



Unlike our pay-to-view reports, **RODNEY'S RAVINGS** and the chapters of the **How the Economy Works** booklet are free. You can sign up for them and notification about forthcoming **Property Research** reports on our website – <http://www.sra.co.nz/lists/>.

## **How the Economy Works**

### **Essential insights for business owners, management and investors**

#### Chapter One

#### **The trade secrets of the economic forecasters**

In this, the first chapter of a no-nonsense booklet on how the economy works, I reveal many of the trade secrets of the economic forecasters. The other chapters of the booklet will be delivered in instalments over the next few months. When completed the booklet will provide business owners, management and investors with practical and easy to understand insights into how the economy works.

What will you get out of the booklet? Unparalleled insight into what drives cycles in economic growth and how economic cycles impact on many industries. Not all economic cycles are the same, but if a recession or a period of sustained strong economic growth hit town most businesses will be impacted, some dramatically. Understanding what drives economic cycles and how they filter from one industry to another represents valuable knowledge for business owners and managers. Economic cycles also have a major impact on investment markets, including the housing market, the share market, the commercial property and fixed interest markets, meaning the booklet will also offer valuable insights for investors.

The unique economic and industry forecasting framework I have developed gets it right most of the time and much more often than the economic forecasters. This framework was developed in response to my disappointment with the ability of traditional economic forecasting techniques, like the mathematical forecasting model used by the likes of the Reserve Bank (RBNZ) where I started working as a research economist in 1980. In the booklet I will share what I have learnt from being at the coalface of economic analysis and forecasting for 30 years. My experience includes having been a member of the RBNZ's Monetary Policy Committee, head of research at ASB, NZ head of research at international investment banks ABN AMRO and ANZ McCaughan, chief economist at NZI Bank, a research economist at the Bank of England in London where I researched the behaviour of international financial markets and having run my own economic and property research company for four years.

Why am I writing this booklet? It is part of the marketing for our pay-to-view economic and industry reports (see [www.sra.co.nz](http://www.sra.co.nz) for info on these). We already have a Whos Who of clients, including many large, medium-sized and small firms, government agencies and investors, but the more the merrier. I also have a desire to improve economic literacy among the business and investor communities.



Rodney Dickens  
Managing Director and Chief Research Officer  
Strategic Risk Analysis Limited  
[rodney@sra.co.nz](mailto:rodney@sra.co.nz)  
[www.sra.co.nz](http://www.sra.co.nz)



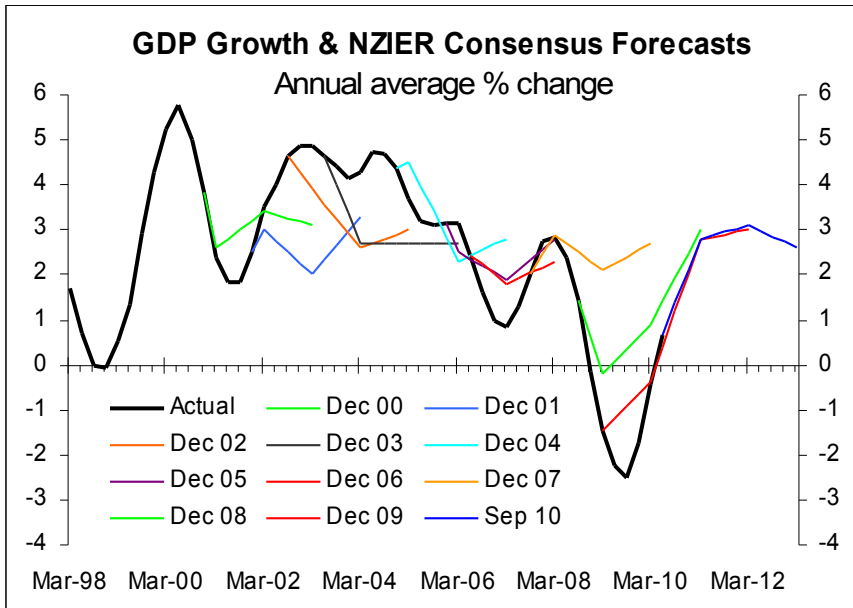
## The trade secrets of the economic forecasters

Reviewing the track record of the economic forecasters reveals their trade secrets. NZIER provides a useful service by surveying 10 economic forecasters each quarter, including the bank economists, the RBNZ, Treasury and their own forecasters. NZIER releases a report presenting the consensus or average predictions by the economists for a range of economic indicators, as well as showing the highest and lowest predictions. This link - [http://www.nzier.org.nz/Site/Publications/Consensus\\_forecasts.aspx](http://www.nzier.org.nz/Site/Publications/Consensus_forecasts.aspx) - can be used to access the NZIER consensus reports. Reviewing the consensus forecasts also tells us whether the economic forecasters as a group are any good or just glorified fortune tellers.

### 1. No matter what the situation, the answer is always 3%

Each quarter NZIER ask the economic forecasters to supply their predictions for economic or GDP growth for the next two or three March years. The chart shows annual average GDP growth (black line) and the consensus or average predictions for GDP growth based on the December surveys conducted by NZIER since 2000, including the most recent survey in September 2010.

In the December 2000 survey the consensus view was that economic growth would be 3.4% in the 2001/02 March year, which was close to the mark, and 3.1% for the 2002/03 March year versus a much higher outcome of 4.9% (left hand green line). In the December 2001 survey the economists were on average predicting 2% growth in 2002/03 versus an outcome of 4.9% and 3.3% for 2003/04 versus an outcome of 4.3% (left hand blue line). In the December 2002 survey the consensus prediction was for 2.6% growth in 2003/04 versus an outcome of 4.3% and 3% growth in 2004/05 versus an outcome of 3.7% (left hand orange line). In December 2003, after economic growth had consistently run well above what the economists had been predicting for almost two years, the consensus view was still that economic growth would run around 3% over the next couple of years (grey line). Eventually the economists got their wish and economic growth slowed to close to 3% in 2005/06, but based on their December 2004 predictions it was supposed to stay around 3% in 2006/07 whereas it fell to 1% (see the light blue line).



The December 2005 (purple line), December 2006 (red line) and December 2007 (right hand orange line) surveys continued the tradition of predicting that economic growth would be near 3%, while more often than not economic growth ran below what the forecasters were predicting. However, this partly reflected shocks like SARs, which economic forecasters can't be expected to predict.

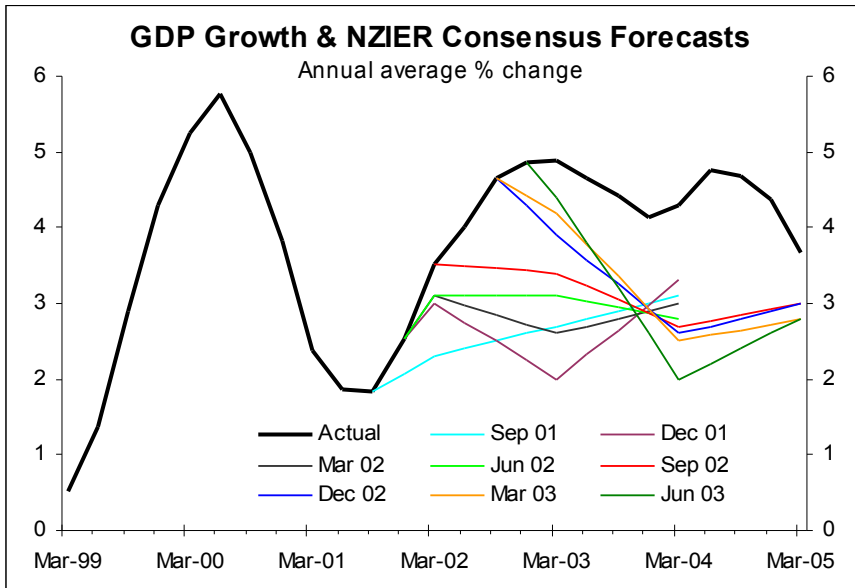
Then came the financial crisis and the mother-of-all-recessions, with GDP growth deteriorating to -2.9% in the year to September 2009. But even the financial crisis didn't put the economic forecasters off

their stride. In December 2008 the consensus view was that economic growth would recover to 3% by the 2010/11 March year (right hand green line). By the time of the December 2009 survey normal service had completely resumed, with the consensus predictions being for 2.8% growth in 2010/11 and 3% growth in 2011/12 (right hand red line). Based on the most recent survey, being that undertaken in September 2010, the economists are on average predicting 2.8% growth in 2010/11, 3.1% growth in 2011/12 and 2.6% growth in 2012/13 (right hand blue line).

If you draw a line on the chart linking the two 3s you will find that the ends of all the coloured forecast lines end up quite close to it. This is despite the fact that in the last 10 years economic growth has run either well above 3% or well below 3% much more often than it has hung around 3%. Predicting that economic growth will converge on around 3% is like picking that all ITM Cup games will end in draws. At any stage in the



competition the total of points for and points against for all teams combined will be the same, so in aggregate it adds up to a draw, but this outcome is the product of lots of wins (like periods of strong economic growth) and lots of losses (like economic slowdowns and recessions) and few draws.



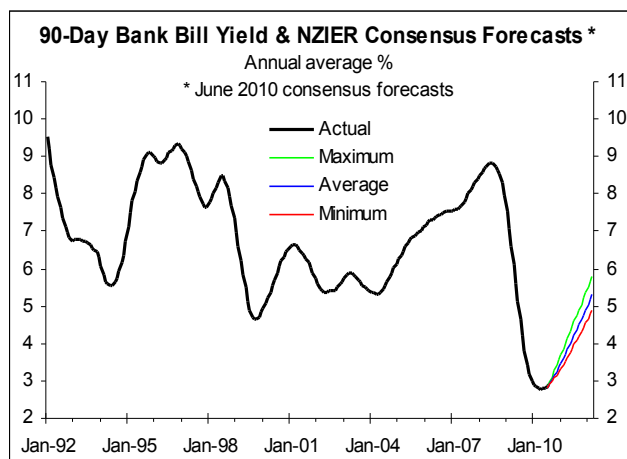
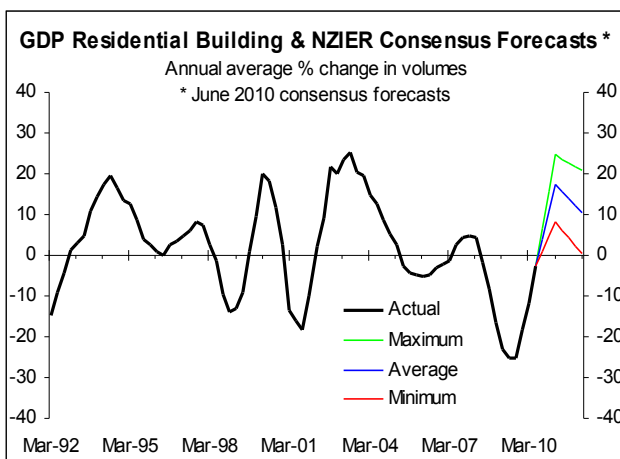
To show that I haven't biased the outcome by presenting only the December surveys in the chart above, this chart looks at all the quarterly surveys between September 2001 and June 2003, as shown by the coloured lines. Again, the dates relate to the months the surveys were conducted and the associated coloured lines show what the economists were on average predicting for economic growth over the subsequent two or three March years.

In September 2001, as annual average economic growth was about to accelerate to almost 5%, the economic forecasters

were on average predicting that it would gradually accelerate from around 2% to 3.1% by the 2003/04 March year (the light blue line). Despite economic growth accelerating well above what the economic forecasters were on average predicting during 2002 and remaining well above what they were predicting in 2003 and 2004 the economists on average stuck to predicting that economic growth would slow to around 3%. This wasn't because they are inherently pessimistic. The chart on the previous page shows that in recent times they have more often than not predicted that economic growth would be stronger than it turned out. It is because they can't help themselves from predicting that economic growth will gravitate towards their somewhat optimistic view of the average rate. Over the period shown in the chart GDP growth has averaged 2.4% per annum, which is close to NZ's sustainable growth rate, so their addiction to 3% reflects a somewhat optimistic view of the average growth rate.

## 2. Never let reality get in the way of predicting that things will return to average levels

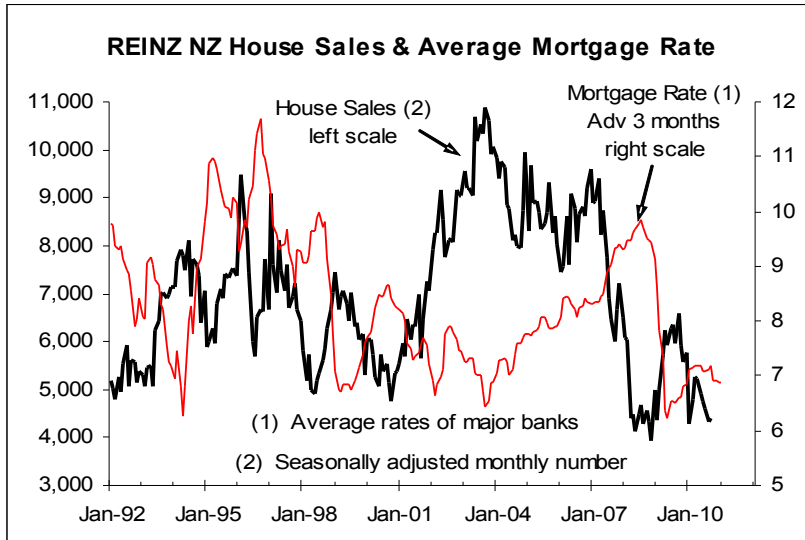
In the 2010 June survey NZIER found that the economic forecasters were on average predicting 17.5% growth in total residential building activity in the 2010/11 March year and 10.6% growth in 2011/12 (blue line, left chart). The RBNZ's was predicting 24.6% and 7.4%, respectively. The average predictions of the economic forecasters are often in the same ballpark as the RBNZ's predictions, reflecting herd behaviour by some of the forecasters. At the same time the consensus view was that the 90-day bank bill yield, the benchmark short-term wholesale interest rate that moves closely in line with the OCR, would increase to 5.3% (blue line, right chart), which was close to the RBNZ's prediction.



While Strategic Risk Analysis Limited will use all reasonable endeavours in producing reports to ensure the information is as accurate as practicable, Strategic Risk Analysis Limited, its employees and shareholders shall not be liable (whether in contract, tort (including negligence), equity or any other basis) for any loss or damage sustained by any person relying on such work whatever the cause of such loss or damage.



The 90-day bank bill yield largely drives the floating and short-term fixed mortgage interest rates, which have been the lowest mortgage rates in recent times and so have the largest impact of housing demand. Only in the twisted minds of economic forecasters can significant increases in the 90-day bank bill yield, which are implicitly predictions of significant increases in the OCR, be predicted at the same time as forecasting robust growth in residential building activity. Housing is the most interest rate sensitive industry around and in the past increases in the 90-day bank bill yield of the magnitude being predicted by the economic forecasters surveyed by NZIER in June 2010 have all resulted in falling housing demand.



This chart shows that whenever there has been a significant change in mortgage interest rates the monthly number of house sales reported by REINZ has changed significantly. The red mortgage interest rate line has been advanced or shifted to the right by three months to reflect how long it takes on average for changes in interest rates to impact on the number of house sales. As discussed in our **Housing Prospects** reports, more than just interest rates drive housing demand, but the chart shows that interest rates are the primary driver of the number of house sales (see

<http://sra.co.nz/housing.html> for info on the **Housing Prospects** reports that are produced 11 months per annum and have attractively-priced annual subscriptions).

The number of house sales reported by REINZ each month is in turn one of the most useful leading indicators of new house building, as discussed in our monthly **Building Barometer** reports that provide the best available insights into the outlook for residential building (see <http://sra.co.nz/building.html> for info on these reports). Every cycle in the number of REINZ house sales shown in the chart above has been followed by a cycle of similar magnitude in the number of consents for building houses. Residential building is as interest rate sensitive as existing house sales, but it takes several months longer for changes in interest rates to impact on residential building than it takes to impact on house sales.

The extreme interest rate sensitivity of housing market activity shown in the chart provides evidence why predicting significant increases in the 90-day bank bill yield at the same time as predicting robust growth in residential building is a nonsense. The forecasters would have to be assuming extreme behaviour by the other drivers of housing demand, like the strongest ever population growth, the end of the financial crisis or a miracle improvement in housing affordability to reconcile these predictions, which they were not.

The other problem is that at the time the economic forecasters supplied their predictions of robust growth in residential building activity for 2010/11 and 2011/12 to NZIER in June 2010 the leading indicators were predicting the risk of an imminent and sharp fall in residential building activity (e.g. between the peak in September 2009 and May 2010 the number of REINZ house sales had fallen 25%, as can be seen in the chart). This on its own should have given the economic forecasters reason to have less optimistic forecasts for residential building activity, completely aside from the sensible idea of not predicting robust growth in residential building activity at the same time a forecasting significant interest rate increases.

So what were the economic forecasters thinking in June 2010? Their forecasts reveal that they were up to much the same thing as they are regularly up to. They were predicting that the level of residential building activity would increase back to around the historical average level at the same time as predicting that the 90-day bank bill yield would increase back towards the historical average rate. This is the sort of thing you might expect people to do if they had little idea of how the economy actually works, no knowledge of what the leading indicators were predicting and had assumed the impact of the financial crisis away.

To my knowledge Dr Rod Deane was the founder of economic forecasting at the Reserve Bank. He was Head of the Economic Department when I joined the bank as a research economist in 1980 and possibly also a Deputy Governor (although that may have come later). One of the early jobs I was involved in at the



RBNZ was building parts of one of the versions of the economic forecasting model. And I can still remember Rod telling us that an important function of economic forecasting models was to make sure that the forecasts are “internally consistent” (i.e. that you don’t forecast robust growth in residential building activity at the same time as predicting significant interest rate increases). It seems that economic forecasters today don’t rate internal consistency highly. It seems that the desire to predict that things will gravitate back towards historical average rates or levels is so strong that the forecasters are at times willing to make outlandish predictions.

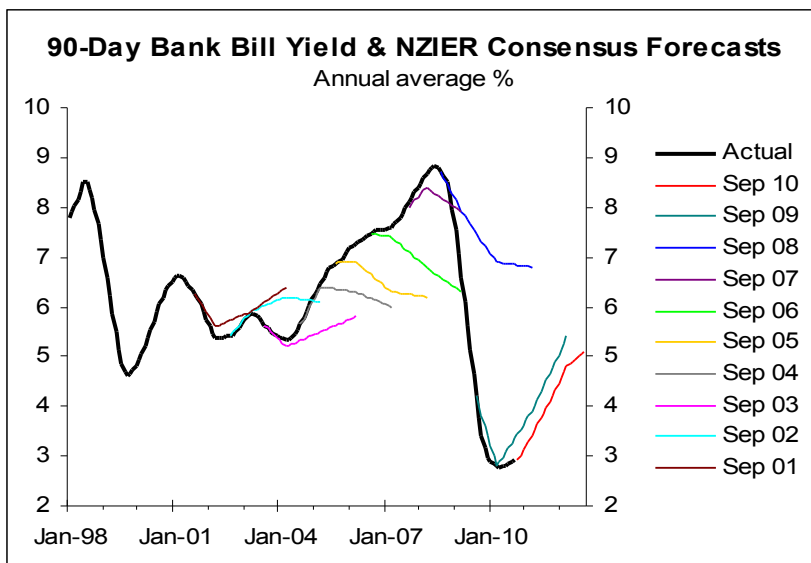
Is it fair to tar all the forecasters with the same brush? The charts at the bottom of page 3 suggest that in this case tar and feathering is justified all round, although this is not always the case. The green lines in the charts reflect the highest predictions by any of the 10 forecasters surveyed by NZIER in June 2010 for the 2010/11 and 2011/12 March years, while the red lines reflect the lowest predictions by any of the forecasters. The right chart shows a close flocking of the predictions for the 90-day bank bill yield, with all the 10 forecasters predicting significant increases. However, none of the forecasters were predicting that the interest rate increases would result in falling residential building activity. In this case all 10 forecasters were off with the fairies to a greater or lesser extent.

**3. Cling to the historical averages even when the world has fundamentally changed**

The consensus forecasts for the 90-day bank bill yield shown in the chart below again reveal the homing instincts of the forecasters for historical averages. In September 2001, September 2002 and September 2003, when the 90-day bank bill yield was a bit below the historical average rate of the previous decade, the economic forecasters surveyed by NZIER were on average predicting moderate increases (see the coloured lines associated with these dates). The 90-day bank bill yield didn’t change a great deal between September 2001 and early 2004, so by either good judgment or chance the September 2001 and September 2002 predictions were not too far from the mark, but things came seriously unstuck in 2004.

The 90-day bank bill yield experienced a major cyclical increase between early 2004 and early 2008, ending up close to the 9% peak rate I had, while head of research at ASB, warned Governor Bollard and one of his senior advised would occur well before it did. Even before Dr Bollard took over as governor in September 2002 the RBNZ had embarked on what I labelled the “go for growth” approach to monetary policy. In my assessment the experiment with low interest rates at this time was inevitably going to result in an inflation problem that would require significant interest rate increases to fix. As the 90-day bank bill yield marched ever higher during 2004, 2005, 2006 and 2007 the economists kept predicting that it would fall back towards the historical average rate (see the Sep 04, Sep 05 and Sep 06 lines in the chart).

After the financial crisis had started the September 2008 consensus prediction was for the 90-day bank bill yield to head back to around the historical average rate (dark blue line). I didn’t predict the crisis, although prior to the crisis arriving I had warned clients that the “go for growth” approach to monetary policy meant that a recession was inevitable and that NZ faced the risk of a large fall in real or inflation-adjusted house prices. Being on the inside of the banking system, the bank economists had a comparative advantage and

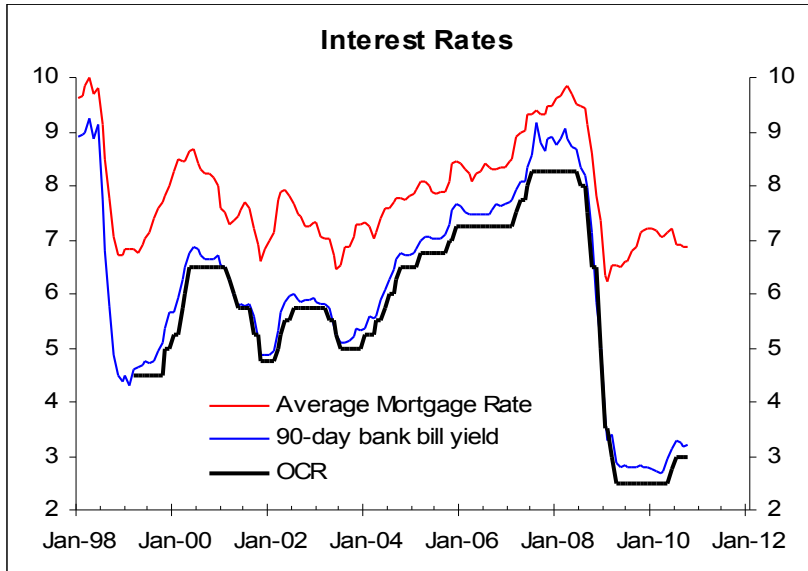


for a period of around six months they earned their keep (i.e. they were quicker than me to realise the magnitude of the crisis and the implications for the OCR and the 90-day bank bill yield). But they were soon back at their old tricks.

In September 2009 and again in the latest survey by NZIER (September 2010) the consensus predictions by the economic forecasters are for the 90-day bank bill yield to increase back towards the historical average rate. I believe the forecasters are partly compensating for the mistake they made between 2004 and 2007 when they predicted that the 90-day bank bill yield would fall when instead it experienced a



large cyclical increase. At times economic forecasters and central bank governors play to their last big mistake (i.e. in trying to avoid repeating the last major mistake they make a different mistake). And there is strong if not overwhelming evidence that the economic forecasters are on average currently making just as big a mistake now as they made between 2004 and 2007, but in the opposite direction.

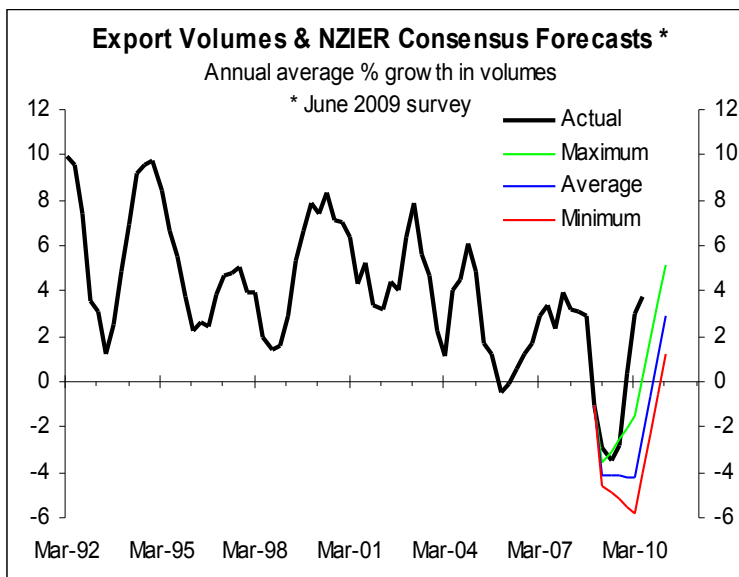


In some parts of the economy the financial crisis is still having a major impact and interest rates is one of these, as reflected in the chart. Prior to the crisis the average mortgage interest rate charged by the major banks averaged 1.5% (150 basis points) above the 90-day bank bill yield. This gap is now 3.7% (370 basis points). This much increased gap reflects the much higher margins local banks are having to pay for overseas funding relative to wholesale interest rates like the 90-day bank bill yield and the RBNZ requiring banks to fund more through more expensive retail deposits (e.g. most banks are today offering up to 6-6.75% for 5-year

term deposits of \$10,000 or more versus the 90-day bank bill yield at 3.2%). The OCR and the 90-day bank bill yield are closely connected, as shown in the chart.

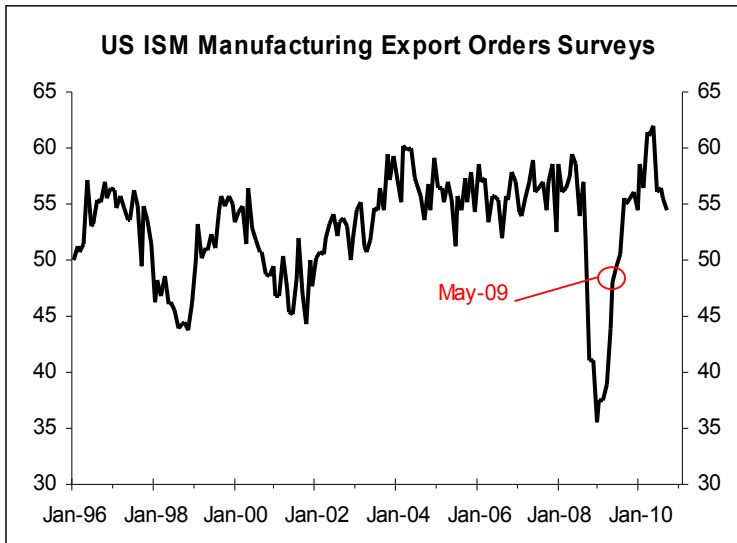
If the financial crisis doesn't magically heal it means mortgage interest rates will remain much higher relative to the 90-day bank bill yield and the OCR than was the case before the crisis. Rather than healing it appears that the crisis is evolving from a private sector crisis in to a government debt crisis, both of which appear to have similar implications for the cost of overseas funds for banks. This may change in time, but the obvious implication at the moment and for the foreseeable future is that the OCR can be much lower than was the case prior to the crisis. So why would any forecaster predict that the 90-day bank bill yield will increase back to around the historical average rate, especially when, to my knowledge, none are predicting a major healing in the financial crisis?! They just can't kick their "mean reverting" habits. The fact that lots of individuals are over geared, thanks to some silly decisions during the speculative bubble in the housing market, adds to the reason why the OCR should be significantly lower now and probably for quite some time to come than was the case before the crisis.

#### 4. Never predict something until after it has happened



In a February 2009 Raving titled **Positive news for economic growth in 2009** I argued that demand for exports could rebound early (see the following link - <http://sra.co.nz/pdf/LifeAftertheCrisis.pdf>). In June 2009 the economic forecasters were still focused on the fallout from the crisis and on average predicted a 4.2% fall in export volumes in the 2009/10 March years, but for growth to improve to 2.9% in 2010/11 (blue line). Even the most optimistic of the 10 forecasters surveyed by NZIER in June 2009 was predicting a 1.5% fall in export volumes in 2009/10. The forecasters were all much too pessimistic, with export volume growth quickly rebounding to 3.8% in the 2009/10 March years, a full year ahead of the consensus forecasts.

While Strategic Risk Analysis Limited will use all reasonable endeavours in producing reports to ensure the information is as accurate as practicable, Strategic Risk Analysis Limited, its employees and shareholders shall not be liable (whether in contract, tort (including negligence), equity or any other basis) for any loss or damage sustained by any person relying on such work whatever the cause of such loss or damage.



In the February 2009 Raving I explained the mechanism by which export volume growth would recover much earlier than predicted by all the economic forecasters surveyed by NZIER in June 2010. This partly reflected a superior understanding of how economic cycles work, but also reflects the fact that many of the economic forecasters are wearing blinkers or something that stopped them from making use of readily available information.

Before NZIER surveyed the economic forecasters in June 2009 the May 2009 US ISM survey of manufacturing export orders was available and this survey, like many of the international indicators that I follow regularly and incorporate into our

monthly economic reports (see <http://sra.co.nz/interesting.html> for info on these) and our twice-monthly forex reports (see <http://sra.co.nz/forex.html>), was showing distinct signs of a V-shaped recovery, as shown in the chart. At the time of writing the February 2009 Raving this survey was only showing early signs of what turned out to be a full V-shaped recovery, but as I argued in the Raving there were good reasons for believing this could happen. But they were obviously not good enough reasons for any of the 10 economic forecasters surveyed by NZIER in June to have noticed.

I have chosen a black-and-white or extreme example to demonstrate the tendency of the economic forecasters to not be able to recognise an economic upturn until after it has occurred. There are plenty more examples of the same behaviour to various degrees that demonstrate a major short-coming of the traditional approaches to economic forecasting. In general economists are good at telling you what happened yesterday, at extrapolating what happened yesterday forward and at predicting that things will revert to historical averages in the not too distant future, but they are seldom any good at predicting upturns and downturns in a timely fashion.

Specifically, economic forecasters have a terrible track record at predicting “turning points” (i.e. situations where export volumes or housing market activity rapidly change from falling dramatically to rebounding strongly or vice-versa). This shortcoming of the traditional approaches to forecasting used by most of the economists is plain to see to anyone who has studied their track record for a much shorter period of time than I have, but despite the obvious shortcoming the economic forecasters trundle on regardless. By contrast, I have spent most of my career developing an alternative approach to economic forecasting that is designed to pick and regularly picks the turning points, which makes it a valuable tool for clients wanting early warnings about economic or industry upturns and downturns.

##### **5. Avoid repeating the last big mistake by making a different mistake**

This rule of economic forecasting has been covered above to some extent, as discussed at the bottom of page 5 and top of page 6. However, it is worth investigating further because the RBNZ is prone to making this mistake from time to time. This is important because the RBNZ controls the OCR but also because the RBNZ plays a pivotal role in the economic forecasting community. The pivotal role played by the RBNZ is partly because the central bank has a major interest in the outlook for the economy and consequently has the largest team of economists working on building and running a forecasting model(s). It is also partly because a number of other forecasts, including some of the bank economists, don't have their own large forecasting models or quality/reliable frameworks for predicting economic outcomes. At times some of the forecasters appear to do little more than check what the RBNZ and other forecasters are predicting and nudging their own predictions either a bit above or a bit below what the RBNZ is predicting or the consensus predictions. This would be fine if the forecasters caring the lamp (i.e. mainly my former colleagues at the RBNZ) knew where the road ahead went.

While Strategic Risk Analysis Limited will use all reasonable endeavours in producing reports to ensure the information is as accurate as practicable, Strategic Risk Analysis Limited, its employees and shareholders shall not be liable (whether in contract, tort (including negligence), equity or any other basis) for any loss or damage sustained by any person relying on such work whatever the cause of such loss or damage.

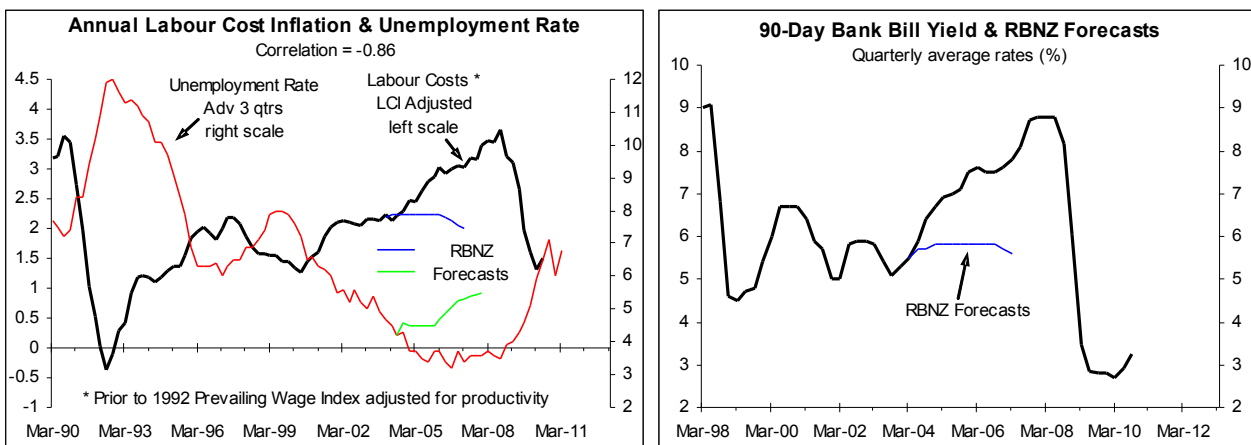


The charts below provide a fascinating case study of the RBNZ forecasters having learnt from a previous major mistake, but possibly in doing so making a new blunder. The left chart below shows what the RBNZ was in March 2004 predicting for the unemployment rate and the adjusted measure of annual labour cost inflation (which measures the bad or inflationary part of labour cost increases), with these predictions having been released after the RBNZ delivered the first of thirteen 0.25% OCR hikes between January 2004 and July 2007. The right chart shows what the RBNZ was forecasting for the 90-day bank bill yield in March 2004, with these forecasts being akin to OCR predictions.

The left chart is a testament to the fact that the economy works much like is taught at university. The black line shows adjusted annual labour cost inflation, left scale. The red line shows the unemployment rate, right scale, with this line having been advanced or shifted to the right by three quarters to reflect how long it takes changes in the unemployment rate to impact on annual labour cost inflation. If the unemployment rate falls it gives greater bargaining power to employees and the chart shows that it takes three quarters on average for employees to take advantage of the improved bargaining power. Equally, if the unemployment rate increases it takes employers three quarters on average to extract a pound of flesh. The unemployment rate is in turn driven by economic growth. The RBNZ's misplaced "go for growth" experiment between 1999 and 2005 generated above average economic growth (see the chart on page 3), which resulted in a large fall in the unemployment rate and with around the normal three quarter lag a large cyclical increase in the bad component of labour cost inflation (left chart below). While the left chart shows that the economy works much like what is taught in stage one economics, for whatever reason it seems that some of the economic forecasters have forgotten this.

Despite the OCR being low at the time, in March 2004 the RBNZ was predicting that the unemployment rate would increase over the next two years (green line, left chart) and that this would result in the bad component of annual labour cost inflation nudging lower over the next two year (blue line). Not surprisingly given the RBNZ's predictions for labour cost inflation, which is at the heart of overall inflation, the RBNZ was predicting that the 90-day bank bill yield could drift sideways (blue line, right chart). Consistent with the teachings of stage one economic the sustained period of below average interest rates generated strong economic growth, a falling unemployment rate, rising labour cost inflation and ultimately much higher interest rates than would have been required if the RBNZ's hadn't subjected us to its misguided "go for growth" experiment. But at least the RBNZ's predictions were internally consistent, although in the context of the cost to New Zealand of the "go for growth" experiment internal consistency is of little consolation.

During this period I visited my ex-colleagues at the RBNZ twice to explain the error of their ways. I was even armed with the left chart below, which at the times of the visits showed a fall in the unemployment rate predicting near-term upside in labour cost inflation. In response I was presented with superficial and dubious reasons why this time would be different. According to the RBNZ's forecasters (and almost all the economic forecasters at the time) the NZ economy had grown wings and could magically experience well above average economic growth without it resulting in inflation. At the time I saw no compelling reasons why this time would be massively different and history has shown that the NZ economy was not able to defy the laws of economics even if the economic forecasters predicted that it could.



The massive errors in the RBNZ's March 2004 predictions demonstrate two tendencies or trade secrets of the economic forecasters. The economic forecasters are prone to getting caught in loops of logic (or

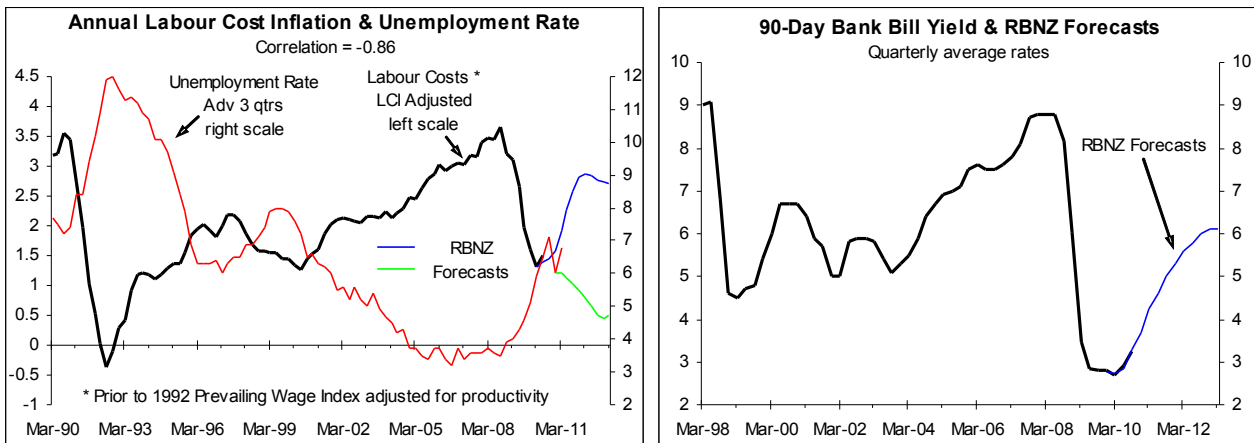


illogic), while they are also inclined to wishful thinking. In this case the wishful thinking was that the NZ economy had grown wings. Once this erroneous assumption was plugged into the RBNZ's forecasting model it would always spit out misguided predictions for the unemployment rate, labour cost inflation and interest rates, like those shown in the charts above, leaving the forecasters trapped by the logic of the forecasting model. This gets to the heart of why economic forecasters are prone to get it wrong more often than right. They too often plug in assumptions that are based on wishful thinking and/or fizzy logic. This is the basis of the phrase "rubbish in, rubbish out".

History has marched on and shown that even aging dogs can learn new bad tricks. The RBNZ's predictions in the charts below are from the June 2010 Monetary Policy Statement and were released when the RBNZ delivered the first of what was supposed to be a series of OCR hikes. The contrast between the predictions in the charts below and those in the charts above is extreme. In 2004 the RBNZ effectively predicted no further OCR hikes after delivering the first one, just to go on to deliver thirteen hikes. The RBNZ's June 2010 predictions built in the sort of normal economic cycle it should have incorporated in 2004. This time around the RBNZ predicted in June 2010 that the super-low interest rates would generate a period of above average economic growth, specifically 3.5% growth during 2010 and 3.6% during 2011, which would drive down the unemployment rate and with around the normal three quarter lag drive up labour cost inflation (left chart). The resulting inflation problem then necessitating that the 90-day bank bill yield be pushed back up to around the historical average level, which implicitly equates to the RBNZ having to deliver a total of around twelve 0.25% OCR hikes (blue line, right chart).

It seems that the lesson the RBNZ forecasters learnt from their massive forecasting errors in the 2004 to 2007 period was that they should build normal economic cycles into their predictions. In general this is a good idea, but if there was ever a time when things were not going to work out normally it is probably now. As discussed briefly on page 6 and in more depth in our monthly **Interesting Times** economic reports, we are still living in the shadow of the financial crisis. And while that remains the case predicting large interest rate increases could end up looking as dumb as predicting no interest rate increases in 2004 (i.e. to avoid repeating the last major mistake the RBNZ has stumbled into a different bear trap). On a positive note, the RBNZ's predictions are again internally consistent, so Rod Deane might be at least a little proud of his legacy.

As an aside, the RBNZ's June 2010 predictions look to me like confessions that the RBNZ believed it would over bake the recovery in economic growth, causing inflation and necessitating large and destructive interest rate increases. Earlier in the economic recovery I shared this concern, but the fact that this time is different in some important respects should have been obvious for the economic forecasters to have seen for some time. The RBNZ's June 2010 forecasts read like the confessions of a central bank bent on causing excessive volatility in economic cycles, but that's a topic that deserves its own chapter.



### Close encounters with economic forecasters

Having worked at the coalface of economic analysis and forecasting for 30 years I have plenty of anecdotal evidence that supports the analysis of the consensus and RBNZ forecasts above. These close encounters with economic forecasters played an important part in motivating me to develop a different and much more reliable approach to predicting economic and industry upturns and downturns.

While Strategic Risk Analysis Limited will use all reasonable endeavours in producing reports to ensure the information is as accurate as practicable, Strategic Risk Analysis Limited, its employees and shareholders shall not be liable (whether in contract, tort (including negligence), equity or any other basis) for any loss or damage sustained by any person relying on such work whatever the cause of such loss or damage.



Relatively early in my career at the RBNZ I was having a casual meeting with the head of the forecasting division when one of his forecasters delivered a wad of computer paper containing the predictions from the forecasting model. While I waited he flicked through the pages of computer printout and delivered succinct instructions to his forecaster. The instructions, delivered in eco-speak (e.g. “exogenous the consumption equation”), were all designed to overwrite what the model was forecasting. This was partly necessary because forecasting models are poor simplifications of the economy, but occurred more so because what the model was predicting didn’t stack up with the head of forecasting’s preconceptions. This early lesson is consistent with what I have observed economic forecasters do regularly (i.e. wishful thinking and preconceptions often dominate, ensuring the saying “rubbish in, rubbish out” often holds true).

When I was chief economist at NZI Bank in the late 1980s there was a monthly meeting of the Wellington-based economic forecasters. I was regularly in Wellington on business and so attended the meetings. In practise it was supposed to provide a forum for the economic forecasters to debate ideas on economic policy and the outlook for the economy etc. After attending several meetings it became obvious that in between the meetings most of the economists spent their time debating reality with their computers, while during the meetings the discussion tended to play a part in reinforcing the often misguided and ill-informed consensus view. My forecasting framework, which is in part based on leading indicator analysis and regular interactions with people at the coalface of the economy, was not as well developed then as it is now, but it regularly provided me with a divergent outlook for the economy than argued by the economists at the meetings. I soon realised that trying to enlighten the economics brains trust was a waste of time, so I stopped attending the meetings.

Since the late 1980s I have largely been a lone wolf, which is a good way of making sure you don’t get dragged into the herd or pack mentality. Herding is great if you are trying to avoid being eaten by predators, while being part of the pack is great for hunting large prey. But neither provides a sound basis for producing quality economic forecasts. There are plenty of psychology studies showing how people are prone to going along with the crowd or consensus view even when they don’t agree. By contrast, because I have developed a unique and now well tested framework for providing economic and industry forecasts I have no use for the safety of the crowd, although I don’t always get it right.

Psychology also tells us why most economic forecasters get caught up in the crowd, with this behaviour common more generally in society. Basically, if all the economic forecasters get it wrong together no one gets sacked. If one of them gets it right on his/her own he/she might get a small reward, but if he/she gets it wrong on his/her own he/she might get sacked. If an economic forecaster doesn’t have a reliable forecasting framework, which is close to the norm, why take the risk of being wrong on your own and getting sacked?!

Thanks to the service provided by NZIER I can check to see how different my predictions are from the consensus forecasts, which when done at a safe distance from the herd/pack still leaves me largely unaffected by the herd/pack mentality. What this regularly reveals is the loop of logic (or illogic) the consensus view is caught in.

### **Why do banks employ economists?**

The likes of the RBNZ and Treasury produce economic forecasts because they have something akin to a statutory obligation to do so, meaning having economic forecasters is a necessary evil. But why do banks employ forecasters when their track record at predicting the outlook for the likes of economic growth, the housing market and interest rates is poor?

I believe banks have a sound commercial reason for employing economic forecasters even though their predictions can offer little help to the banks’ clients. I believe the main payback banks get is media coverage. How much would it cost to get your company’s name on the six o’clock news on a regular basis? The cost is employing an economist. This can be relatively cheap because you have the option of employing a garden variety macro-economist and letting him/her loose on the unsuspecting public without he/she having a proven track record in economic forecasting.

### **Is there a better way?**

Yes, as will be covered in future chapters. Some clients have partly joked that they get things right more often if they take the opposite view to that of the economic forecasters. This contrarian approach works in some circumstances, but the best approach is to make use of a forecasting framework with a proven track record, like the one I have developed.

While Strategic Risk Analysis Limited will use all reasonable endeavours in producing reports to ensure the information is as accurate as practicable, Strategic Risk Analysis Limited, its employees and shareholders shall not be liable (whether in contract, tort (including negligence), equity or any other basis) for any loss or damage sustained by any person relying on such work whatever the cause of such loss or damage.