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Themed issue: Forecasting the New Zealand economy

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Editor's note

This edition of the Reserve Bank *Bulletin* features the theme of forecasting the New Zealand economy. Because adjustments to official interest rates mainly act with a lag of some quarters on inflation, accurately forecasting inflation and other economic developments is critical to central banks across the world.

In our first article on this theme, we are very pleased to introduce the Reserve Bank's new model of the New Zealand economy, KITT (Kiwi Inflation Targeting Technology). The Reserve Bank has for many years emphasised the benefits that models can bring to organising policy discussions about economic conditions and the outlook. To support the Reserve Bank's monetary policy deliberations, KITT will soon replace the current model, FPS, which is now more than ten years old. As Kirdan Lees explains, the theoretical foundations and empirical content of KITT significantly advance our modelling towards the current frontier of central bank practice. The article discusses how KITT models the interactions between New Zealand households and firms to build a richer picture of the macroeconomy.

Theoretically-consistent models such as KITT and FPS are a central tool in our economic assessments and policy consideration because they capture economic behaviour at a deep level. However, they are not the only modelling strategy available for forecasting purposes. In our second article, Chris Bloor discusses a range of models we use in our policy process that offer alternative means of interpreting the statistical patterns in the data and extrapolating them forward. The statistical model forecasts help develop our overall forecasts and provide a cross-check on the output of the central model.

Yet another important source of information for our economic assessments is provided by staff analysis of the economic indicators measuring activity at a very detailed level in New Zealand and other countries. These indicators number in the thousands, requiring expert assessment of which are providing the best signal about economic conditions at any given time. In our third article, Tim Aldridge provides an example of this style of analysis, focusing on business investment. Understanding developments in business investment is a key part of interpreting overall

economic developments and building up a rich picture of the economy.

Our fourth article, by Christina Leung, looks in depth at how members of the public themselves form views about the future, particularly with regard to inflation. Durably maintaining price stability depends on the public being well-informed about the inflation situation, and acting on the basis that inflation will remain low and stable. The article discusses evidence from the Marketscope survey of household inflation expectations suggesting that households consistently over-predict inflation, and presents results of her research on the possible demographic influences on household inflation perceptions.

This micro-economic approach continues in our fifth article, in which Lynda Sanderson summarises a range of recent empirical work in which Reserve Bank staff have been involved on the impact of exchange rates on export behaviour. This research focuses on the impact of exchange rate movements at the level of the individual firm, including the effect of exchange rate volatility on bilateral exports and firms' incentives to mitigate volatility in their export receipts through hedging. Like Christina Leung's research, it is an example of how looking at individual firms' and households' behaviour can provide a deeper understanding of the channels through which economic and policy developments will be transmitted through the economy.

Finally in this edition, we present an interview with Prasanna Gai, a Professor at the Australian National University and consultant to the Bank of England. Professor Gai visited the Reserve Bank early in 2009. In the interview, he talks with David Hargreaves about the current financial crisis and its challenges for policy.

I hope you enjoy the range of articles in this edition.

Tim Ng
Editor



**RESERVE
BANK**
MUSEUM

The Reserve Bank Museum celebrates and records New Zealand's economic and banking heritage.

Displays range from timelines and interactive exhibits to comprehensive display panels outlining both the Reserve Bank's history and role, and how the New Zealand economic system has developed.

Artefacts include the only working example in New Zealand of the MONIAC hydro-mechanical econometric computer developed by New Zealand economist and inventor Bill Phillips in the late 1940s.

In early 2008, the museum received its 10,000th visitor.

The museum is open 9.30a.m.–4.00p.m. weekdays. It is closed weekends, public holidays, and for special events. Please call to confirm opening hours.

Reserve Bank Museum
2 The Terrace
Wellington
New Zealand
ph 04-471-3682
museum@rbnz.govt.nz
<http://www.rbnz.govt.nz/about/museum/2766074.html>



Photography by Stephen A'Court.