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A short note on our GDP and OCR forecasts compared to the Reserve Bank's

12 February 2018

Following a news article today, we thought we should clarify our thoughts on our GDP forecasts compared to the Reserve Bank's. Last week we said that the Reserve Bank's forecast for GDP over 2018 was too high. This is critical to the outlook for interest rates. If the RBNZ receives successive downside surprises on GDP growth, as we anticipate, then the RBNZ will become more dovish as the year progresses. That is why we are forecasting no hike in the OCR until late-2019, compared to the RBNZ's forecast that the OCR will rise in mid-2019, and compared to financial market pricing for a hike in early-2019.

Despite our expectation that the RBNZ will become a little more dovish, we have not gone so far as to forecast an OCR cut this year. This is partly because we expect the exchange rate to fall faster than the RBNZ is currently assuming. A lower exchange rate will provide some offsetting inflation pressure, making up for the weaker economy as far as inflation forecasts are concerned.

Of course forecasting is an uncertain business, and we did warn last week that although an OCR cut this year is not likely, it remains a possibility. Indeed, given our views on GDP growth, we regard a cut in the OCR this year as more likely than a hike. The NZIER's "Shadow Board" asks Chief Economists and others to put odds on where the OCR should move – our most recent response put the odds of a cut being required at 25%, and the odds of a hike at 15%.

In today's news article the RBNZ said that in order to meet its inflation target, it requires a certain level of GDP growth. If GDP is too weak it can lower the OCR, which would then stimulate GDP growth back to the required level. In its simplest form, this is exactly the point we are making – we believe that surprisingly weak GDP growth will prompt the RBNZ to keep the OCR low for longer than it is currently forecasting. But this narrative misses two important subtleties.

First, it takes time for OCR changes to flow through to the economy. Over the course of this year Statistics New Zealand will release GDP figures relating to the period from October 2017 to September 2018. There is no realistic way the RBNZ could influence these figures, even if the OCR was cut tomorrow, such are the lags that operate in the economy. Our expectation that the RBNZ will hold the OCR low for longer is, however, one of the reasons we are forecasting a pickup in GDP growth over 2019 and 2020.

Second, GDP growth is not the only thing going on when one produces a fully-fledged forecast of the OCR. As mentioned above, we are forecasting a more substantial decline in the exchange rate than the RBNZ is forecasting. This, we expect, will dissuade the RBNZ from cutting the OCR.

Successfully forecasting the OCR requires fully "endogenous" thinking. A key aspect of our job is to anticipate how upcoming economic developments might surprise the RBNZ. We then need to predict how the RBNZ will respond to those surprises. Finally, we need to think through how the predicted RBNZ behaviour will affect the wider economy and inflation.

Predictions of the RBNZ's future behaviour should always assume that the RBNZ is doing what it can to achieve its inflation target. But they need not assume that the RBNZ is right about what will be required to hit the target. A recent case in point occurred in mid-2015. Westpac Economics predicted that the OCR would fall from 3.0% at the time to a new all-time low of 2.0%. The RBNZ Governor responded shortly afterwards in a speech, saying *"Some local commentators have predicted large declines in interest rates over coming months that could only be consistent with the economy moving into recession."* At the time, the RBNZ predicted that 2.5% would be the low-point for the OCR, and the Governor's speech implied that although anything was possible, it would take a lot for the OCR to be cut beyond that.

Six and a half months later the Reserve Bank cut the OCR to 2.25%, and it cut again to 2.0% in August 2016. There was no recession at the time.

We are releasing our *Quarterly Economic Overview* next week. The GDP and OCR forecasts in that document will be internally consistent, but different to the Reserve Bank's forecasts. We are comfortable respectfully maintaining that difference of opinion.

Dominick Stephens
Chief Economist

Contact the Westpac economics team

Dominick Stephens, Chief Economist +64 9 336 5671

Michael Gordon, Senior Economist +64 9 336 5670

Satish Ranchhod, Senior Economist +64 9 336 5668

Anne Boniface, Senior Economist +64 9 336 5669

Paul Clark, Industry Economist +64 9 336 5656

Any questions email: economics@westpac.co.nz

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