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Item No. 4

Halifax Regional Council
November 25, 2008

TO: Mayor Kelly and Members of Halifax Regional Council

SUBMITTED BY: ______________________________

Geri Kaiser, Deputy Chief Administrative Officer - Corporate Services & Strategy

DATE: November 20, 2008

SUBJECT: **Budget Impact - World Economic Conditions**

INFORMATION REPORT

ORIGIN

At the Council meeting on October 28, 2008, (item #11.3.1) Halifax Regional Council requested an Information Report from staff advising what, if any, impact there might be on HRM's Budget from the world market collapse.

In addition, if there are any Budget impacts, what rationalization or adjustments may be required including Investment Policy changes.

BACKGROUND

GLOBAL FINANCIAL CONDITIONS

The continuing revelations from the world markets are best summarized by former U.S. Reserve Board Chairman Alan Greenspan's comments on October 22, 2008 before the U.S. House Oversight Committee. In his testimony, Mr. Greenspan blamed the problems on heavy demand for securities backed by subprime mortgages by investors who did not worry that the boom in home prices might come to a crashing halt.

In 2007, Canadian investors saw a freeze in a relatively small part of the lending market - non bank asset backed commercial paper. As a result, the market for this type of financial instrument is now dead. The issue for asset backed commercial paper was and is one of inadequate assessment of the risk of these financial instruments. The same inadequate assessment of risk is now a primary problem throughout our global financial systems.

Thankfully, Canadian financial markets have not directly contributed to the subprime mess - that type of lending is simply not permitted in Canada. Our banks are relatively healthy compared to many around the globe. A recent global survey by the World Economic Forum ranked Canadian banks as the most sound in the world. However, the effects of the global problems are being felt in Canada. There is no consensus on the answer to the question how significantly those effects may be felt in Canada.

For example, usually in a market crash situation, if it is a short term problem with the economy, there are wide fluctuations in stock market prices just prior to the bottom of the market. We are seeing just such wild gyrations in the market at present - across the globe. But this time, the economy is not the only problem - it's trust in the financial system. And trust still does not exist in the markets. Commentators are mixed in their views of what stage the market is in right now.

The situation appears to be getting better, due to unprecedented Government intervention across the globe. Current estimates put that intervention at over three trillion dollars and includes bank nationalizations, purchases of debt, and guarantees for interbank lending. The normal monetary measures that governments use to reduce the impact of recessions - reductions in interest rates - are not working because market rates are effectively ignoring Government rates and pricing significant risk of default in lending rates. That risk is a symptom of a lack of trust among lenders world wide. No one knows if the other party will be able to repay those loans. Several countries have negotiated International Monetary Fund rescues in the last few days, with Pakistan currently considering its options. Governments may be required to intervene still further.

In a recent press release (October 23, 2008) the Bank of Canada commented that ..."major economies have announced extraordinary measures to stabilize their financial systems. These initiatives will be pivotal to the resumption of the flow of credit to support global economic growth. Canada's economy and strong financial system will benefit directly from these actions."

As an example of the potential for intervention, on October 21, 2008, Bloomberg News carried a story on a developing problem with the global industry that lenders rely on to reduce risk by insuring lending transactions. The story indicated that outstanding Credit Default Swaps (CDS's) - a form of insurance against counter party risk - may not be reliable in defaults as the capital of the companies which issued them is seriously in question. Normally, protection like this could be purchased for a fee of about 2.5% of the loan. On default, the full amount of the principal would be paid by the insurer. At present, Bloomberg highlights the level of risk in the market by indicating that some premiums have risen to 75% up front, and 5% a year for 5 years. In effect, this insurance is no longer available or reliable to manage risks among lenders. CBS's "Sixty Minutes" has done two recent reports on this issue.

GENERAL ECONOMIC CONDITIONS

Media across the world is very consistent in the expectation that the world is in or starting a very significant recession. The developed world has now been joined in this expectation of a recession by Brazil, Russia, India and China (BRIC), which up to quite recently have been seen as a possible hedge against a recession. The theory was that Canada would be protected as they would still need our commodities.

Recent media reports sampled via Google News, however, paint a gloomy picture of those prospects. Russia and Brazil have been severely impacted by both the financial situation and the significant drops in commodity prices. They are expected to join the developed world in recession. Both India and China are expecting significant downturns in their growth rates. While they may not face recession, a drop in their growth will limit demand for Canadian commodities.

With the recent drop in the value of oil and other commodities, and the resultant drop in the value of the Canadian dollar, we may see positive impacts for our manufacturing and export sectors - if there is demand in other countries. With our economy being so dependant on the U.S. markets, those cost reductions may not be an advantage until the U.S. economy recovers.

The G20 countries recently met to develop a coordinated approach to these issues.

On a micro level, Monster.ca recently reported that, for the third quarter of 2008, its Canadian Employment Index for online job postings fell 12% from a year earlier. Nine out of ten job types registered declined. Eleven of thirteen cities, including Halifax, tracked weaker on line job postings. Job postings are a primary indicator of growth in the economy.

DISCUSSION

The HRM budget areas impacted for this fiscal year are as follows:

Investment Returns and Investment Policy

Staff are currently projecting a shortfall in Operating Fund Investment Income of $650,000. The vast majority of this is as a result of the lower interest rate environment. In reaction to the credit crisis Central Banks have cut interest rates aggressively. In October alone the Bank of Canada cut rates by .75% to help mitigate the Investment Income impact. Staff are reviewing measures to lessen the cash flow burden on the Operating Fund from providing bridge financing to Capital Projects as well as ensuring that all payments to vendors are in accordance with contractual terms.

The Investment Policy Advisory Committee and staff recently conducted the annual review of the Investment Policy in the context of the current credit market turmoil. The conclusion was that the Policy in its present form continues to provide relevant guidance even in these unprecedented market conditions. The Objectives of the Policy in order of importance are listed below:

1. Adherence to Legal Requirements
2. Preservation of Capital
3. Liquidity
4. Diversification of Investment Portfolio
5. Competitive Return on Investments
6. Regular Review of Performance

The Investment Advisory Committee of Council will continue to monitor and report as required.

Sale of Recyclables

Due to strong demand, our revenue from sales of recyclable paper and metals had been higher than budgeted until August of this year. For the remainder of the year, due to a collapse in the demand for recyclables, we expect a significant reduction in revenue. Business Unit projections indicate that our revenue should equal the budgeted amount for this fiscal year, but will be reduced in the next fiscal year (2009-10)

Oil

Our original budget for fuel was based on a price of US$85 per barrel. A reserve was set aside at US$100 per barrel, as we recognized the risk of an oil price increase. The current price is approximately US$54.00 per barrel. While earlier this year, the actual price of oil exceeded our budgeted amount, the current price is below our currently budgeted price. With the current volatility in the commodity markets we are unable to accurately forecast the full year impact on the budget. Our current assumption is that the overall impact this year will be neutral.

Potential impacts for the future:

Property and Deed Transfer Taxes:

Some of our main sources of revenue are property taxes and deed transfer taxes. Commentators across the country are expecting a recession, which may lead to reduced property values and lower sales of housing units.

This may lead to a reduction in the assessment value base on which property tax is based and a reduction in the revenue from property tax unless the tax rate is adjusted. This reduced value may not reflect itself in the assessment roll immediately as values are based on market value levels from two years previous. The assessment roll we are using this year is based on market values as of January 2006.

Lower sales of housing units may lead to a reduction in revenue from deed transfer tax. Deed transfer tax from commercial sales may increase as businesses reposition their asset holdings to accommodate the global economy impacts in Halifax.

Canada Mortgage and Housing Corporation predicts a 3.9% decline in the number of homes sold in 2009 leading to a reduction in revenue from deed transfer tax. However, if, as CMHC forecasts, home prices increase by 3.1% this will mostly offset the reduced volume of housing units sold.

Pension

With the current economic situation, solvency of pension plans has become an issue. An actuarial valuation of the HRM Pension Plan as of December 31, 2007 showed the Plan having a small surplus ($12 Million on a total value of $1 Billion) on a going concern basis and a solvency ratio of 86.2%. Since the solvency ratio was greater than 85%, no special payments would be required and the minimum contribution for 2008 through 2010 would be a combined (HRM and employees) 16.6%. In fact the actual contribution rates are 20.7% to cover plan improvements.

During 2008, the total value of the Plan has fallen by approximately 20%. If an actuarial valuation were to be done today, the Plan would have a deficit of approximately $10 Million on a going concern basis and the solvency ration would be approximately 67%. This would trigger special payments and would increase the combined contribution rate by approximately 10% of payroll. This would equate to an extra $10 Million per year by HRM as well as $10 Million per year by employees.

To make matters worse, the Pension Review Panel of the Province of Nova Scotia has recently presented an interim recommendation on valuation for comment. For most pension plans, the recommendation provided welcomed relief from the impact of the current situation. However, the impact of the proposed change for HRM would increase our current service costs by an additional approximately $16 Million per year, $8 Million by HRM and $8 Million by the employees. This would be over and above the market generated increases.

Because of the current situation, the Pension Committee, on November 20, 2008, approved the filing with the Superintendent of Pension the actual valuation as of December 31, 2007. Under the current Pension Benefits Act Regulations, the filing of this valuation would freeze the current contribution rates for another two years and the next valuation which would have to be filed would not be until December 31, 2011 in respect of December 31, 2010. This would have the effect of buying time for the financial markets to recover, which all analysts agree is a step that is necessary for all pension plans.

With respect to the recommendations of the Pension Review Panel, both the Pension Committee and HRM have filed submissions with the Panal advocating that the recommendations of the Panel be reconsidered in the context of similar work which is being done in other Provinces and at the Federal level which appears to be leaning in a diametrically opposite position and/or defer the implementation of the recommendations until the financial crisis has passed.

Should the current situation not reverse itself to the extent that the deficit is eliminated, HRM and the Pension Committee would have to consider long term adjustments to contributions, benefits or both.

BUDGET IMPLICATIONS

We will be adjusting other areas of expenditure and providing for more contributions to the Operations Stabilization Reserve so as to cushion any uncertainty in fuel and electricity impacts in the current fiscal year. An updated and more comprehensive analysis will be provided as part of staff's report on the 2009/10 Fiscal Framework discussion with Council scheduled for January 2009.

FINANCIAL MANAGEMENT POLICIES / BUSINESS PLAN

This report complies with the Municipality's Multi-Year Financial Strategy, the approved Operating, Capital and Reserve budgets, policies and procedures regarding withdrawals from the utilization of Capital and Operating reserves, as well as any relevant legislation.

ATTACHMENTS

Halifax and the World Economy: Waiting to Exhale, Fred Morley, Greater Halifax Partnership

A copy of this report can be obtained online at http://www.halifax.ca/council/agendasc/cagenda.html then choose the appropriate meeting date, or by contacting the Office of the Municipal Clerk at 490-4210, or Fax 490-4208.

Report Prepared & Approved by : ______________________________

Paul Fleming, Manager, Budget and Financial Analysis, 490-7203

Attachment 1

From: Fred Morley [mailto:fmorley@greaterhalifax.com]
Sent: 2008, October, 29 2:05 PM
Subject: Halifax and the World Economy: Waiting to Exhale

Remember a couple of years ago when there was a lot of talk about whether the housing bubble would burst in the United States and what it would mean for rest of us? Well bubbles always burst and for the last 8 weeks it has been like watching a train wreck in slow motion, entirely predictable but none the less horrifying.

Government response has been unprecedented. Governments have moved to shore up confidence in financial markets by extending deposit insurance, providing direct injections of cash into banks to thaw capital markets, and even injecting equity into the most troubled financial institutions. Markets are still very uncertain and have been behaving badly. They are not sure that all the bad news is out. Likely the US election cycle will have to finish up before we see all the economic cards on the table.

So what does all this mean for Halifax? Well, Canada has side stepped the worst of the financial downturn. We resisted the siren song of deregulation and the conservative nature of our banks has left us better off than most nations.

Closer to home, our city has always been somewhat sheltered from economic downturn by its uniquely diversified and stable economy. The combination of the Navy and other government spending, together with universities, hospitals, a large and stable service sector and a growing population provides a very strong foundation.

The Canadian financial services sector seems healthy by world standards and the big cluster of bank and insurance presence in Halifax will continue to be an important part of growth here. While credit around the world is tight, Canadian banks have not tightened the screws too much. However, tight money and slower growth may mean a few big development projects in Halifax will evaporate. Long approval times for the current batch means some will miss the growth cycle. Only time will tell how many of the billion dollars worth of projects approved this year will actually break ground.

Public investment continues at a slow pace driven mostly by HRM expenditures. Federal and provincial governments have showed a unique reluctance to invest in Nova Scotia's capital region although gateway expenditures hold some promise if recent talk turns into action. Consumers from across the Maritimes have embraced the Halifax region's new retail offerings. This trend should continue.

The dollar fell to the 80-cent range in the course of a couple of weeks. There is consensus that this is now close to where it belongs, although it wasn't expected to get to this level until the last quarter of 2009. A low dollar should keep a few more shoppers close to home and away from the US factory outlets this fall. The dollar should also provide some relief for hard-pressed exporters in manufacturing and services in coming months.

Overall, the Halifax economy will not miss the economic downturn, but we will do better than most. The real question is how do we insure that these short term problems don't affect our long term prospects.

The standard responses to economic downturn may hurt us this time around. It's not the time to layoff good workers because good talent is getting harder to find. It's not the time to give any weight to the self fulfilling prophecies of doom and gloom. It's not the time for governments to defer investments in education and infrastructure. It is a time for smart investors to make money. It's a time for smart businesses to dig out their strategic plans and look for opportunities as well as threats.

In Halifax, our diversified economy will help us like it did during the last big economic dip in the early 1990s. If you were holding your breath for the last two months, it may be time to exhale.