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## Editor's Note

The two core objectives of most central banks are price stability and financial stability. In most advanced economies, the objective of monetary policy in one form or another is price stability (sometimes in combination with other economic objectives). Similarly, most central banks, sometimes in association with other government agencies, seek to promote financial stability through various policy instruments, typically by promoting strong banking and payment systems. These twin objectives – price stability and financial stability – are seen as the most effective way that central banks can contribute to the ultimate goal of creating the conditions required for sustainable economic growth. Price stability and financial stability are essential prerequisites for growth, given that they provide the conditions necessary for investor, consumer and producer confidence and assist in promoting efficient and productive investment and resource allocation.

This edition of the Bulletin focuses on different aspects of these two objectives. The first article discusses the relationship between inflation and economic growth and assesses the extent to which there is a trade-off between achieving and maintaining a low rate of inflation, on the one hand, and promoting economic growth on the other. It is an abbreviated version of a paper prepared by the Reserve Bank as part of the recent review of the Policy Targets Agreement. That paper, and the summarised article, were prepared in order to shed further light on the question of what effect, if any, might a change in the inflation target have on economic growth prospects.

The article reviews the economic literature on this subject, with a particular focus on whether there is a relationship between inflation and growth at very low rates of inflation. It concludes, not surprisingly, that high inflation (generally regarded as inflation above about 10 per cent per annum) has a significant detrimental effect on economic growth, but that below an inflation threshold point, the relationship between inflation and growth is much less clear. Although there is no clear evidence as to the level of this threshold, some research indicates that it might be in the order of 3 per cent. On this basis, some of the literature appears to suggest that, below an inflation rate of around 3 per cent, further declines in inflation are unlikely to have a material effect on growth. However, some literature also suggests

that there may be adverse effects on growth where inflation falls below zero – ie in situations of deflation. The literature therefore provides some evidence for concluding that aiming for a low positive inflation rate up to about 3 per cent per annum over the medium term, is the optimal range for economic growth.

The second article discusses aspects of financial stability and is the first of what is intended to be a regular series of articles on macro-prudential indicators for the New Zealand economy and financial system. In recognition that New Zealand's macro-financial stability is significantly influenced by what is happening in the world around us, the article discusses recent macro-financial developments in the United States, Europe, Latin America and Asia. Despite the considerable turbulence in international equity markets, uncertainty over the extent of recovery in the United States economy and continued structural and financial difficulties in Japan, the article concludes that New Zealand's macro-financial position remains relatively sound. An important aspect of this is the soundness of the New Zealand banking system, which continues to display good asset quality and capital adequacy, reflecting relatively conservative lending practices in recent years and sound risk management systems.

However, as noted in previous articles, there are points of potential vulnerability in the New Zealand economy, including the high level of external debt, our continued dependence on capital inflows and the relatively high leverage in the household sector. It is therefore essential, particularly in a world of considerable financial and economic volatility and uncertainty, that New Zealand maintains sound economic and financial policies, and that we keep a close eye on international developments and their potential impact on the New Zealand economy and financial system.

The third article explores a different aspect of financial stability. It is a slightly amended version of a paper summarising the conclusions of an APEC Policy Dialogue held recently on the theme of strengthening market disciplines in the financial sector. The Policy Dialogue was co-chaired by the Reserve Bank of New Zealand (which authored the paper) and the finance ministries of Chile and Thailand. The paper, and this article, discuss the role that market disciplines can play in encouraging sound risk management practices in financial institutions.

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Market disciplines take many forms, but typically include the extent of risk premium that investors (including creditors and depositors) require in order to place funds with a financial institution, taking into account the risk profile of that institution. In addition, markets impose discipline on financial institutions through other channels, including the extent of market access and market share enjoyed by a financial institution and, ultimately, the potential threat of a sudden withdrawal of funds where market confidence in an institution falls sharply.

Although market disciplines can be a source of instability in periods of financial distress, in the longer term they are a vital element in strengthening the incentives for sound risk management. Unfortunately, various government interventions and policies can weaken the effectiveness of market disciplines, and have done so in many countries. In particular, government policies or market structures that insulate investors and creditors from the risk of loss tend to weaken the incentives for markets to monitor financial institutions and to respond to a deterioration in the risk profile of a financial institution. Government ownership of financial institutions, government guarantees, deposit insurance and the "too big to fail" syndrome are all factors that tend to weaken the effectiveness of market disciplines. Equally, inadequate disclosure by financial institutions and a lack of

contestable and competitive financial markets also weaken the extent to which markets can impose appropriate disciplines on financial institutions.

Ultimately, weak market disciplines will reduce the soundness of the financial system and increase the frequency and severity of financial crises. It is therefore essential that central banks and other government agencies take all reasonable steps to ensure that market disciplines are working effectively, while seeking to minimise the destabilising effects of excessive volatility sometimes associated with financial markets.

Finally, this edition of the Bulletin contains a summary of the results of the survey of Bulletin readers conducted earlier this year. We much appreciate the time and effort made by those who completed the survey questionnaire. The feedback we obtained has been very valuable to us and will greatly assist in the process of making further, ongoing improvements to the style, format and content of the Bulletin.

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