

Fiscal and monetary coordination

This note explains how the monetary and fiscal authorities in New Zealand take account of each other's objectives and actions. Key features of the operational framework for the conduct of monetary and fiscal policy include that:

- the Reserve Bank, as the monetary authority, has 'operational' independence to pursue its statutorily imposed goal of price stability;
- the Reserve Bank, therefore, is required to respond to developments in the economy – including changes in fiscal policy – that have material implications for the achievement of the price stability target;
- the Government, as fiscal authority, is required to conduct fiscal policy with full transparency; which means that
- most major discretionary changes in fiscal policy are announced well in advance, which generally provides enough time for the Bank to factor them into its macroeconomic assessments and monetary policy settings.

These four features mean that monetary and fiscal policy co-ordination occurs through the Reserve Bank taking fiscal policy into account as an element of the environment in which monetary policy operates. This approach is to be contrasted with approaches to co-ordination that involve joint determination of monetary policy by the monetary and fiscal policy agencies.

Operational independence of monetary policy

1. Under the Reserve Bank of New Zealand Act 1989, the Bank's primary goal is the maintenance of price stability. The Bank is exclusively responsible for this objective – reflecting that inflation is ultimately a monetary phenomenon. That is, whereas monetary policy's only lasting effect is on inflation, fiscal policy has no lasting effect on inflation. The exception is where fiscal policy subverts monetary policy from its objective, as when a government finds that funding a large fiscal deficit in the market causes unacceptable pressure on interest rates and directs the central bank to provide the funding, that is, to "monetise" the deficit. The structures in the Act very substantially militate against this kind of subversion of the price stability objective of monetary policy, a key feature of the Act. Although the objective may be overridden by the government of the day, this can be done only by way of a very transparent process, and then any override can last for no more than twelve months unless explicitly renewed. These requirements establish a high hurdle for a government wishing to change the objective, and in the absence of the override being invoked, the price stability objective prevails.

How then does fiscal policy matter for monetary policy?

2. Fiscal policy influences demand pressure via both direct spending by the government and changes to private disposable income through the taxation and benefit system. In these ways, fiscal policy affects demand and inflation pressure, in much the same way as changes in trading-partner demand for our exports, or confidence-based changes in private investment, for example. While demand – and thus inflation – pressures may originate from a range of different sources, the task of monetary policy is to respond so as to maintain an *overall* level of demand consistent with keeping inflation in one to two years' time within the target range. For example, if the government increases its net spending, all other things being equal, monetary policy needs to be tighter for a time, so as to slow growth of private demand and “make room” for the additional government spending.

The fiscal policy framework

3. The Fiscal Responsibility Act (FRA) requires the government to act in accordance with the principles of responsible fiscal management laid out in the Act. These include that the level of Crown debt should be held to a prudent level, and that there should be predictability about future tax rates.
4. As with monetary policy, the fiscal policy framework puts a great deal of emphasis on transparency. Transparency about the government's short- and long-term fiscal intentions is very useful from a monetary policy point of view, since it enables timely monetary policy responses. There is a *Budget Policy Statement*, which lays out several months in advance of the *Budget* itself the government's long-term objectives for operating expenses and revenues, total debt and Crown net worth, and its short-term intentions for each of the long-term objectives. The *Budget Policy Statement* is published at least three months prior to the Budget. Other fiscal reports relevant to macroeconomic policy include:
 - the *Budget* itself, which is typically brought down in May or June, together with an accompanying *Fiscal Strategy Report*, which sets the *Budget* in a longer term fiscal context;
 - the *Budget Economic and Fiscal Update*, which presents macroeconomic and fiscal projections for four years ahead; and
 - the *December Economic and Fiscal Update*, and a *Pre-election Economic and Fiscal Update*, which provides economic fiscal updates in December of each year, and ahead of each General Election.
5. These arrangements provide a framework within which the government sets fiscal policy independently of monetary policy, and the Reserve Bank takes fiscal policy into account, along with everything else, in determining the policy settings required to maintain medium-term price stability. The advance notice of new fiscal initiatives provided in the government's fiscal publications generally allows the Bank to anticipate and respond to any material fiscal impulse to demand and inflation pressure they may imply.

6. The emphasis on transparency in the framework is also thought to be likely to lead governments to give more weight to the longer-term consequences of their decisions for the fiscal position, increasing the likelihood that fiscal policy settings will be more stable, sustainable, and predictable. In practice, this appears to have happened, with fiscal policy in the last several years having been directed more towards the management of longer-term pressures on the fiscal position than towards shorter-term macro stabilisation or, in other words, demand management objectives.
7. Within this longer term fiscal policy framework, taxation and social welfare benefit schedules do have some “automatic stabiliser” features that help to dampen the shorter-term fluctuations in economic activity and inflation pressure arising from those fluctuations. Fiscal policy has tended to allow this helpful process to happen, and to try neither to inhibit nor to augment it. In the 2000 *Budget*, the Minister of Finance said: “If the economic cycle turns out different to expectations, the Government will keep tax and spending plans unchanged and let the automatic fiscal stabilisers operate. This should support monetary policy, help moderate cyclical movements in interest rates and the exchange rate, and contribute to sustainable economic growth” (p 26).
8. Overall, though, it remains substantially the case that monetary policy and (discretionary) fiscal policy operate essentially in their own spheres, pursuing independent objectives with their respective instruments. Of course, the Bank and the government’s principal adviser on macroeconomic policy, the Treasury, maintain close contact to compare views on macroeconomic developments and the outlook. But formal ‘co-ordination’ between the two arms of macroeconomic policy does *not* take the form of the two authorities acting in concert to pursue joint objectives. Rather, monetary policy responds to fiscal policy initiatives to the extent that there are assessed to be implications for demand and hence inflation pressure. Likewise, the government generally takes account of the implications of fiscal initiatives for aggregate demand and hence for monetary policy when considering those initiatives.
9. A good example of this interplay between fiscal and monetary policy is provided by the way in which income tax cuts were foreshadowed by the Government in 1995. In its 1995 *Budget Policy Statement*, the Government signalled that a rapidly-falling ratio of public debt to GDP pointed to the possibility of future tax cuts. However, the Government recognised that tax cuts could imply material stimulus to demand. Accordingly, in the *Budget Policy Statement*, the Government indicated that the actual size and timing of the tax cuts would depend on a number of conditions being met, one of which was that:

“there will be no introduction of tax cuts if there are significant risks of strong inflationary pressure or balance of payments pressures emerging as a result”.
10. The Government subsequently consulted with the Reserve Bank regarding likely macroeconomic conditions in 1996-97. On receiving the Bank’s assessment that the outlook for aggregate demand was such that the tax cuts should be capable of being accommodated without causing significant inflationary pressure, the Government went ahead with an income tax reduction equivalent to about one per cent of GDP in 1996. Here, there was active consultation between the fiscal and monetary authorities, but not in the sense that they acted in concert. Rather, each retained responsibility for their individual

areas of policy. Indeed, in the event, the macro-economy evolved differently from what the Bank had envisaged, with aggregate demand significantly stronger in 1996 than had been expected. In these circumstances, the Bank tightened monetary policy, notwithstanding its earlier indications to the Government. The consultation that had taken place with the Government over the tax cuts did not bind the Bank to a particular monetary policy; on the contrary, the Bank was bound to continue to pursue its price stability objective.

11. The 1990 Budget provides another, earlier, example of the interplay between fiscal and monetary policy under the operational independence arrangements established for the Bank under the Reserve Bank Act, but before the Fiscal Responsibility Act was enacted. The Government brought down an unexpectedly expansionary Budget, which resulted in negative market reaction and a fall in the exchange rate. This in turn prompted a response from the Bank that had the effect of raising interest rates. Unpopular as such an interest rate rise was, it was widely seen as a consequence of an inappropriately easy fiscal policy. Moreover, it was accepted that the onus lay with the Government to adjust fiscal policy, given that it had itself laid down in advance the inflation objective the Bank was aiming at. This is a case where the Government and the Reserve Bank did not seek to co-ordinate policy: each made their own decisions in their respective spheres of policy responsibility.
12. These arrangements beg the question whether it would be more sensible for the two authorities to coordinate more actively in pursuit of *joint* objectives. We discuss this issue in the next section.

Could fiscal and monetary policy be coordinated better?

13. As noted, fiscal policy changes impart impulses to demand and inflation pressure. This raises the possibility that discretionary fiscal policy might be used jointly with monetary policy in managing shocks to the economy, so that the burden of maintaining stable growth and inflation might be 'shared' across the fiscal and monetary authorities.
14. Beyond that, to the extent that fiscal policy and monetary policy impact on different parts of the economy, the two instruments might be used simultaneously to target two stabilisation objectives – say, price stability at the same time as balance of payments equilibrium. In this view, the 'mix' of monetary and fiscal policy would be managed as well as the overall level of stimulus provided by both monetary and fiscal policy to the economy, thus better promoting internal equilibrium (price stability) at the same time as external equilibrium (a sustainable balance of payments).
15. New Zealand has chosen *not* to go down the path of determining monetary and fiscal policy jointly – which would require a different set of institutional arrangements from those established by the Fiscal Responsibility Act and the Reserve Bank Act. Under the existing arrangements, a decentralised approach to co-ordination is provided for. The Government, as fiscal authority, and the Reserve Bank, as monetary authority, co-ordinate policy by each taking account of the policies of the other, but within their respective long-term frameworks. This decentralised approach to co-ordination is facilitated by each being very transparent about their respective policies.¹ A more centralised approach would imply

on occasion subordinating the long-term objective of one or the other in the interests of short-term stabilisation.

Microeconomic considerations

16. One important consideration bearing on the question of the appropriate roles of monetary and fiscal policy in macroeconomic stabilisation is the effectiveness of these policies for this purpose, taking into account the possible side effects on microeconomic efficiency. Monetary policy influences demand pressure via interest rates and the exchange rate, whereas fiscal policy influences demand pressure via direct spending by the government and changes to disposable income via the taxation and benefit system.
17. A concern is that there would be microeconomic costs if government spending and taxes were to be subject to frequent change, as would be required if fiscal policy was to be given an active macro stabilisation role. Maintaining stable and predictable tax rates is thought to be helpful for generating growth in the private sector. Also, it is thought that maintenance of a stable, medium-term focus in government spending programmes, makes those programmes more likely to deliver desired outcomes, relative to “on again, off again” government spending.
18. Fiscal policy also tends to be less flexible than monetary policy. Constitutionally, all tax changes must be legislated by Parliament, and all government expenditure must be appropriated by Parliament. These processes take time, and the lag between policy being formulated and being passed through the legislative process means that there would be a risk of fiscal adjustments ending up being pro-cyclical rather than stabilising.
19. There are also questions concerning whether monetary or fiscal policy is the more “efficient” instrument for influencing aggregate demand, in the sense of achieving the desired change in aggregate demand whilst least distorting spending decisions at the microeconomic, or individual agent, level. One view is that monetary policy works mainly by changing the *incentive* to spend or save, whereas changes to taxes and benefits tend to influence private demand more *directly* – at least over horizons relevant to macro stabilisation – by easing or tightening agents’ budget constraints. And adjustments to government spending on goods and services clearly impact on demand directly.
20. To the extent that monetary policy is less direct in its effect, it may leave individual agents with more scope to respond in a way that takes account of their individual circumstances and preferences. For example, a firm facing a particularly profitable investment opportunity might decide still to proceed notwithstanding that interest rates have risen. And a household might still decide to borrow to help finance, say, a family wedding, whereas another that was considering buying a new car might conclude that the higher interest rate makes it more worth their while to leave their savings in the bank a little longer.
21. But how much weight should be attached to these points about the possibly greater “efficiency” of monetary over fiscal policy is difficult to say, as monetary policy is not entirely neutral either. As well as affecting the decision to spend or save, interest rate

changes also affect the disposable incomes of borrowers and savers, and therefore also influence aggregate demand through this channel.

22. Moreover, some might debate whether variable tax rates cause more uncertainty and thus microeconomic cost than do variable interest and exchange rates. This issue may be of more significance in an open economy, where interest rate changes tend to be reflected fairly directly in exchange rate changes, with the result that monetary policy tends to be felt disproportionately by the exporting and import-competing sectors of the economy (and therefore the balance of payments). There has been a concern that large swings in the exchange rate can deter firms from seeking growth by selling into world markets, and thus constrain the economy's growth potential. This raises the question whether making more active use of fiscal policy as a stabilisation instrument might help to take pressure off monetary policy and help to moderate exchange rate cycles.
23. In this regard, one of the scholars invited to New Zealand under the Victoria University Foundation's Professorial Fellowship programme, Professor Larry Ball, has proposed the establishment of an institutional structure under which a variable income tax could be managed in conjunction with the setting of interest rates – precisely so as to share the load of macroeconomic stabilisation.² Whether a proposal such as this has merit, of course, turns largely on the relative magnitude of the damage caused by big swings in the exchange rate relative to the microeconomic costs of an activist approach to fiscal policy (though there would also be constitutional questions to resolve, and issues for the credibility of long run monetary and fiscal objectives, which we discuss below).
24. Another dimension in any assessment of how monetary and fiscal policy should be used to stabilise demand, and hence inflation, concerns the degree of stabilisation being sought. In this regard, we need to acknowledge that there are limits to the extent to which monetary policy – or fiscal policy – can stabilise the economy. A small open economy like New Zealand is inevitably exposed to shocks that the authorities cannot hope to smooth out completely. Indeed, if they are over-ambitious in their attempts to do so, there is a risk that the economy is further destabilised. (See [*"Inflation targeting in principle and practice"*](#) for further discussion of the tradeoffs involved.) In other words, in considering whether there may be a larger role for fiscal policy in achieving macro stabilisation objectives, consideration needs to be given not only to the respective costs and benefits of monetary instruments versus fiscal instruments, but also to the costs of some variability in the macro economy relative to the costs incurred from using either policy to counter it.
25. Suffice it to say that, in New Zealand, the judgement has been to assign primary responsibility for macro demand management to monetary policy, but:
 - the horizon over which the stabilisation (inflation) objective is to be achieved should be medium-term rather than short-term; and
 - it is highly desirable that the management of fiscal policy within its own medium-term framework should take account of the implications for inflation pressures and hence for monetary policy.

Implications for policy credibility

26. A second important consideration relevant to the design of the New Zealand framework is that it is felt that joint determination of monetary and fiscal could undermine the ‘credibility’ of both monetary policy and fiscal policy, and that credibility is important for macroeconomic performance. In this context, credibility means that the public believes (1) that the monetary authority, as the agent of the government on monetary policy, is committed to the maintenance of price stability; and (2) that the government is committed to the achievement of its long-term fiscal objectives. Joint determination of fiscal and monetary policy might undermine the clarity of objectives and the assignment of responsibility for them.
27. In our *Monetary Policy Statements*, we emphasise the link between shocks to the economy, including fiscal shocks, and future inflation pressure, and between future inflation pressure and the Bank’s interest rate decisions. The Bank’s operational independence, together with the very explicit and transparent way in which monetary policy is formed, helps buttress public expectations that inflation will remain anchored and consistent with price stability. Likewise, the focus of the Fiscal Responsibility Act on requiring governments to draw explicit links between their short-term fiscal intentions and their longer-term fiscal objectives is intended to “increase predictability about, and stability in, fiscal policy settings, which helps promote economic growth and gives people a degree of certainty about the on-going provision of government services and transfers”.³

Conclusion

28. These arrangements, we think, contain elements of the “best of both worlds”. The fiscal and monetary policy authorities are independently responsible for their respective areas of policy, but within a framework which leaves room – and, indeed, establishes a strong incentive for – each to have regard for the actions of the other. The existing institutional arrangements certainly do not preclude consultation between the Reserve Bank and the Government/Treasury aimed at achieving co-ordination of monetary and fiscal policy, and generally, there is active consultation. However, that consultation and co-ordination takes place within a framework which attaches importance to long-term objectives not being compromised by pursuit of short-term stabilisation objectives.

Endnotes

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- ¹ See Buitert, Willem H and Anne C Sibert (2000), “Designing a monetary authority”, in an unpublished paper available at <http://www.nber.org/~wbuitert/sweden.pdf>, for a discussion of this point in the United Kingdom context.
- ² See Ball, Laurence (1996), “A proposal for the next macroeconomic reform”, *Victoria Economic Commentaries*, Vol 14, No 1.
- ³ See New Zealand Treasury, “Economic and Financial Overview”, page 2 of “Public Finance and Fiscal Policy” section, 2000.