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Editor's Note

In recent issues of the *Reserve Bank of New Zealand Bulletin*, we have published articles covering a range of the Reserve Bank's functions, including ones that tend to lie in the shadows of the Bank's more prominent roles. In this issue of the *Bulletin* we continue that practice by including an article on an important, but generally not well known, role of the Bank – the management of foreign exchange reserves. We also continue our recent series of articles on the theme of macro-prudential stability issues, with a piece on the balance of payments. But our first article deals with the Bank's core function of monetary policy, focusing on a central element in monetary policy – the Bank's economic forecasts and the accuracy of those forecasts.

An important part of the Bank's approach to monetary policy is forecasting economic conditions and assessing likely inflationary pressures. In order to enhance the transparency of the Bank's forecasts, and to assist market participants understand the Bank's thinking in relation to monetary policy, the Bank has long been in the practice of publishing its forecasts as part of its quarterly *Monetary Policy Statements*. In doing so, we are obviously mindful of the need to make our forecasts as accurate as possible. However, despite all the best intentions and thorough preparation, no forecasts will ever be completely accurate. That is the nature of forecasting – when looking into the future, the only certainty is that there is no certainty.

Like other forecasters, the Bank makes strenuous efforts to make its forecasting processes as robust as possible and to continuously improve our forecasting ability. Part of this process involves periodically reviewing the accuracy of our forecasts and comparing their performance with that of other economic forecasters.

We have recently concluded a review of our forecasting performance. The first article in this issue of the *Bulletin* summarises the results of that review. The article focuses particularly on the Bank's CPI inflation forecasting performance, but also examines our forecasts of other key macroeconomic variables, given their relevance for explaining our CPI forecasts.

The article notes that the accuracy of the Bank's inflation forecasts is similar to that of most other forecasters over the period under review (ie most of the 1990s), but that we

tended to have a bias towards under-predicting the inflation rate. We conclude that, in the mid-1990s, underestimation of growth, and overestimation of the economy's capacity to grow without generating inflation pressures, were the source of most of our under-prediction of medium-term CPI inflation. From 1998 until recently, the major factor appears to be sizeable and persistent differences between the assumptions we used for the path of the exchange rate and its actual evolution. We also conclude that contributions to forecast inaccuracies have at times been made by our understanding of the non-inflationary output growth rate, the equilibrium exchange rate and exchange rate pass-through into CPI inflation. However, these factors do not appear to be systematic sources of inflation forecast bias.

Overall, the article concludes that our CPI forecasting bias has not compromised the Bank's ability to conduct sound monetary policy and that CPI inflation outcomes over the period reviewed are fully consistent with the Bank's obligations under the Policy Targets Agreement.

The second article deals with the Bank's approach to the management of foreign exchange reserves. New Zealand holds foreign reserves primarily to enable the Reserve Bank to intervene in the New Zealand currency market if serious liquidity problems were to develop. Holding reserves involves balancing a number of factors. We need to have assets that we can readily convert into cash in a crisis. But holding reserves costs money. We want to minimise that cost wherever possible, but do so without exposing the Bank to excessive financial risks. Much of this article is about how we balance these considerations and about the risk management framework applicable to our foreign reserves operations. It also discusses our active management approach to foreign reserves, undertaken with the objectives of reducing the risk-adjusted cost of holding reserves and enhancing our understanding of financial markets.

In the third article, we continue the series on external and macro-financial stability issues. This article looks at the balance of payments data for New Zealand, particularly in relation to capital transactions, and tries to deepen our understanding of the way balance of payments data are compiled and the difficulties inherent in interpreting trends in the balance of payments. The article provides several

examples of how corporate financing choices could affect measured flows in the balance of payments capital and current accounts. An important conclusion of the article is the need for caution when interpreting balance of payments data, particularly in assessing a country's macro-financial stability.

This issue of the *Bulletin* also contains a copy of the speech given recently by the Governor of the Bank, Dr Alan Bollard – his first on-the-record speech since his appointment as Governor. It provides a useful insight into Dr Bollard's interpretation of the new Policy Targets Agreement and how he sees this influencing the Bank's approach to monetary policy.

I hope readers enjoy the material in this issue of the *Bulletin*. On behalf of my colleagues at the Reserve Bank, I wish our readers a joyful Christmas and a rewarding year ahead.

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