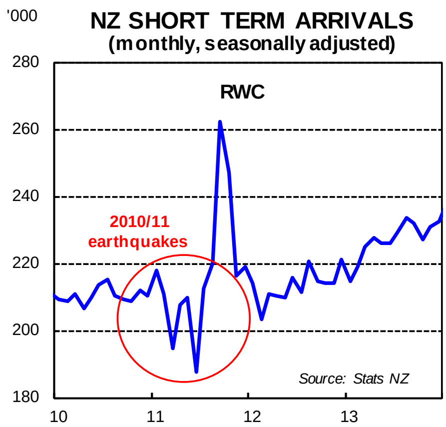
South Island earthquakes – a long day after

- **Major cities returning to normal, but provincial South Island still disrupted.**
- **Transport links directly north and south of Kaikoura in the South Island have been most heavily hit, and are a major hurdle.**
- **At the margin, the quakes could increase the odds of another RBNZ rate cut next year.**

Overview



An extra day has given **more chance to assess the likely economic impacts** of the South Island earthquakes. Encouragingly, Wellington (the large urban centre most affected) is getting back on its feet relatively quickly. The same cannot be said for the provincial communities much closer to the epi-centre. The most significant damage from Monday's earthquake has been to key South Island transport links, particularly State Highway 1 and the main trunk rail link between Picton and Christchurch. **Transport links directly north and south of Kaikoura have been most heavily hit**. A recent gorge road repair suggests that it could be upwards of a year (or even longer) before these links are able to be reopened, but the unique nature of this event means a number of uncertainties remain.

Damage costs are highly speculative at this point, though the Prime Minister is talking of billions of dollars. We'd expect a heavy weighting of damage to be towards government-owned transport infrastructure. For purely illustrative purposes we have pencilled in a totally arbitrary figure of $2.5 billion, or roughly 1% of GDP, much of which would likely be borne by the Government. One positive is that the **Government's books are in a strong position** and as a result, **the costs are likely to be able to be absorbed fairly well.** We expect the Government will fund the rebuild using a combination of spare cash, borrowing and reprioritisation costs. This will keep borrowing costs below the full cost of the repairs.

However, a lingering effect from Monday's quake is likely to be higher inflation. Freight, which can no longer be moved south via rail will instead have to be moved by either ship or truck (with trucks taking the long road). Either way, transport-associated costs look set to rise. Further, reconstruction work will add capacity pressures to an already-constrained construction sector, also impacting on inflation.

At the margin, we think **the earthquakes could increase the odds of another rate cut by the RBNZ next year** if economic disruption is greater than we currently anticipate. **But, with the broader economy in good shape and the earthquakes slightly inflationary if anything, we continue to expect the RBNZ to keep interest rates firmly on hold.**

Magnitude of road and rail damage

It would appear that **much of the earthquake repair bill and lasting disruption will come from reopening the key road and rail link** between Christchurch and the ferry terminal in Picton. These links have been extensively damaged and blocked along the coast north and south of Kaikoura.

We have one recent example of a road reopening to use as context. The Manawatu Gorge was closed in September 2011 after the largest landslide in NZ's history (to that date) blocked part of the road. The slip height was about 70m above road level and it took 14 months to reopen the gorge. Original estimates were quickly revised higher when it was realised that the bridges under the slip needed to be completely repaired. In total, the project cost $21.4m which included $5.4m for maintaining alternative routes. In comparison, original estimates were for a cost of around $11.5m (excluding rebuilding bridges). To complete the work within this time frame, construction workers worked 75-80 hour weeks and construction occurred 7 days a week at peak construction times.

Vision Manawatu estimated the daily cost to the region from the road closure at around $62,000 - $74,500. This includes $34,000 a day in lost productivity, $20,000 in extra fuel requirements and $8,500 a day in additional pay for drivers. Over the whole closure, this was estimated to be between $25 – 30 million.

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The **sheer number and size of the landslides** caused by Monday's earthquakes makes the Manawatu slip pale in comparison. Further, while it is early days, a few landslides look like they could definitely be contenders for NZ's largest. While we have no cost estimates available at this early stage, the Prime Minister has indicated that the total cost of the repairs could well be in the billions. Our guess is that the significant proportion of all earthquake remediation will be road and rail repairs.

At this stage, **we do not think that there will be any quick fixes**. If the Manawatu Gorge is anything to go by, it could conceivably take up to a year, if not longer, to reopen the links – assuming that is deemed feasible. Further, there are a number of complicating factors that could delay repairs. The length of time will depend heavily on the resources that are deployed. Some repairs might have to take place in succession due to access issues. That is, if one landslide must be cleared before the next can be accessed, this could drastically increase the time taken to reopen roads. The sheer height of some cliff faces may require complex engineering to ensure that the links are safe over the long term. Finally, the ongoing aftershocks mean that safety concerns will be paramount. As a result, it may be some time before it is deemed safe enough for repair work to get underway, one lesson from Canterbury earthquakes.

It is possible that it **will be easier to restore the rail link than the road link**. The rail line makes more extensive use of tunnels, which has shielded the rail link in some places where slips have extensively covered the road. However, all tunnels will need to be assessed for earthquake damage.

<u>Rejigging transport logistics</u>

The **impact on inter-island freight transport appears to be the main commercial challenge** created by the earthquakes.

As it stands, the rail network in the North Island is now fully functioning. Inter-island ferry services are constrained, with only 1 of 3 ships currently operating until damage to ferry loading infrastructure in Wellington is repaired. At this stage the ferry service is only carrying freight. The Port of Lyttelton (servicing Christchurch) is now fully operational, and rail services from Christchurch to Invercargill are open.

The main challenge from the earthquakes is the **significant damage to the key road and rail linkage**, particularly rail due to the lack of an alternative route. Rail carries around 15% of New Zealand's total freight movement, so losing the rail link between that effectively connects Christchurch with the North Island is not inconsequential.

The disruption to rail and road for transport down the East Coast means road freight that arrives into Picton via ferry will be driven round the earthquake impacted area. At the moment this is via Arthur's Pass, a 10-12 hour trip to Christchurch. When the Lewis Pass fully opens (it is down one lane in some areas at the moment), the journey time will be cut to 7-8 hours vs. the normal 4 hours. Added travel time and displaced freight from rail will pose some capacity constraints on the trucking industry. Restrictions on where very heavy trucks (50MAX, i.e. 50-tonne) can travel may need to be waived for a period, to enable trucking companies to operate as effectively as possible.

Some freight is also likely to be moved by sea from North Island ports to Lyttelton. Firstly, Lyttelton port does not have roll-on-roll-off rail facilities (as far as we can ascertain), and running rail ferries from Picton to Lyttelton would drastically reduce existing ferry capacity in any event. That points to greater use of coastal shipping, with a question mark over whether additional vessels will be needed.

All up, inter-island freight is likely to be more expensive and take longer until the road and rail link along the coast gets restored.

<u>Tourism and quakes</u>

Given the **growing importance of tourism to the NZ economy, there is a risk the latest earthquake could adversely impact visitor arrivals.** However, looking at the 2010/11 earthquakes, the long-term impact appears to be limited. While, of course, there was a steep decline in the immediate aftermath, the long-term trend resumed roughly a year later (but with a big Rugby World Cup boost in the interim). The Canterbury earthquakes were very high profile through the extraordinary loss of life and damage they caused. The latest earthquakes have been tragic, but are unlikely to get as much global attention. Any impact on visitor arrivals is likely to be small in comparison, though immediately-affected areas (Wellington through to North Canterbury) are likely to see reduced visitors to varying extents. Kaikoura, the whale-watching capital, is both damaged and temporarily off the main road route.

<u>Implications for the NZ Government Fiscal Position</u>

The Prime Minister has stated costs of damage from the North Canterbury earthquakes are likely to run into "the billions of dollars". At this very early stage, this estimate is as good as any so for illustrative purposes we take this to mean NZ$2.5bn – but stress this is a totally arbitrary number. **$2.5bn equates to 1% of GDP.** For comparison, the cost Christchurch earthquake rebuild was equivalent to circa 15% of GDP. We'd expect the costs to be disproportionately weighted to the costs of restoring government-owned infrastructure.

With the NZ Government's books in a strong position, **this magnitude of cost could be absorbed without changing the broader picture of either its fiscal position or its fiscal policy stance.** For example, for the year to June 2016 the OBEGAL (Operating balance excluding gains and losses) was a surplus of $1.8bn, some $1.2bn higher than forecast in Budget 2016 (and the Core Crown residual cash deficit was also $1.3bn lower than forecast).

In other words, we would expect broad operating surpluses, albeit smaller ones, to continue despite this extra cost (assuming that the costs would be spread across several years with front-loading into the 2017 and 2018 fiscal years).

Moreover, as a result of its strong fiscal position and the relatively small estimated cost at this stage, the Government has choices in how to deal with this cost. The choices include:

1. Using its higher expected cash balances to fund the cost and borrowing any shortfall;
2. Borrowing the full cost of the rebuild;
3. Prioritising the rebuild over other spending and other capital projects either by cutting or deferring spending in those other areas; or
4. Some combination of the above.

In addition to the direct rebuild costs, there will be other economic costs that will impact on the Government's tax and investment revenues. For example, tourists may cancel travel to NZ and this would reduce export revenue and thus tax revenues as well. However, the earthquake will also generate rebuild activity, with some of this funded by previously paid for insurance premiums.

Implications for the NZ government borrowing programme

In our view, and following the Christchurch rebuild experience, the Government is likely to fund the rebuild costs using a combination of using spare cash, borrowing and reprioritisation of costs (number 4 in the list above). **This scenario will result in some additional borrowing, but not the full amount.** Again for illustrative purposes, if half the cost ($1.25bn) was borrowed, we would expect much of this to be front-loaded in 2016/17 and 2017/18.

Growth, inflation and interest rate implications

Barring the Canterbury earthquakes, other recent natural disasters have had little overall discernible impact on NZ growth. We largely expect this to be the case again. Economic activity may well take a hit in the worst-affected areas (and some government support may be forthcoming). This disruption will be broadly offset by the spike in construction activity required to repair the damage to infrastructure and buildings. Further, because the earthquake was centred away from heavily urbanised areas, the overall economic impact has been contained as the majority of New Zealanders will be back at work relatively quickly. For the Balance of Payments the impacts are likely to be very small, with any reinsurance inflows muted compared to the circa $20bn inflows triggered by the Canterbury earthquakes.

There is a marginally higher risk that the RBNZ is forced to cut the OCR below 1.75% next year if the economic disruption is greater than we are currently anticipating. But, in the longer term, the probability of higher transport and construction costs means inflation pressures are likely to be slightly greater than otherwise. Our base case remains that the RBNZ will leave interest rates on hold for the foreseeable future. We will continue to monitor developments closely as more information becomes available.

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