MONETARY POLICY BRIEFING

Sample Report

CONTENTS OF THE REPORTS

The front page of each **Monetary Policy Briefing** report contains a concise executive summary. The reports identify what game the Reserve Bank (RBNZ) is playing, present the RBNZ's forecasting for the key parts of the economy that are relevant to future Official Cash Rate (OCR) decisions and review the past accuracy of the RBNZ's forecasts. Most importantly, the reports critiques the RBNZ's analysis and forecasts and identify where outcomes for key parts of the economy, including the likes of inflation, labour costs, interest rates, consumer spending, housing activity and the exchange rate, are likely to differ materially from what the RBNZ is predicting.

Our critiquing of the RBNZ's analysis and forecasts will provide valuable big-picture or strategic insights into whether the OCR will behave in line with what the RBNZ is expecting or indicating. Our analysis will also often show that prospects for the OCR differ significantly from what the bank economists and other economic forecasters are predicting.

The rest of this **Sample Report** supplies some examples of forecasts by the RBNZ and our analysis highlighting shortcomings in the RBNZ's analysis. Appended to each report will be the RBNZ's News Release that accompanies the OCR decision.

WHY PAY FOR AN ECONOMIC REPORT WHEN BANKS SUPPLY THEM FREE?

Why should you pay for our six-weekly **Monetary Policy Briefing** reports when the major banks, the RBNZ and Treasury provide free economic reports?

Our quick answer is that the reports by the bank economists and other economic forecasters more often than not contain poor analysis and misleading predictions, which makes them a negative value proposition even though they are free. By comparison, we have a proven track record at providing rigorous and insightful analysis that will be of considerable value to you for business risk management and/or investment strategy. All delivered in plain English and with a bit of fun had along the way.

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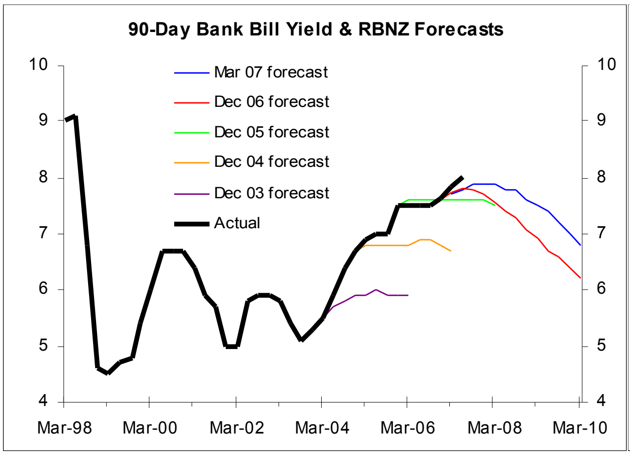
The RBNZ's interest rate, inflation and growth forecasts are often not well founded

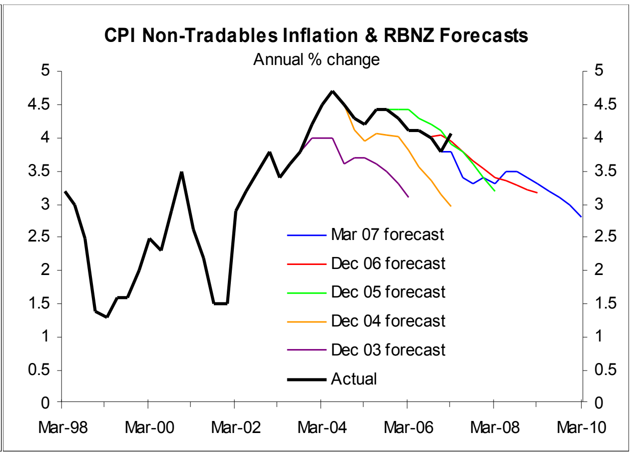
The RBNZ employs lots of economists to try and analyse the economy, it spends lots of money building and running the flashest mathematical forecasting models in the country, it undertakes regular fact finding visits to a wide range of firms and it sets the OCR, so you would think that if anyone was well placed to forecast interest rates it would be the RBNZ's forecasters. However, when we review the RBNZ's track record at forecasting the 90-day bank bill yield, the key short-term wholesale interest rate that the RBNZ effectively controls with its OCR decisions, we find that the RBNZ is no better than the bank economists at forecasting interest rates.

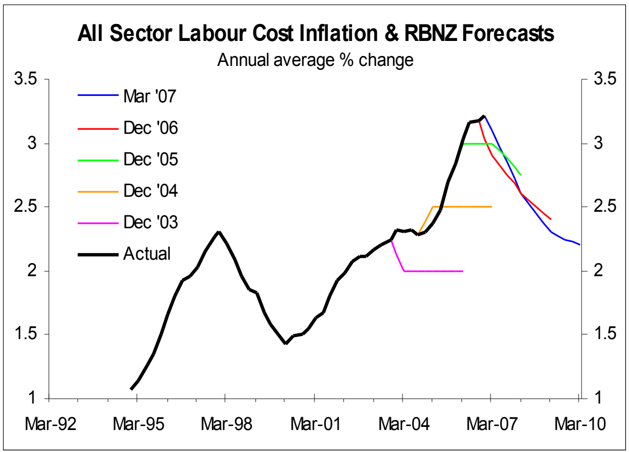
The coloured lines in the left chart are the RBNZ's forecasts of the 90-day bank bill yield, while the dates are the months in which the forecasts were released in Monetary Policy Statements. In December 2003, for example, the RBNZ was predicting that the 90-day bill yield would not increase above 6% over the subsequent nine quarters (the purple line), and yet by March 2006 it had increased to 7.5%. At no stage over the last few years has the RBNZ forecast the upside we have seen in interest rates.

The RBNZ has consistently been too low with its interest rate forecasts in recent years because it has been too optimistic about inflation, especially non-tradables or domestic inflation (see the right chart below). The right chart shows annual price inflation in the domestic economy, which abstracts from the direct impact of exchange rate and oil price movements on overall CPI inflation. Keeping domestic inflation below the top of the 1-3% inflation target range is critical if the RBNZ wants to keep overall CPI inflation within the target range "on average over the medium-term".

In December 2003, for example, the RBNZ was forecasting that domestic inflation would fall to 3.1% by March 2006, when it ended up at 4.1%. In December 2004 the RBNZ was forecasting that domestic inflation would fall to 3% by March 2007 when it turned out to be 4.1%. If the RBNZ was better at forecasting domestic inflation it would be in a better position to assess the outlook for interest rates, but we do not see any reason to believe the RBNZ will improve its track record.



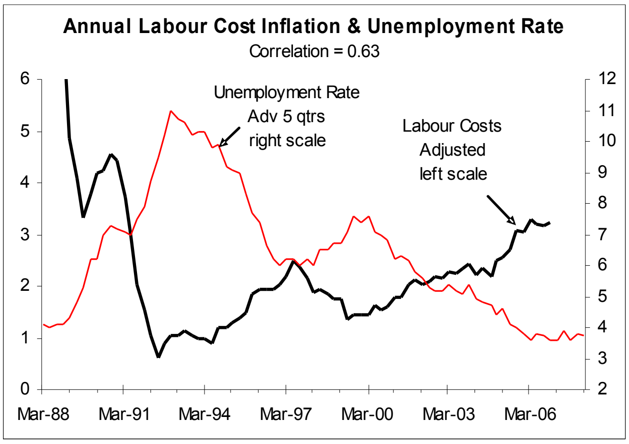




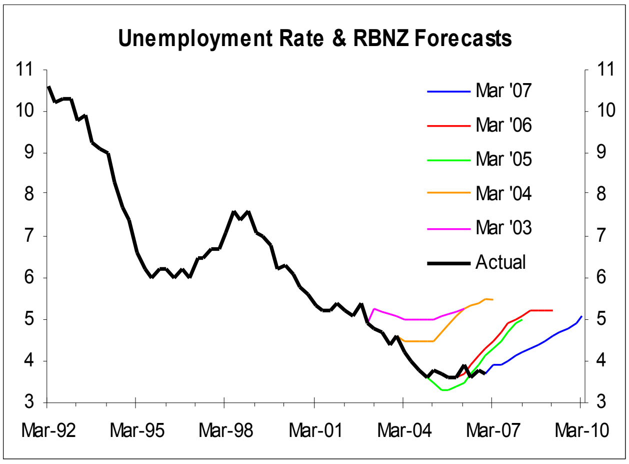
Central to forecasting domestic inflation is predicting labour cost inflation, with labour costs being the single largest cost component for most firms. The chart shows that the RBNZ has consistently under-estimated labour cost inflation over the last few years. For example, in December 2003 the RBNZ was predicting that this particularly measure of annual labour cost inflation would fall to 2% by March 2006 when it actually weighed in at 3%.

What should start to be evident is that the RBNZ's forecasts of labour cost and price inflation are laced with large doses of wishful thinking and/or politics (i.e. trying to kid people into believing that inflation will turn out lower to hopefully keep inflation expectations down).

In the **Monetary Policy Briefing** reports we confront the RBNZ's forecasts with quality analysis based on leading indicators. The chart below is one of the leading indicator charts we use to predict labor cost inflation. In the chart the red unemployment rate line has been advanced or shifted to the right by five quarters reflecting how long it takes changes in the unemployment rate to impact of labour cost inflation. If the unemployment rate falls, which happens when economic growth is allowed to run above the sustainable rate, it gives increased bargaining power to employees and on average it takes them five quarters to convert the increased bargaining power into larger pay increases.



While the RBNZ has persisted in predicting falling labour cost inflation over the last few years this chart kept giving a five-quarter-ahead warning that labour cost inflation was going to rise because the unemployment rate had fallen over the previous five quarters. The chart is currently predicting that labour cost inflation will stabilise somewhere around the recent higher rate and yet the RBNZ persists in predicting that labour cost inflation is about to fall. Using this chart makes it easy for us to beat the RBNZ at forecasting labuor cost inflation, domestic inflation and hence interest rates. However, there is more to identifying the RBNZ's misguided labour cost inflation forecasts than the adjacent chart



Even if the RBNZ made use of the chart above to help it forecast labour cost inflation it would still produce poor forecasts. This is because of its tendency to forecast that the unemployment rate is about to increase (see the adjacent chart). By contrast, just as we use reliable leading indictors of labour cost inflation we also use leading indicators of economic growth and the unemployment rate, which increases the time into the future that we can identify errors in the RBNZ's inflation forecasts.

The **Interesting Times** sample report available from our website explains the full scope of our forecasting framework, including the leading indicator chart analysis and coal-face sampling.

The left chart below shows what the RBNZ has been forecasting for growth in consumer spending over the last three quarters. Between September 2006 and March 2007 the RBNZ significantly upgraded its near-term forecasts, but continued to predict that growth in consumer spending would fall to around 0.5% in 2008. Enter the leading indicators and sound judgment. The right chart below shows a survey of consumer confidence as a leading indicator of growth in retail sales, which is predicting a stronger upturn in growth than the RBNZ is predicting. Enter sound judgment. 2008 is election year and the government not only has a fiscal surplus to die for, it will also not hesitate to throw a couple of billion dollars at the economy next year to help win the election. Short of Governor Bollard being reincarnated with the inflation fighting spirit of Dr Brash there is no way consumer spending growth runs as low as 0.5% next year.