

12:50 pm, one of our darkest moments

- Christchurch's second major earthquake, on February 22, was more devastating and deadly than September 4's.
- There is likely to be a greater extent of business disruption; reconstruction boost further away now.
- A 50bp cut from the RBNZ would provide some insurance/confidence but uncertain - 35% chance of a cut.

Christchurch was hit on February 22nd 2011 by another major earthquake, of magnitude 6.3. The earthquake was closer and shallower than the September 4 7.1 magnitude earthquake and seems to have done far more damage. 75 fatalities have been confirmed by police at the time of writing, with many more people unaccounted for.

Our thoughts and prayers are with all New Zealanders, and in particular those living in Christchurch who have had to endure another horrendous earthquake. We hope all your family and friends are safe.

The devastating earthquake is a further hit to an already weak economy, not to mention the personal toll. The size and scale of further destruction will push back the timing of reconstruction, adding further to uncertainty on the economic outlook. We have changed our OCR call: we now expect the first OCR hike in December 2011 at the earliest. We also place a 35% chance on a 50 basis point OCR cut in the short term. Targeted support will be the most effective way of financially helping Christchurch people and businesses – as it was after the September earthquake. But this earthquake has come at a time when the economy is clearly vulnerable and domestic demand is weak. We would expect that a cut would be more a response to signs the wider economy is flagging, or to give some confidence-restoring insurance.

Financial markets have reacted sharply to the earthquake, with short-term interest rates falling around 20 basis points by the following afternoon in choppy trade. Expectations of OCR increases over the coming 12 months have been reduced from around 50 basis points to 25 basis points, and markets have now priced in around 60% chance of an OCR cut at the March meeting. Given the scope for an emergency rate cut, we suggest keeping an eye out at 9am each morning over the next week. However, the RBNZ will need time to assess the situation and the implications and we do not expect any knee-jerk reactions.

Q1 GDP likely to be affected by disruption in Canterbury.

Economic impact – short-term disruption

Q3 GDP was clearly affected by short-term disruption as a result of the September Earthquake, although accurately quantifying the impact is difficult. Rough estimates ranged from 0.1 to 0.2 percentage points. Many businesses were forced to close for a number of weeks until it was deemed safe to return to work. Likewise, residents may be unable to return to work straight away as they need time at home to sort out damage or to recover from trauma. The extent of damage caused by the February quake suggests that the physical and personal impact is likely to be much higher and disruption is likely to persist for longer.

Retailing and tourism activity likely to be affected.

Retailing is likely to be disrupted. In addition, summer is one of the peak times for tourism. With most tourists likely to be quickly evacuated to Wellington or elsewhere, the struggling industry will now have to deal with a loss in activity (along with destruction of property) at a crucial time of year.

Manufacturing activity also disrupted.

Christchurch's large manufacturing base will also be disrupted. At this time, the damage to manufacturing base remains unclear. This industry suffered minimal damage in September, and was able to return to business relatively quickly. Manufacturing is concentrated west of the city and away from water. However, this quake appeared to be more violent, so there is potentially greater scope for damage to equipment which could see production halted for longer.

Emergency repairs, redistribution of goods and calling activity provide some offset.

There are some offsets to the disruption described above. A large amount of emergency repair work has to be done in a short amount of time, including getting key infrastructure back on line. Various agencies will be working frantically to return water and power to households, and to restore waste processing facilities as quickly as possible. In addition, there is likely to be a lift in transport activity around the country, as goods have to be relocated to replace damaged stock and goods in Christchurch. Likewise there will be a surge in communications activity as people try to contact each other.

Canterbury Earthquake Appeal 2011 account number: 12-3205-0146808-00

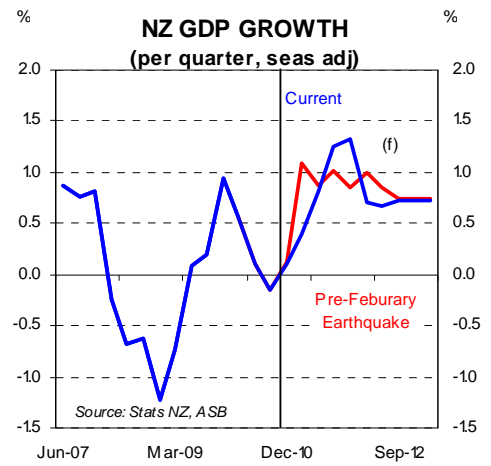
Nick Tuffley Chief Economist – 649 374 8604 – nick.tuffley@asb.co.nz

General Advice Warning

As this report was prepared without taking into account your objectives, financial situation or particular needs, you should not take any action in reliance of this report without considering your particular circumstances and, if necessary, obtaining professional advice.

Reconstruction activity likely to be further delayed as new assessments required.

Economic impact – reconstruction delayed further
6 months on since the September earthquake, we now have a better understanding of how the February quake will impact activity in Christchurch. Much of the GDP growth we had pencilled in for this year was underpinned by reconstruction activity in Christchurch, and improving confidence more generally. The February earthquake serves a major blow to both. We had previously expected that building activity in Christchurch would be starting to pick up around Q1 (i.e. now) as the assessment process over the past 6 months has taken much longer than first anticipated. However, with the most recent quake and the increased scale of destruction, repair work is unlikely to get underway in a meaningful sense until later this year. Moving the timing of this activity will reduce growth over the first half of 2011, but boost growth over the second half of the year.



Further uncertainty on timing of recovery.

One lesson from September’s quake is that many people have been holding off repairs and waiting for the aftershocks to stop. This could take a very long time (possibly a full year), and suggests risk of a later start to rebuilding than we are currently factoring in.

A large degree of uncertainty remains, even from the first quake back in September. The assessment process has taken a long time, and anecdotally very little rebuilding activity had begun. In addition, decisions had yet to be made on the future of areas badly affected by liquefaction. These factors will also likely hamper the reconstruction of damage caused by February’s quake. In reality, it is likely to be a number of years before Christchurch would have finished rebuilding. Furthermore, capacity constraints could slow this progress. Anecdotes before the quake suggest that frustrated builders in Canterbury were opting to go to Queensland and help with the flood damage there instead.

Airport functioning.

Airport Christchurch Airport has reopened for domestic flights and expect the backlog will be cleared by the end of the day. Domestic and international flights resumed today (Wednesday).

Temporary medical facilities set up.

Hospitals and medical facilities are operational in Christchurch. All hospitals are reported as being operational despite suffering from some damage and power outages. People with minor injuries have been advised to go to smaller medical centres around the city rather than Christchurch Hospital. A temporary mortuary has been set up at Burnham Military Camp. The Canterbury District Health Board has looked to move some patients out of Christchurch hospitals to make space for people injured.

Water supply severely disrupted.

Water supplies have been severely disrupted. An estimated 80% of the city is without running water. All residents need to boil water until systems can be checked for contamination. The waste water system is likely to be extensively damaged, and is described by Mayor Bob Parker as “completely trashed”. Water distribution centres are being set up around Christchurch and should be operational today. Toilets are also being brought into the region to help manage the wastewater problems. Water and sewage systems will be a major focus over the weeks ahead, and have the potential to be very disruptive to both households and businesses.

Power slowly returning.

Power is still out in large areas of the city. In September, power was restored to 95% of the city very quickly. Roger Sutton, chief executive of lines company Orion said half the city remained without power. “Mr Sutton said the west of the city was back up and they were working on the eastern suburbs and hope to get more power on today” ... “The bulk of Christchurch’s power should be back on within 24 to 36 hours but the worst affected areas could take one to two weeks” ... “The last earthquake was small pockets, bits and pieces to fix. This earthquake we’ve got some really serious damage to our infrastructure. We haven’t even checked parts of the network. We haven’t been able to get to Lyttelton or the hill areas around Banks Peninsula because of damage to the roads.”” (Source: Stuff)

Communications were severely disrupted.

Telecommunications are patchy. Telecom says power outages mean large parts of its network are working off backup power and mains power outages will mean more services are likely to go down as back-up batteries and generators run down. TelstraClear says phone services have been cut as the batteries in its cellphone cabinets have run low or out of battery power.

Rail currently stopped.

Rail. Kiwirail has halted service in and out of Christchurch, including the route through to Lyttelton Port until further notice. However, trains are functioning north of Rangiora and South of Ashburton. Track inspections are underway today.

Urban roads damaged.

Roads. As was the case last September, many roads are visibly damaged, but there are no reports of major highways being closed. Damage to urban/suburban roads and bridges appears more severe this time.

Port damaged, status uncertain.

Lyttelton Port has suffered major damage. Chief Executive Peter Davie commented the damage was bigger than the September quake. It is not clear how long the port would be closed. "At this stage we'll say 24 hours ... and we'll go from there." The CEO commented in an interview published in the NZ Herald.

Risk of longer-term impact on tourism.

Economic impact – longer-term considerations

Tourism: tourism is extremely important for the Canterbury economy, with guest nights in the region accounting for 16% of the national total (an outsized share given Canterbury's share of national GDP). Furthermore, Christchurch International Airport is a very important gateway for visitors into the South Island. While the international airport is largely unaffected, any negative perceptions of visiting Christchurch could potentially have flow-on effects to the greater part of the South Island tourism industry.

Being the second major quake in 6 months, and the large number of tourists caught up in the tragedy, this event is likely to have a far more damaging impact on foreigners' perception of Christchurch's attractiveness as a tourist destination. The industry is already grappling with the decline in numbers arriving from the US, UK and Eurozone (typically big spenders). The risk is that the earthquakes deter the growing number of visitors from Asia as well.

Rugby World Cup now uncertain.

Rugby World Cup: reports suggest that many hotels have been badly damaged by the February earthquake. There is a possibility that Canterbury may no longer be in the position to host matches for the Rugby World Cup. This loss would also be a blow to the Canterbury region.

Port damage could create bottle neck in recovery.

Port: any material impairment to the Port's functionality and tunnel access would be concerning, given reduced function of the port would limit the speed in which other sectors of Canterbury's economy can recover (including manufacturing). Christchurch would be able to divert rail freight south to Timaru and Dunedin once rail line damage has been repaired.

Population: this is the second major earthquake. It is also the most damaging one and occurred while people were awake. Many people have experienced far more trauma than in the September quake, and have already endured months of nerve-fraying aftershocks. Further damage has been done to an already impaired housing stock. Some people may choose, or be forced, to live somewhere else, crimping Christchurch's population.

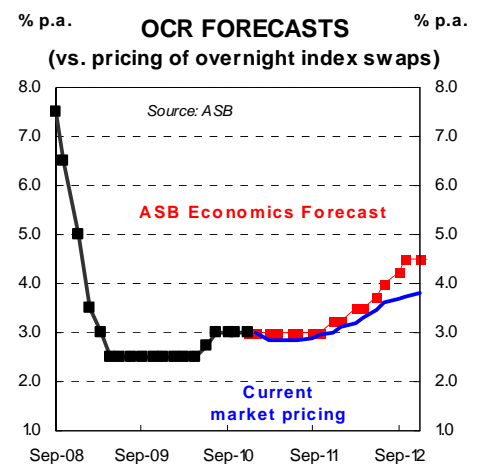
OCR on hold for longer.

OCR outlook

The earthquake comes at a time when the economy was already proving much more fragile than expected. With rebuilding activity delayed and underlying confidence very weak, we now expect the RBNZ to leave the OCR on hold until at least December (September previously) if not later. In addition, we see around a 35% chance of an OCR cut, in order to boost confidence. The RBNZ would have very little to lose by providing more stimulus, given household and business credit appetites remain weak.

35% chance of OCR cut.

The case for cutting is more "why not" than anything else. For Canterbury, targeted assistance from government and banks will be most effective.



EQC adequately resourced to meet claims.

EQC and insurance companies will cover most private sector damage

EQC will again be picking up the bulk of the household damage bill. The EQC still has sizable funds and \$2.5 billion of reinsurance that comes into effect once the damage bill exceeds \$1.5 billion (which it undoubtedly will). Should EQC's total bill exceed \$4 billion EQC will still have further funds in reserve as well as the government guarantee to draw on as a last resort. NZ Finance Minister Bill English has said the EQC has enough resources to cover its costs.

Private insurance largely reinsured.

Residual household and all commercial claims will be covered by private insurers, with the vast majority of claims being paid by foreign reinsurers again.

Government likely to fund infrastructure.

It is likely the Government will again commit to paying for uninsured public infrastructure. Rough guestimates put September's bill at potentially \$1 billion, and it could be higher this time.

OCR could weight on NZD in short term.

FX implications

Although the NZ dollar has weakened in the wake of the earthquake, influences going forward will be mixed. What the RBNZ does in the short term with the OCR will matter: a cut would probably soften the currency more than remaining on hold would. Longer term, an increased amount of reinsurance inflows to cover insurance claims could easily reach \$3 billion overtime. 30% of the funds EQC held prior to the September 4 earthquake were held offshore: it probably has enough domestic securities to cover the roughly \$3.5 billion net it needs to fund past claims and February's excess. However, if its total claims bill from the latest earthquake exceeds the \$4 billion cut-off for reinsurance it may choose to repatriate some of its foreign holdings.

Greater extent of cash inflows over longer-term.

Initial market reaction

Markets pricing in chance of rate cut in March.

Financial markets have reacted sharply to the earthquake, with short-term interest rates falling around 20 basis points to date. Expectations of OCR increases over the coming year have been reduced from around 50 basis points to 25 basis points, and markets have now priced in around 60% chance of an OCR cut in the March meeting.

Concerns weighing on bond market.

Influencing long-term interest rates are concerns the Debt Management Office may need to liquidate some of the Earthquake Commission's (EQC) local bond holdings or increase issuance of NZ Government debt to fund the additional fiscal support for Christchurch.

Equity markets saw mixed results.

The NZX50 closed Tuesday 0.7% lower, as an increase in the share price of Fletcher Building partly offset declines in the share price of most other companies. NZ equities were flat on Wednesday.

Sharemarkets were weak elsewhere, reflecting the tension in the Middle East at present. Global reinsurers were negatively impacted overnight. Reinsurers had already raised their loss forecasts in the wake of the September earthquake, and yesterday's earthquake will increase their losses.

NZ dollar lower.

The NZ dollar also fell sharply, with the NZD/USD dropping a cent immediately following the earthquake from around 0.7630 when the earthquake hit. The currency continued to fall steadily in the overnight session, falling to a low of 0.7455.

Summary

The latest earthquake, on February 22, appears far more devastating than September 4's, both its physical and human toll.

Disruption likely to be far greater this time.

We expect a greater degree of business disruption will result from this earthquake given the severity of the damage. The reconstruction phase, expected to be kicking in about now for the original earthquake, is likely to be pushed further out in time. The economy is likely grow only weakly in the first half of the year, with reconstruction and the Rugby World Cup giving significant boosts in the second half of the year.

Reconstruction pushed out.

An OCR cut is a wildcard (35% chance); we say what's the harm.

It is possible the RBNZ cuts the OCR in the near future (around a 35% chance). Cutting the OCR in itself will not do much to help Canterbury back on its feet – the targeted assistance of the Government and banks will be more effective. But a cut, at a time when the economy is vulnerable, would provide some added insurance. The RBNZ will have the time to make a considered assessment by the March 10 Statement – but we see little downside in the short term.

It's also time to show we care.

The human toll is more important. People have been affected in ways they never were by last year's quake, and have received this blow after enduring months of aftershocks. Even more than last year the people of Christchurch need support and comfort from those of us more fortunate. It would be wonderful if you can do your small bit, and an appeal account number is highlighted overleaf.

Useful information

ASB Crisis Line: 0800 272 029

ASB Earthquake information: <https://www.asb.co.nz/story22684.aspx>

Canterbury Earthquake Appeal 2011 account number: 12-3205-0146808-00

Red Cross Person Enquiry Line: 0800 REDCROSS (0800 733 276)

Civil defence (Canterbury information): <http://www.civildefence.govt.nz/memwebsite.nsf>

Earthquake Commission: www.eqc.govt.nz

Insurance Council of NZ: <http://www.icnz.org.nz>

<https://reports.asb.co.nz/index.html>

<http://www.research.comsec.com.au>

ASB Economics

Level 9, 135 Albert Street, Auckland

ASB Economics & Research		Phone	Fax
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 374 8604
Economist	Jane Turner	jane.turner@asb.co.nz	(649) 374 8185
Economist	Christina Leung	christina.leung@asb.co.nz	(649) 369 4421
Economist	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 374 8819

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