Alan Bollard: The implications of the Canterbury earthquakes for the Reserve Bank

Opinion piece by Dr Alan Bollard, Governor of the Reserve Bank of New Zealand, at the implications of the Canterbury earthquakes for the Reserve Bank, 13 May 2011.

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As Canterbury's recovery from its devastating earthquakes progresses, it is timely to assess the economic damage in Canterbury and beyond, and consider what the Reserve Bank – and monetary policy – should do.

Prior to the February earthquake, New Zealand's economic activity had been weaker than expected through 2010. Households were already spending less, focusing on reducing debt, and this had slowed business investment. By late 2010, however, signs of recovery had begun to emerge, notably among exporting firms benefiting from improved overseas demand and commodity prices.

The February earthquake disrupted this recovery. It resulted in significant loss and trauma, compounding the effects of the September 2010 earthquake and subsequent aftershocks. In addition to the considerable impact on peoples' lives, there has been substantial damage to assets, as well as disruption to economic activity.

The total cost of damage has been estimated at $15 billion – approximately 8 percent of annual nominal gross domestic product. That is a very large proportion of our economic activity, in relative terms twice as big as the impact of the recent Japanese earthquake. These estimates are very uncertain and could move around a lot.

The vast bulk of the losses to residential and commercial property will be covered by insurance – via the Earthquake Commission (EQC) for residential property, and private insurance for both residential and commercial property. Unlike some other countries like Japan, there is a high level of reinsurance in New Zealand, meaning the majority of privately insured losses will be borne by global insurance companies rather than domestic insurance firms.

The Government will bear the majority of the remaining losses, with an estimated $3 billion in damage to uninsured public infrastructure and government buildings, as well as the costs being met from the EQC reserves. Fiscal costs will also include the array of additional government support programmes – support to small businesses, clean up and recovery costs, and ACC payments. These costs are material and will place pressure on the Crown accounts at a time of fiscal consolidation.

We see three distinct phases in economic activity following the earthquakes: disruption, stabilisation and reconstruction.

Economic disruption is most pronounced in Canterbury, but flowing through to other regions. Consumer spending, tourism and residential investment can be expected to have deteriorated.

Most businesses with operations in the centre of Christchurch have lost some production, generally from the impact on their workforce. The Canterbury Employers Chamber of Commerce estimates around 30 percent of businesses in Christchurch were materially impacted by the February quake.

However, we may be seeing the first signs of a stabilisation phase, with business confidence surveys recovering strongly.

The Official Cash Rate cut in March, along with government support programmes, looks like it has been helpful in stabilising confidence, and we would expect the deterioration in activity to be arrested by mid-2011.

In Canterbury, activity can be expected to lift due to resumption of business activity, replacement spending and government support. But the Canterbury economy will remain subdued due to wealth losses, weakness in tourism and construction, and obstacles including damage to infrastructure and capital.

Nonetheless, recovery in the Canterbury economy, combined with the boost from the Rugby World Cup, will result in a marked pick-up pace of overall GDP growth.

The reconstruction phase is expected to begin in earnest in 2012, with residential and non-residential investment lifting growth sharply. Spare capacity and labour will be absorbed rapidly, and inflation pressures will pick up from current low levels, prompting interest rates increases.

The likely drivers of inflation from a reconstruction such as we will see in Christchurch are the demand and supply of labour, materials and equipment, and the availability of finance. How government policy affects regulatory standards and the rebuild is also clearly important.

How will the Reserve Bank deal with this? We are guided by our Policy Targets Agreement (PTA) with Government that says, in the case of natural disasters, we should accommodate any initial inflation effects, such as higher rents or insurance premiums. However, we should respond to any *medium-term* generalised inflationary pressures that are likely to develop, as resources are devoted to reconstruction in Canterbury. This means assessing the extent to which wages, construction costs and other prices rise nationally, as resources are drawn into the Canterbury region.

At the same time, monetary policy should also look to avoid any unnecessary instability in activity, the exchange rate and interest rates resulting from the earthquakes. This consideration was behind the decision to reduce the OCR in March so as to mitigate the near-term negative impact of the February earthquake.

It is appropriate for monetary policy to remain supportive, given the continued downside risks to economic activity stemming from the Canterbury earthquakes and more broad fragility in the New Zealand economy. It is likely that the OCR remains on hold until these downside risks pass and the economy begins to recover.