 *(-0.1)*	4.6 *(0.0)*	4.4 *(-0.1)*
Current Account	-2.4 *(0.0)*	+0.8 *(2.7)*	-4.4 *(0.4)*	-5.2 *(1.5)*	-6.5 *(0.0)*	-6.2 *(-0.4)*

These are preliminary estimates and are subject to a significant amount of uncertainty. One risk is that the impact of the earthquake could be more pronounced with more rebuilding occurring within the 2011/12 - 2014/15 forecast period. This would see more domestic demand and price pressure resulting in higher nominal GDP.

Assumptions for the direct fiscal costs from the Earthquake

Our preliminary BEFU forecasts assume that the total cost of damage in Canterbury (including direct costs covered by the private sector) from both quakes will be $15 billion in aggregate (refer annex one). This damage is spread over residential ($9b), commercial ($3b), and infrastructure assets ($3b). The total fiscal impact to the Crown of this damage is estimated to be $7.5 billion, although this figure is subject to change.

The residential costs from either quake to EQC are not currently expected to go over $4 billion, although the risks around these early estimates are significant. For the purposes of this note, we assume that the Government's EQC exposure for each quake is capped at the EQC insurance levy of $1.5 billion, although a larger hit on EQC's reserves is possible.

The top down total cost of repairing infrastructure in the forecasts is currently assumed to be $3 billion. This compares to a $5-6 billion bottom up estimate, although this could be reduced by insurance cover. In practice, there is little 'science' behind either estimate as a firm estimate for this infrastructure costs are not expected to be known for a number of months. **[2]**

The Government will also want to support efforts to rebuild Canterbury and provide assistance to firms and households. To cover additional costs we have factored in a one-off cost of $1.5 billion in 2010/11. In reality the size, cost, and timing of actual expenses is highly uncertain.

Fiscal savings included in the prelim BEFU savings scenario

One of the scenarios included later in this paper also includes some assumptions for savings. The savings used in the scenario reflect all of the savings and spending options that Ministers are currently considering in Budget 2011 (as set out in '*Summary of Budget 2011 Spending Pressures and Savings Options*', refer BR2011/12). This includes significant fiscal savings arising from changes to the KiwiSaver and Working for Families programmes.

Table three summarises the savings figures used in the scenario. In December Cabinet made decisions about allocating the operating allowance, this is reflected in the top row. On top of that, Budget Ministers are considering proposals for new spending, shown in the 'total additional operating pressures' line. There are also a number of savings options being considered, which are picked up in the 'total fiscal savings line'.

Table three: summary of spending and savings

SUMMARY OF SPENDING AND SAVINGS	$ m (change in operating expenses)			
	2011/12	2012/13	2013/14	2014/15
Allocation of operating allowance	**1,122**	**1,122**	**1,122**	1122
Plus* total additional spending pressures *based on Treasury recommendations	**201**	**732**	**359**	373
***Less* total fiscal savings being considered by Budget Ministers**	**853**	**1,320**	**1,340**	1,468
BOTTOM LINE (spending minus savings)	**470**	**534**	**141**	**27**

The impact of these decisions is that by 2014/15 the new spending in Budget 2011 is almost totally offset by savings, so expenses only rise by $27m in 2014/15 and out-years, although the costs are higher in the earlier years of the forecast period.

The reduced ($27m) operating allowance in 2011/12 returns to $1.1bn, growing at 2% a year, from Budget 2012 onwards. With the net new operating spending significantly lower than the allowance in the HYEFU, there may be scope to establish an 'Earthquake Contingency' within the allowance.

The scenario also incorporates a capital allowance of $1.39bn in Budget 2011, as in HYEFU. In the 2012, 2013 and 2014 Budgets the scenario includes a zero capital allowance (in net terms). This means that any new capital spending would need to be met from other sources of funds, including any partial floats of SOEs. From Budget 2015 onwards the capital allowance returns to the same level as in the HYEFU.

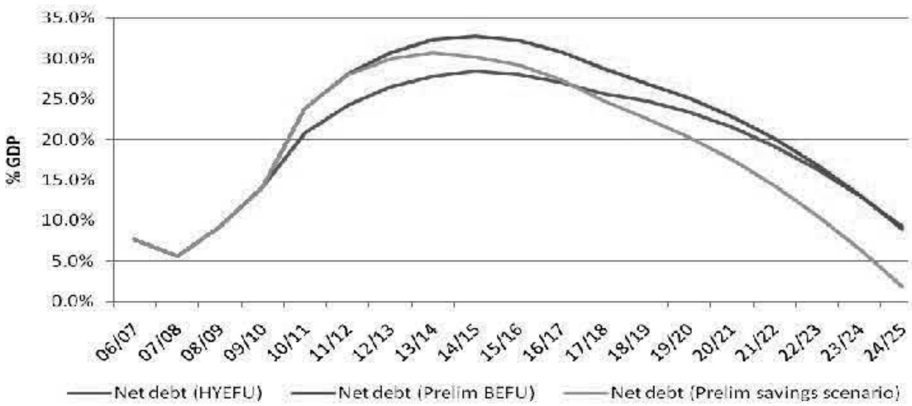
Fiscal scenarios

The next two sections contrast two fiscal scenarios with the numbers included in the HYEFU 2010 projections. The first scenario ("*prelim BEFU*") includes our preliminary BEFU forecasts and the preliminary spending assumptions discussed in the next section. The policy assumption for the "*prelim BEFU*" scenario is that future operating and capital spending remains the same as in HYEFU. The second scenario ("*prelim savings scenario*") is identical to the prelim BEFU scenario, except the spending cuts of approximately $1 billion discussed above are applied in the 2011/12 budget.

1. The "prelim BEFU" scenario

Under our first "*prelim BEFU*" scenario, net core Crown debt increases by $10.1 billion over the forecast horizon (refer figure one). This increase is caused by a reduction in revenue ($3.4 billion relative to HYEFU) and an increase in core Crown spending ($4.5 billion). As a result, net debt rises to 33% of GDP by 2014/15 compared to a peak of 28.5% in HYEFU. Debt servicing costs under the prelim BEFU scenario are $1.87 billion higher over the forecast period. This equates to an increase in debt servicing costs of $534 million in 2014/15.

Figure one: Net Core Crown debt (% GDP)

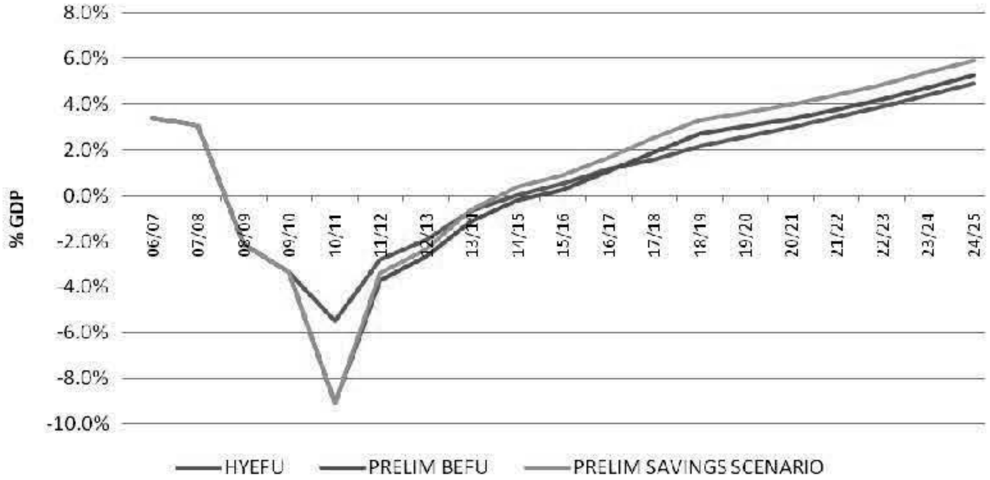


The HYEFU and prelim BEFU net debt tracks largely converge at 9% by the end of projection period despite a lack of policy change. This effect occurs for two reasons. First, capacity constraints push a lot of investment associated with rebuilding out into the projection period. This leads to a nominal post-quake GDP track that is higher through most of the projection period. Second, inflation is higher out until 2020/21. The boost provided by inflation to nominal figures causes net debt (as a % of nominal GDP) to decline at a faster rate in our prelim BEFU projections. These assumptions are still being debated.

The EQC costs, while not formally included in the core Crown net debt measure, also reduce the fiscal buffer. The EQC costs, which reduce the Commission's financial asset reserves, will decrease total Crown net worth by at least $3 billion. In general, lower financial asset reserves suggest that a future call on the government to borrow funds is even more likely if another natural disaster should occur before these reserves were able to be rebuilt.

Many of the costs of the Canterbury earthquake are temporary (refer figure two). Thus, while the operating balance under our prelim BEFU scenario peaks at 9.1% of GDP in 2010/11, from 5.5% of GDP in HYEFU, the Government could still achieve a surplus ($720 million) in 2015/16.

Figure two: operating balance (before gains and losses) as a % of GDP



2. The "prelim savings" scenario

Under the "*prelim savings scenario*", the net impact of government savings returns the Budget to surplus one year earlier than the prelim BEFU and HYEFU tracks. The surplus in 2014/15 is $911 million (0.4% of GDP). This decreases the level at which net debt peaks to 30.7% of GDP in 2013/14 compared to the 32.8% peak under the prelim BEFU scenario. Additional debt in 2014/15 servicing costs are also roughly halved compared to the prelim BEFU scenario. The cost of debt servicing (following savings measures) would be $260 million in 2014/15.

The size of the negative spending shock and increase in debt is short lived and sharp. Trying to completely offset this increase in debt in the first two years, when deficits are large as a % of GDP, would require enormous savings. The savings scenarios responds to rising debt over the first five years when the risks associated with debt are most significant. However, the $1 billion reduction in the operating allowance reduces spending across the entire projection period. As a result, given the continuing stimulus associated with reconstruction over the projection period, the level of net debt in 2024/25 currently appears low (1.9%). More so than ever, this number at this preliminary stage, is likely to change significantly as forecasts are finalised.

The level at which net debt peaks in the "prelim savings" scenario is still above the level at which net debt peaks in HYEFU (28.5%). Lowering debt to the level observed in HYEFU to more quickly rebuild the fiscal buffer would require savings beyond those currently built into the savings package.

Next steps

Budget Ministers are currently scheduled to meet on 22 March to consider a final Budget package. This meeting may be bought forward a week if a suitable time can be identified. At this meeting Ministers will be invited to make decisions about the overall fiscal strategy approach, and the key saving and spending components of Budget 2011.

The scenarios in this paper are based on very early information. We are continuing to review both our estimates of damage from the earthquake and the impact on the economy. Pending any feedback or suggestions for alternative scenarios, Treasury will keep you informed of material changes.

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Annex: Background assumptions for preliminary earthquake costs
(not published in the MEI)

	Damage	Government's obligation	Notes	OBEGAL / Net Worth	Net debt
Total Residential Damage ***(Total 9 Billion)***					
Sep-10	$3b	$1.5b	EQC estimate of their share between $2.75bn and $3.5bn.	-$1.5b	nil
Feb-11 *(Numbers attempt to remove double counting of the same house damaged but not yet repaired)*	$6b	$1.5b	EQC's very early estimate is that their share of the $6b will not exceed their $4b reinsurance limit. However there is a risk that the scale of the event may exceed the reinsurance limit.	-$1.5b	nil
Infrastructure **(*Total $3 Billion)***					
(State-owned assets (e.g. schools, hospitals), local council & regional council assets e.g. critical infrastructure (like water, sewage, stopbanks) local roads and other operational and recreational assets)	$3b	$3b	Assumption based: [2] Assumption based: September infrastructure estimated at $500m. Current bottom up estimates are as high as $ 6 billion.	-$3b	+$3b
Commercial ***(Total $3 Billion)***					
Commercial e.g. business assistance	$3b	$1.5b	Assumption based: September policy responses estimated at $220m.	-$1.5b	+$1.5b
Other Policy Support e.g. social assistance					
Total for both Sept & Feb earthquakes	**$15b**	**$7.5b**		-$7.5b	+$4.5b

* only the $15 billion total figure has been publicly released. We suggest this breakdown of costs be treated as working assumptions only i.e. is not for public release.