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Pandemic lessons on the monetary and fiscal policy mix.

Julian Wood and Daniel Wills

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Reserve Bank of New
Zealand
PO Box 2498
Wellington
NEW ZEALAND

www.rbnz.govt.nz

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Introduction

Monetary and fiscal policy are key policy levers used by central government agencies to achieve a range of macroeconomic objectives. Given institutional arrangements across most developed economies separate the monetary and fiscal functions, coordination between central banks and fiscal authorities can be important to achieve broad macroeconomic objectives. This coordination generally encompasses several key dimensions. In particular, strong institutional arrangements at each respective agency, clear assignment of objectives, information-sharing between agencies, common knowledge or understanding of the effects of each agencies' tools, and crisis management planning.

The COVID-19 period saw large-scale use of fiscal and alternative¹ monetary policy tools worldwide to offset the negative economic impacts of the global pandemic. This occurred as the policy interest rates worldwide typically used to manage the business cycle approached zero, and, in some countries, become slightly negative. In some countries, these tools were being used by their respective central banks and fiscal authorities for the first time, often with uncertainty over the magnitude of their effect. The use of alternative tools also occurred amidst a particularly sharp rise in public debt levels worldwide. Such factors drew close attention to the role that both monetary and fiscal policy can potentially play in supporting an economy during a crisis and the importance of effective monetary and fiscal policy coordination during such episodes. Unfortunately, this episode also highlighted that many central banks and fiscal authorities were not well prepared for the degree of monetary-fiscal coordination required (Buckle, 2023).

This Bulletin reviews the recent international literature on monetary-fiscal coordination and outlines lessons for policymaking at the Reserve Bank of New Zealand. These lessons include: i) monetary policy's primary role continues to be cyclical stabilisation post-COVID-19; ii) both fiscal and monetary policy potentially have a role at the Effective Lower Bound (ELB)², depending on the shock; iii) the timely and consistent use of buffers is key to ongoing effective coordination; and iv) coordination arrangements should emphasise transparency, flexibility and independence.

This work is part of the wider response to recommendations in the Reserve Bank's 2022 *Review and Assessment of the Formulation and Implementation of Monetary Policy* (RAFIMP) to understand the future role of fiscal policy instruments in managing economic shocks. The aim of this work is to improve the Reserve Bank's response to the next crisis and, in doing so, support the Reserve Bank's ability to navigate volatile, uncertain and complex macroeconomic environments. This is particularly relevant to the current environment, which is characterised by significant structural fiscal challenges associated with geopolitical uncertainty as well as adaptation to the demographic and climate changes that are on the horizon (Stephens, 2024).

We start by explaining what monetary and fiscal policy are and how they differ in their key objectives. We then outline the international convention prior to COVID-19 for how each policy area could be used to help stabilise fluctuations in the macroeconomy, illustrated in the New Zealand context. Next, we introduce how this global consensus has come under pressure over recent decades. Against this backdrop, we establish a framework for assessing the impact of different policy combinations on macroeconomic outcomes and financial stability, applying this to New Zealand's experiences over the past 50 years. We then turn our attention to the emerging

1 Known in New Zealand as additional monetary policy tools.

2 The ELB reflects that there is a limit as to how far central bank policy rates can be lowered before their effectiveness as a monetary policy tool diminishes.

lessons from the international literature around the key determinants for effective monetary and fiscal policy coordination, drawing on the recent COVID-19 period. A more detailed assessment of monetary and fiscal policy institutional arrangements, policy decision making, and policy tool selection and use in the New Zealand context is left for future work.

Fiscal and monetary policy, their objectives and the consensus assignment

Monetary and fiscal policy play distinct and separate roles in contributing to macroeconomic stability, looking across a variety of developed economies. Institutional norms and arrangements for these policy areas trace back to the 1990s-era and the formation of the ‘consensus assignment’.

Under this ‘consensus’ fiscal policy’s role in economic stability works passively, using automatic fiscal stabilisers. For example, much of a government’s expenditure remains fairly stable relative to trend (potential GDP) rather than actual GDP. This means that fiscal policy will become a greater percentage of actual GDP in cyclical downturns and vice versa” (Bernstein, Gaukrodger, & Parkyn, 2024). This is reinforced through the parts of government revenues (tax) and expenditures that are sensitive to economic conditions. This characteristic means that a negative (positive) economic shock is further offset via a lower (higher) tax take and higher (lower) welfare spending through preset policy settings. In this way, the government budget balance automatically adjusts to help the economy absorb part of the economic shock (Barker, Buckle, & St Clair, 2008; Tam & Kirkham, 2010).

The consensus assignment provides a very limited role for discretionary countercyclical fiscal policy – deliberate government actions aimed at stabilising the business cycle.³ This is due to a variety of practical limitations with using fiscal policy for active macroeconomic stabilisation, including:

- **Decision-making and implementation lags** can mean that many forms of fiscal spending aimed at bringing economic stability instead amplify the economic cycle by the time they are implemented. This risks frustrating efforts by monetary authorities to ensure low and stable inflation (Brook, 2013; European Central Bank, 2021; Buckle, 2023).
- **Misaligned incentives for politicians**, risking short-term policy actions when political priorities and economic stability are in conflict. There are incentives to boost pre-election spending or cut taxes to win votes and this can ignore long-term debt and fiscal spending sustainability (Buckle, 2023).
- **Time-inconsistent behaviour**, whereby political pledges and commitments to fiscal sustainability are subsequently revoked or overridden, risking an erosion of trust in fiscal rules and amplifying volatility due to unfulfilled commitments. This means investors may not expect reductions in government debt following discretionary fiscal policy and therefore raise borrowing costs.
- **An insufficient emphasis on macroeconomic stabilisation during upturns**. Increasing fiscal support during economic downturns, but not reducing support during upturns, can

³ Any discretionary countercyclical fiscal policy tool or option is often assessed according to the three T’s: how timely, temporary and targeted the tool is (Elmendorf & Furman, 2008).

reduce fiscal buffers and leave the economy vulnerable to future shocks (Brook, 2013; Barker, Buckle, & St Clair, 2008; Tam & Kirkham, 2010).

- **Moral hazard from repeated bailouts**, whereby people and businesses come to expect fiscal policy 'bailouts' during every downturn and respond by acting in more risky ways. For example, households might save less and businesses may take larger risks believing that taxpayers will bear the costs should losses emerge. This risks an ever-deepening cycle of bailouts and riskier behaviour resulting in larger crises and then bigger interventions (Borio, Farag, & Zampolli, 2023).

Underlying features of the economy such as initial economic conditions or how households and businesses respond to stimulus also limit the usefulness of discretionary fiscal action. Underlying high levels of capacity utilisation or employment increase the likelihood of crowding out, whereby private sector activity that may have taken place in the absence of the government spending no longer occurs. Offsetting also occurs if households and firms anticipate higher taxes or inflation in the future and choose to increase savings (Bernstein, Gaukrodger, & Parkyn, 2024).

Rather, the primary responsibilities for fiscal policy under the consensus view are to maintain fiscal sustainability (meeting current and future debt obligations), and promoting effective fiscal structure through the equity and efficiency of the provision of government services and the tax system, including its contribution to long-term productive economic growth (Barker, Buckle, & St Clair, 2008; Tam & Kirkham, 2010). Fiscal policy (as outlined above) can also promote economic stabilisation via automatic stabilisers.

Fiscal policy then, in this framework, has broad objectives related to economic growth, employment, income distribution, and providing public goods and services. These objectives are met across a range of time periods from the very short run (e.g. emergency disaster response) to the long run (e.g. contributing to productivity growth). The relative prioritisation and implementation of objectives may change over time depending on the economic and political context. Often, fiscal policy changes require legislative approval, against a backdrop of political cycles. They are also set within budgetary constraints consistent with legislated guidelines or conventions. In New Zealand these are set out in the Public Finance Act (1989). There is also a wide breadth of fiscal policy tools available (many bespoke in nature) including changes in investment spending, tax policy, transfer policy, and wider economic regulation. These impact economic activity and inflation through a variety of channels and across a range of time horizons.

In contrast, monetary policy under the consensus assignment has a narrower focus on achieving price stability, with some focus placed on secondary considerations (often employment) in the pursuit of this objective given its broad-based effects on the economy. This reflects that price stability is considered the best long-run contribution monetary policy can make to wellbeing. (Reserve Bank of New Zealand, 2024).⁴

This responsibility under the consensus assignment is generally delegated to an operationally independent monetary authority. In New Zealand this is the Reserve Bank of New Zealand through the Monetary Policy Committee (MPC). Independence ensures that the setting of monetary policy

⁴ Price stability in New Zealand has evolved since the introduction of an initial inflation band of 0-2 percent in the mid-1990s to its current form as prescribed in the *Monetary Policy Committee Remit* as achieving and maintaining "future annual inflation between 1 and 3 percent over the medium term, with a focus on keeping future inflation near the 2 percent mid-point" (Monetary Policy Committee Remit, 2023).

is largely unconstrained by government budgetary conditions or political preferences. In carrying out this price stability role in New Zealand, monetary policy is expected to contribute to broader macroeconomic cyclical stabilisation by considering how its decisions impact the real economy, financial stability, and financial markets.⁵ Monetary policy is adjusted relatively frequently compared to broad fiscal policy. In New Zealand reassessment of monetary policy occurs every six weeks throughout most of the year, compared to the six-monthly re-assessments for fiscal policy as part of Budget rounds and updates. Both monetary and fiscal policy changes can occur more frequently if required in exceptional circumstances, such as during the start of the COVID-19 pandemic.

Monetary policy typically uses the official cash rate⁶ (OCR) to influence domestic borrowing and lending rates, which in turn affect household and business decisions, overall economic activity, and inflation; in crisis situations, this tool can be extended to moderately negative levels when demand is exceptionally weak (Reserve Bank of New Zealand, 2024; Brandão-Marques, Casiraghi, Gelos, Kamber, & Meeks, 2024).

The monetary authority has additional tools available when the OCR is approaching its effective lower bound (slightly below zero percent per annum). These alternative tools include:

- Large Scale Asset Purchases (LSAP), often called ‘quantitative easing’, designed to help lower market interest rates, and,
- Forward Guidance (FG) stronger and more explicit guidance or a commitment around the forward path of the OCR to lower financial market expectations of future interest rates (Kengmana, 2021; Reserve Bank of New Zealand, 2024), and
- Term lending programmes (TLP) that lower interest rates by reducing funding costs for banks and encouraging competition for lending (Reserve Bank of New Zealand, 2022).

The operational independence of the central bank combined with the price stability objective largely determine the dynamics of the monetary policy making process. Monetary policy becomes a ‘second mover’ (or from a Stackelberg framework, a ‘follower’ (Brook, 2013)) after fiscal policy decisions are made by the government of the day. As a follower, monetary policy internalises or takes into account fiscal policy decisions, including any fiscal responses to a crisis when acting to ensure price stability.

The ‘leader’ (fiscal policy) can influence the decisions of the ‘follower’ (monetary policy), setting the lead in the mix of policy chosen over time. In extreme cases, ‘fiscal dominance’ can occur when unsustainable fiscal spending and debt levels frustrate the central bank’s ability to pursue its monetary policy goals, i.e. price stability (Buckle, 2023). In New Zealand, the Public Finance Act 1989 recognises this leader-follower dynamic with the introduction of section 26g(f) in 2013. This requires the Government to have regard to the interaction between fiscal and monetary policy when formulating fiscal strategy.

5 The Monetary Policy Committee when pursuing the operational objectives for the formulation of monetary policy as outlined in the *Monetary Policy Committee Remit*, where appropriate should seek to understand and communicate material interactions between monetary policy and the Government’s economic objectives. These Government objectives are not however a direct factor in MPC deliberations unless explicitly outlined as a *Remit* objective (as per preamble of the *Remit*).

6 This is the interest rate on the deposits and loans that registered banks have with the RBNZ see [The official cash rate \(OCR\) - Reserve Bank of New Zealand - Te Pūtea Matua](#)

Overall, fiscal policy has a broader set of objectives and tools than monetary policy. It can be quite well targeted but can also face budgetary constraints, implementation lags, and is more influenced by political cycles. The objectives of fiscal policy can also change over time. Monetary policy is more narrowly focussed on medium-term price stability, using a limited number of frequently adjusted tools with minimal political interference. Monetary policy contributes to broader macroeconomic cyclical stabilisation through its impact on the real economy and financial markets.

In short, monetary and fiscal policy have different objectives, operate on different timeframes and make use of different tools (Lazarowicz, 2021).

Challenges to the consensus gained traction over the past 20 years

Challenges to this 'consensus assignment' gained traction in the late 2000's during the Global Financial Crisis (GFC) after conventional monetary policy tools in some countries were unable to provide enough support to ensure that inflation targets would be met. This reflects that there is a limit as to how far central bank policy rates can be lowered before their effectiveness as a monetary policy tool diminishes. This limit is known as the effective lower bound (ELB).

At the ELB the theoretical gains from discretionary fiscal policy are potentially high, and additional monetary and fiscal policy coordination was advocated over this period (Bernstein, Gaukrodger, & Parkyn, 2024; Woodford, 2021). Ongoing spare capacity in the economy following the GFC meant that monetary policy could potentially 'accommodate' higher fiscal spending without the need for an offsetting rise in interest rates to temper inflation. That is, government spending would be unlikely to 'crowd out' private spending as might occur when resources are relatively scarce.

In addition, some economists raised distributional concerns citing what is termed 'hysteresis' effects from what they deemed to be an inadequate combination of monetary and fiscal support over the period. This effect occurs when macroeconomic shocks, like those experienced during the global financial crisis (GFC), have large negative impacts that persist long after the economy has recovered, especially on those already disadvantaged. In response to this, some prominent economists such as Larry Summers argued for discretionary fiscal policy and structural tax policy to 'crowd in' investments in renewable energy and to raise the share of total income going to those with high propensity to consume, building on the earlier work of Alvin Hansen. This response was seen as necessary to avoid an extended period of subdued growth and hysteresis effects, termed 'secular stagnation' (Summers, 2016).

A variety of theoretical alternatives to the consensus assignment have been proposed over recent decades ranging from libertarian approaches that reject the manipulation of interest rates by central banks (Huerta de Soto, 1995) to approaches that only modify the consensus by arguing for a heightened role for automatic stabilisers and the use of semi-automatic stabilisers (Sahm, 2024).

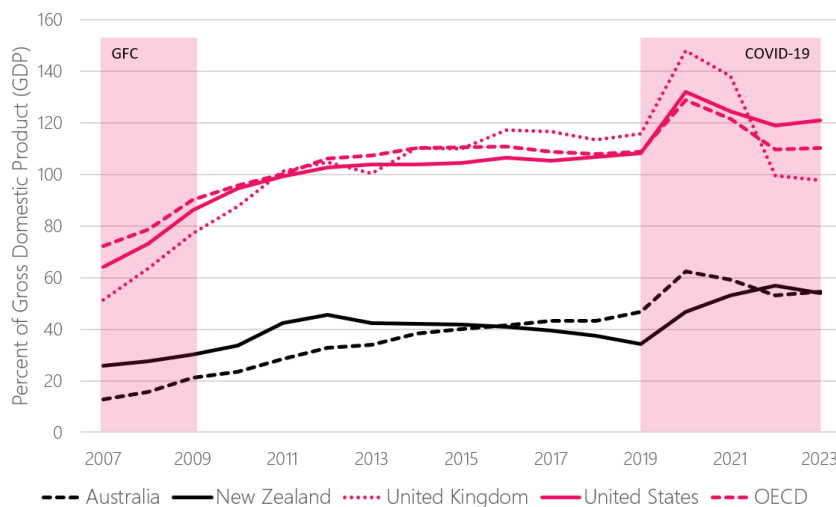
While none of the alternatives have gained widespread acceptance or practical adoption, recently two theoretical alternatives have gained more prominence – modern monetary theory and the fiscal theory of the Price Level. Modern monetary theory focusses on the ability of a country to issue sovereign currency to finance government spending and the ability of a government to adjust tax and spending policy to control inflation (Mitchell, Wray, & Watts, 2019; Juniper, Sharpe, & Watts, 2015). The fiscal theory of the price level says that the price level is determined by the government's fiscal policy – especially the present value of future budget surpluses – rather than by monetary policy alone (Katagiri, Ogawa, Sudo, & Sunakawa, 2024). This argument places fiscal credibility at the heart of inflation control. The importance of fiscal sustainability in underpinning

the effectiveness of both monetary and fiscal policy in macroeconomic stabilisation is a closely related lesson from the COVID-19 experience for the consensus assignment (see below).

Coinciding with more use of discretionary fiscal policy and rising debt

The calls for greater coordination between monetary and fiscal policy and the use of discretionary fiscal policy as a stabilisation tool were realised with sizable increases in government spending following large economic shocks during COVID-19 in 2020, occurring alongside the widespread adoption of alternative monetary policy (AMP) tools. The widespread use of AMP and discretionary fiscal policy tools, and ongoing deficits (Gómez-Cram, Kung, & Lustig, 2024) coincided with a substantial rise in government debt levels around the world (see figure 1).

Figure 1: Gross general government debt ratios: Selected OECD countries, 2007 to 2023



Source: Data from OECD (2025) General government debt (indicator) doi: 10.1787/a0528cc2-en (Accessed on 10 May 2025).

Prompting questions around the role of fiscal and monetary policy in a crisis

The role of fiscal versus monetary policy in managing economic shocks is now being reassessed worldwide. This follows uncertainty around the relative effect of monetary policy and fiscal policy actions during the pandemic. This uncertainty relates to the outcomes and costs of the pandemic response across different policy areas, including the more widespread use of a variety of discretionary fiscal policies in the pandemic. For example, the Reserve Bank's RAFIMP recommended that the Reserve Bank needed to understand the future role of fiscal policy instruments in managing economic shocks.

The key role of policy coordination was also highlighted by the scale and speed of policy implementation during the pandemic, as well as new aspects of the tools used across both policy areas. In New Zealand the inclusion of a Treasury observer to MPC meetings supported information sharing, alongside ongoing engagement between RBNZ and Treasury staff. However, the crisis highlighted some aspects of monetary-fiscal coordination that require further development, as highlighted by some policymakers that navigated the COVID-19 crisis. For example, New Zealand MPC member Professor Bob Buckle noted that "[t]he pandemic warranted a degree of policy coordination for which central banks and fiscal authorities were not adequately prepared" (Buckle, 2023). This sentiment was echoed by the recommendations of the New Zealand

'Phase One' report for the Royal Commission of Inquiry into COVID-19 Lessons Learned. It noted challenges in the coordination of monetary and fiscal policy "in terms of having a broad common understanding of how they might interact with each other" or "how these should be adjusted as the pandemic evolved." The Royal Commission also highlighted that looking forward, that there is no commonly understood 'playbook' for how (and how much) to coordinate monetary and fiscal policy in future crisis scenarios.

This Bulletin is part of work across the Treasury and Reserve Bank to respond to these questions, and to address gaps and risks around monetary-fiscal coordination. A forthcoming system for managing monetary-fiscal information-sharing during a crisis is expected to be published by the Reserve Bank, building on fiscal insights from the 2025 Long Term Insights Briefing from the Treasury and the work presented in this publication. This is designed to provide an overarching monitoring framework to guide when and how closer Reserve Bank engagement with Treasury and the government could evolve before, during, and after a crisis that pushes the OCR to around its Effective Lower Bound (ELB). This work sits alongside a variety of amendments already made to the New Zealand monetary-fiscal institutional settings, which include:

- the establishment of the memorandum of understanding for AMP tools,
- formalising the role of supporting information sharing between the Reserve Bank and Treasury in the MPC Charter,
- an enhanced role for the RBNZ board managing and reporting on financial risks (including those to the Government balance sheet) as per the Statement of Financial Risk Management, and
- changes to the MPC risk appetite statement and Charter to acknowledge the role of financial risks and fiscal responsibility in decision making.

Defining effective monetary and fiscal policy coordination

Developing a monetary and fiscal policy coordination framework

The concept of a monetary-fiscal policy mix emerged post-World War II (Bartsch, Bénassy-Quéré, Corsetti, & Debrun, 2020). Under this concept, monetary and fiscal policy can potentially each exist in one of three states, reflecting the impact of the policy on the economy. These are countercyclical (acting to stabilise economic fluctuations), procyclical (acting to amplify fluctuations), or neutral (having no stabilising or destabilising impact on the economy). Accordingly, the two policy areas can technically co-exist in nine possible states/policy combinations, as shown in Table 1.

Table 1: Monetary and Fiscal policy coordination - the nine possible states

		Monetary Policy		
		Countercyclical (stabilise fluctuations)	Neutral (No impact)	Procyclical (amplify fluctuations)
Fiscal Policy	Countercyclical (stabilise fluctuations)	1. Aligned stable Monetary dominance Safe debt regime	2. Misaligned Potentially benign	3. Conflict
	Neutral (no impact)	4. Misaligned Potentially benign	5. Aligned neutral	6. Misaligned Potentially benign
	Procyclical (amplify fluctuations)	7. Conflict	8. Misaligned Potentially benign	9. Aligned unstable Fiscal Dominance Risky debt regime

Source: Author derived from (Bartsch, Bénassy-Quéré, Corsetti, & Debrun, 2020).

The top left to bottom right diagonals of this table (panels 1, 5, and 9) are aligned positions. Under policy alignment monetary and fiscal policy act in a concerted way on the economy. However, the different aligned combinations can lead to very different macroeconomic outcomes. While the top left position leads to macroeconomic stability, the bottom right can lead to high inflation, rapid government debt growth, and the possibility of sovereign debt default.

The four misaligned states are where monetary and fiscal policy differ but are not necessarily in direct conflict (panels 2, 4, 6 and 8). A recent example in New Zealand, was the Canterbury earthquake in 2011. This saw a countercyclical fiscal response from the government equivalent to 11.3% of 2011's GDP that acted to cushion the regional economic shock (Treasury, 2025). However, the monetary policy stance was adjusted to be only moderately more expansionary overall in the aftermath of this event, as national-level measures of core inflation (excluding one-off GST changes) remained close to target around 2 percent (panel 2).

The bottom left and top right stances (panel 7, and 3) illustrate when monetary and fiscal policy are in direct conflict. This can occur when policies are adjusting from previous periods of alignment as economic circumstances change. Procyclical policy from one policy sphere can place varying degrees of pressure on the other to work harder towards cyclical stabilisation. While such instances of conflict have generally been manageable over recent decades in New Zealand, the magnitude of the conflict does matter for cyclical macroeconomic outcomes and spillover effects on other aspects of the economy such as wealth distribution.

The consensus assignment's focus on monetary policy achieving price stability aims to rule out procyclical monetary policy and hence constrain the three states in the far right-hand side column (panels 3, 6 and 9). In doing so it aims to rule out the possibility of aligned procyclical monetary and fiscal policy (panel 9), otherwise known as fiscal dominance.⁷ This situation was last seen in

⁷ Fiscal dominance occurs when a Central Bank loses its ability to effectively control inflation, as it must focus on stabilising government debt rather than pursuing its inflation objective and target.

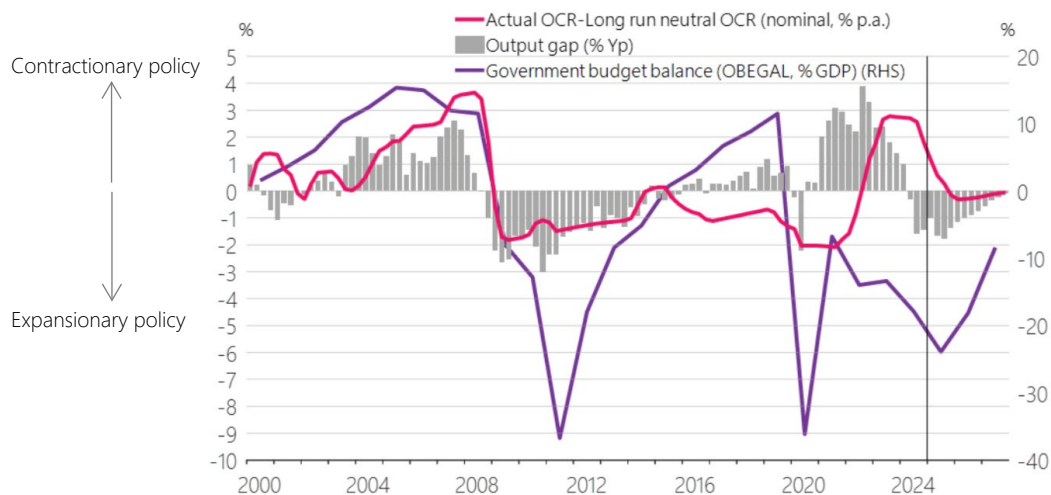
New Zealand in the 1970s and early 1980s (before the consensus assignment emerged) when monetary policy was directed towards achieving full employment. The consequent policy emphasis on stemming the rise in unemployment over this period limited the extent to which interest rates were allowed to rise to keep inflation in check (Graham & Smith, 2012).

Following this period of aligned unstable policy, New Zealand has seen examples of a variety of policy combinations over recent decades under the consensus assignment for policy roles.

Aligned countercyclical policy (panel 1, a safe debt regime akin to ‘monetary dominance’⁸) was seen in the ‘Great moderation’ period between the early to mid-2000s (2002–2005 in figure 2). This period saw high and sustained annual economic growth alongside contained inflation. Increasing monetary restraint was coupled with rising fiscal surpluses as the economy saw sustained strong expansion on factors including high immigration and house price growth (White, 2024).

Countercyclical fiscal policy and relatively neutral monetary policy was seen over the mid-2010s (panel 2). Fiscal policy began running fiscal surpluses to rebuild fiscal buffers after a run-up in government debt following the GFC and Canterbury earthquakes (figure 2). By contrast, monetary policy largely maintained a modest expansionary stance overall amid ongoing tepid growth and subdued inflation (White, 2024). This mid-2010s period was associated with relatively low interest rates and rising house price inflation, driving a growing wedge in wealth between older people (who are more likely to be home owners) and younger people (who typically are not yet home owners) (Symes, 2021).

Figure 2: Policy stances



Source: Reserve Bank of New Zealand, The Treasury New Zealand. Figure 2 uses proxy measures for both monetary and fiscal policy. Contractionary policy during positive output gap periods is countercyclical, and vice versa. Contractionary policy during negative output gap periods is procyclical, and vice versa.

⁸ Eric Leeper defines monetary dominance as a state where inflation is under the control of the central bank and the central bank does whatever it needs to do to get there with fiscal policy passively working to support the bank's objectives. More technically it equates to active monetary/passive fiscal policy whereby monetary policy is free to determine the price level, and fiscal policy adjusts future surpluses sufficiently to ensure an intertemporal equilibrium condition where the market value of liabilities equals the expected present value of future net real surpluses, see (Leeper, 2009) for more detail. A safe debt regime therefore rules out unfunded spending shocks because of the fiscal authority's commitment to pay for any surprise spending with future taxes.

Procyclical fiscal policy and countercyclical monetary policy (panel 7) occurred in the early post-COVID-19 rebound period around 2023. Monetary policy began tightening rapidly above levels assessed as neutral⁹ to offset high levels of inflation (see figure 2). This reflected the combination of a rapid and exceptionally large demand growth recovery, global supply chain bottlenecks, and worldwide commodity price shocks from the Ukraine war. Fiscal policy, in contrast, remained expansionary, with much of the previous levels of COVID-era spending and deficits persisting (White, 2024). This resulted in a higher policy rate than otherwise as procyclical fiscal policy placed pressure on monetary policy as the main countercyclical tool.

This variety of policy states underlines that there are a host of possible fiscal and monetary policy combinations consistent with macroeconomic and financial stability, or what some call the ‘zone of stability’ (Bank for International Settlements, 2023). This understanding predates COVID-19. It underpins the original premise of the consensus assignment for relatively robust policy arrangements for sustained macroeconomic stability. In particular, the consensus assignment entails setting up arrangements that attempt to minimise the risk of aligned unstable policy combinations.

Effective Coordination is not necessarily policy alignment

‘Coordination’ requires different elements of a complex system to work together effectively, smoothly and efficiently.¹⁰ This does not necessarily mean that all the parts of the system are undertaking the same task on the same timeframe or even carrying the same burden at the same time. A well-coordinated or effective mix of monetary and fiscal policy does not necessarily equate to policy stance alignment i.e. that monetary and fiscal policy are influencing the economy in the same way. Rather, it reflects a policy mix that enables the overall economy to perform well over time and avoid fiscal dominance i.e. scenarios where the central bank’s perceived focus on medium-term price stability is eroded by unsustainable fiscal spending. While in a crisis objectives may align, the most effective policy mix or response to an economic shock might at some points include non-aligned or even conflicted monetary and fiscal policy. These policy areas may be working to solve different economic problems using different tools across different timeframes.

Coordination is an intricate and dynamic challenge

Coordination between monetary and fiscal policy is an intricate challenge that needs to balance a range of competing factors. The factors for effective mix of policies evolve with changes in macro-financial conditions, public confidence, productivity, demographics, structural reforms, and regulatory frameworks (Bank for International Settlements, 2023). Even the cumulative impacts of monetary and fiscal policy themselves can shift the set of stable policy options in the future. Short-term policies providing financial or fiscal support after major shocks can create future instability if not withdrawn in a timely manner. This timeliness will be related to whether the clearly defined objectives of the temporary fiscal intervention have been met and how quickly the policy can be unwound. This in turn will depend on changing conditions surrounding the shock itself, the impacts over time, and any political economy concerns around the withdrawal of the policy intervention.

9 “The neutral interest rate is the level of the Official Cash Rate that, over time, would be consistent with no over- or under-utilisation of economic resources and stable inflation” (Castaing, Chadwick, Galimberti, Sing, & Truong, 2024, p. 2)

10 (Merriam-Webster.com Dictionary).

Good coordination is contingent on timely and accurate information

Effective monetary and fiscal policy decisions (as well as coordination) require timely and accurate information for both monetary and fiscal policy decision makers. For uncontrollable external events that have substantial effects on a country's markets (exogenous shocks)¹¹, this requires an understanding of a variety of contextual factors. These include the current state of the economy and broader financial markets, the nature and impact of a shock, how the shock is likely to evolve over time, how any monetary, fiscal and financial policy tools will be used to counter the impact of the shock, and how any of these tools might interact with each other.

Simply understanding the current state of the economy is difficult given imperfect data, data revisions and lags, including the relatively low frequency with which CPI and GDP data is published (Reserve Bank of New Zealand, 2022). Given this uncertainty, forecasting is a critical tool for guiding real-time policy decisions, as are policy makers' understandings of structural relationships in the economy over the medium term (Conway, 2025).

Monetary policy as mentioned above is also a 'second mover' after fiscal policy in a 'repeat game' over time. This puts high importance on institutional arrangements that enable flexible and rapid sharing of likely policy reactions during a fast-moving shock. COVID-19 highlighted that institutional arrangements need to be clear, flexible, nimble, cooperative, and promote transparency between policy organisations and to the general public (Orr, 2024; Bernanke, 2024).

For slower-moving shocks, effective policy requires an understanding of how gradual forces are changing the policy combinations that promote macroeconomic stability and growth over time. This includes understanding the impact of structural reforms, changes in productivity, demographics, changes to regulation aimed at improving financial stability and the resilience of markets, as well as the cumulative impact of policy stances and strategy over time.

Regular reviews of monetary and fiscal policy improve transparency around how monetary and fiscal policy are meeting their respective policy mandates. They can also improve accountability for meeting these mandates over a longer time frame. In New Zealand, these reviews include the Review and Assessment of the Formulation and Implementation of Monetary Policy and Remit Reviews for monetary policy, as well as regular statements on the long-term fiscal position for fiscal policy.

Emerging insights from COVID-19: effective monetary and fiscal policy coordination

A variety of international studies provide pandemic-era evidence that monetary policy's principal role continues to be in cyclical stabilisation (as argued for in the 'consensus assignment') (Bonam, Ciccarelli, & Gomes, 2024; Bhattarai & Neely, 2022). This is under the proviso that monetary policy is unconstrained by the effective lower bound of conventional monetary policy tools. When conventional monetary policy is constrained, both monetary and fiscal policy can play an effective and interrelated stabilisation role depending on the shock. As such, well-informed decision-making from both sets of policymakers near the ELB is essential given the potential role of both policy

¹¹ See [exogenous shocks](#) for a United Nations definition of exogenous shocks.

areas in macroeconomic stabilisation. This can be supported by coordination arrangements that emphasise transparency, flexibility, independence and accountability.

The effectiveness of both monetary and fiscal policy at the ELB is also underpinned by public and private balance sheet strength, alongside broader macro financial stability (Bank for International Settlements, 2022). This makes building public and private sector balance sheet resilience an important component of macroeconomic stabilisation and resilience.¹² Strengthening public balance sheets is important in providing scope for borrowing in response to large economic and financial shocks. Similarly, safeguarding the resilience of the banking system via prudential policy is essential. For example, this helps support the effective transmission of monetary policy settings to financial conditions faced by households and firms via the borrowing and lending intermediated by the banking system (Ovenden, 2019).

More detailed insights from COVID-19 for effective monetary and fiscal policy in macroeconomic stabilisation are outlined in Table 2 and 3 below.

Monetary policy – insights and implications from the international literature

Global studies generally provide evidence that AMP tools can be an effective addition to conventional tools for macroeconomic stabilization in some circumstances near the ELB. More specifically, negative interest rate policies, funding for lending, quantitative easing (QE), and forward guidance have all largely helped central banks achieve their goal of stimulating the economy over the COVID-19 period (Spisso, Stelzer, & Zörner, 2024). However, this was “not without trade-offs and unintended consequences” (Holzmann, 2024). There is some mixed evidence that negative interest rates may have increased risk taking by banks and hence may have negatively impacted on financial stability (Spisso, Stelzer, & Zörner, 2024). AMP’s impact on resource allocation, and income and wealth distribution remain unresolved within the wider academic literature (Spisso, Stelzer, & Zörner, 2024).

Further, there is widespread agreement in the academic literature on the need to refine the readiness for, execution of, and understanding of the interactions between AMP tools and fiscal tools near the ELB (Bonam, Ciccarelli, & Gomes, 2024). Certain AMP tools have also carried significant balance sheet risks for central banks and broader consolidated public sector balance sheets. As such, the financing of AMP tools has raised concerns about central bank credibility and independence in episodes where the OCR approaches its effective lower bound of effectiveness.

Exit strategies for AMP tools need to be considered carefully and in some cases be part of the initial tool design and implementation process. Consideration should be given to how the exit may impact on monetary policy transmission and signalling, financial market stability, and institutional credibility. There may be trade-offs that exist between initial tool impact and timeliness of exit that

¹² Buffers are supported by a host of prudential instruments including: capital and liquidity buffers for banks and restrictions on lending to households like loan to value ratio (LVR) which can limit the levels of household debt – and therefore the potential losses that banks have to absorb in a downturn. “Financial liberalisation and globalisation have increased access to finance and expanded growth opportunities” (Bank for International Settlements, 2022). They have also led to stronger global financial spillovers – narrowing the scope for autonomous monetary policy, weakening the transmission of monetary policy via the exchange rate, and creating trade-offs between stabilising inflation today and output tomorrow. For fiscal policy these spillovers can limit access to funding when it is most needed during a crisis, and in the event of domestic banking failures compound fiscal stress via bank bailouts when government accounts are already under fiscal stress (Bank for International Settlements, 2022).

decision makers should be aware of and understand when choosing which tool to use for a given set of circumstances (Reserve Bank of New Zealand, 2024).

A more detailed analysis of the effectiveness and implementation considerations for using specific monetary and fiscal policy tools is beyond the scope of this paper.

Table 2: Monetary policy – international lessons from COVID-19

Lesson	Evidence
Monetary and fiscal policy tools are closely interlinked at the ELB	<ul style="list-style-type: none"> • QE by central banks directly affected government financing costs by lowering interest rates (at a time of high issuance of government debt). This created more fiscal space by allowing governments to borrow more and offset some of the shortening in the average duration of Crown debt (Reserve Bank of New Zealand, 2022). Indirectly, QE also supported fiscal expansion and helped underpin government tax revenues and governments fiscal positions (Adrian, Erceg, Kolasa, Lindé, & Zabczyk, 2024). The large expansion of central bank balance sheets through QE blurred the line between monetary and fiscal policy, with central banks holding significant shares of government debt. • QE AMP tools are a significant balance sheet risk for central banks when the economy recovers (Bell, Chui, Gomes, Moser-Boehm, & Pierres Tejada, 2023). • QE AMP tools risk making a claim on fiscal resources should interest rates rise, with the scale of losses or gains dependent on the path of interest rates. If fiscal claims eventuate, offsetting improvements in tax revenue gained via improved economic activity (as well as the realistic costs of any alternative policy options) need to be considered (Clouse, et al., 2013; Adrian, Erceg, Kolasa, Lindé, & Zabczyk, 2024). These claims might represent an opportunity cost to the taxpayer of fiscal funds that could have been used elsewhere depending on the overall impact. • Different approaches adopted by central banks to unwinding QE underscore the need to consider a variety of aspects in forming exit strategies, including monetary policy transmission and signalling, financial market stability, and institutional credibility. During recent unwind episodes post-GFC and post COVID, central banks tailored strategies to the specific design of the QE tools implemented as well as their unique economic, financial and structural contexts. (Kent, 2024; Federal Reserve Board, 2024; Gravelle, 2024; Cipollone, 2025; Hauser, 2022; Sveriges Riksbank, 2025).
Institutional arrangements need to be clear, flexible, cooperative, and promote transparency, while also safeguarding Central	<ul style="list-style-type: none"> • Best practice institutional coordination arrangements¹³ should be tailored to a country's specific institutional and cultural context, be clear, flexible, promote transparency, and foster informal arrangements that support rather than subvert formal arrangements (Diessner, 2024; Bank for International Settlements, 2024).

¹³ Different countries exhibit a wide range of institutional and informal arrangements including cooperative (formal and informal arrangements working together), substitutive (informal institutions fill the gaps left by a lack of formal institutions), uncooperative (a lack of coordination institutions) and subversive (where informal institutions subvert formal arrangements) see (Diessner, 2024) for more detail.

Lesson	Evidence
Bank operational independence	<ul style="list-style-type: none"> • Clarity over the central bank's own internal assessment of the limits (if any) of its own financial independence are a key determinant in AMP financing decisions (Diessner, 2024). • Central bank operational independence is key to eventual outcomes, with any loss of independence likely to undermine the credibility of central banks and reduce the effectiveness of monetary policy actions to control inflation (International Monetary Fund, 2022).
There is no consensus around financing methods for AMP asset purchases	<ul style="list-style-type: none"> • Each AMP financing option carries risks (Buckle, 2023): • More explicit fiscal backing (like indemnities) can lead to large funding transfers which can spark political controversy, public criticism, and potentially undermine independence (Bell, Chui, Gomes, Moser-Boehm, & Pierres Tejada, 2023). • Less explicit funding methods (like using negative equity): (1) may not be as credible to the market for small economies, as economic size may limit the capacity for the central bank to raise seigniorage revenue in a timely manner (Diessner, 2024; Long & Fisher, 2024); (2) may require a higher communication budget in order to communicate well with both politicians and the public (English & Kohn, 2022) and (3) impact central bank behaviour (making it more risk adverse) if there is a risk that equity may become too low (Berriel & Bhattarai, 2009). • There is no clear empirical relationship between central bank equity levels and subsequent inflation outcomes¹⁴ (Hampl & Havránek, 2018). While this means "that negative central bank equity does not inherently compromise inflation stability", the key factor appears to be preserving the "trust in money" via the sustainability of public finances (Bell, Frost, Hofmann, Sandri, & Shin, 2024).
AMP policy tool risks rise as economies move toward what is perceived as an unsustainable debt regime	<ul style="list-style-type: none"> • Large-scale asset purchases carry risks. In the case of potential losses on bond holdings, these risks include public finance challenges in a risky debt regime, impairing price discovery in bond markets, and transferring losses from bondholders to taxpayers. (Gómez-Cram, Kung, & Lustig, 2024; Hall & Sargent, 2022)
Positive externalities from international monetary policy spillovers can't be relied on	<ul style="list-style-type: none"> • Central banks do not fully internalise how their policies affect the world interest rate and hence how other countries' central banks may be impacted by their actions (Bianchi & Coulibaly, 2024). New Zealand as a small open economy was likely a recipient of positive spillovers in the recent COVID-19 experience as monetary policy was internationally aligned with exceptionally large amounts of policy stimulus.

¹⁴ Hampl & Havranek conduct a meta-analysis of 176 estimates from 9 studies examining the relationship between central bank financial strength and inflation.

Fiscal policy – insights and implications from the international literature

The international literature provides evidence that fiscal policy can sometimes be used effectively in a timely manner, with strong support for discretionary fiscal policy at the ELB under some circumstances and with some caveats (discussed in more detail in the table below).

A key theme of COVID-era studies is that the building of sufficient fiscal buffers in good times is an important component of effective macroeconomic coordination. The effectiveness and timeliness of fiscal policy delivery can also be strengthened if fiscal authorities use good times to put systems in place for the next crisis to consider key objectives and exit criteria for different types of fiscal policy tools and to improve delivery efficiency of stimulus programmes. (Treasury, 2025)

Table 3: Fiscal policy – international lessons from COVID-19

Lesson	Evidence
Strong support for discretionary fiscal policy at the ELB, with caveats	<ul style="list-style-type: none"> Fiscal policy is seen as a relatively effective tool for cyclical stabilisation near the ELB according to a variety of international empirical and modelling literature. Fiscal multipliers measure how much economic output changes when government spending increases or taxes are lowered. In New Zealand these fiscal multipliers are estimated to be 0.15-0.25 percentage points larger, hence more effective, when monetary policy is at the ELB¹⁵ (International Monetary Fund, 2019; Haug & Power, 2022) . Some discretionary fiscal policy tools have proven to be relatively more timely, temporary and targeted, than previously thought possible, such as lump sum payments. Nonetheless many fiscal tools are still not timely, have been difficult to reverse or exit from, or suffer from poor targeting (Treasury, 2025).
Supply vs demand components of a shock are important for the effectiveness of discretionary fiscal policy	<ul style="list-style-type: none"> While fiscal policy can be effective in responding to some shocks and appeared well-suited to the initial COVID-19 response, the next shock may not have a supply-related component in the same way COVID-19 did. In an open economy, the effectiveness of fiscal spending depends not just on the marginal propensity to consume (how much of the stimulus is spent and not simply saved for another rainy day), but on trade openness, trade elasticities (how peoples international trading activity responds as the cost of trading changes), and the relationship between stimulus spending and financing (how people make different choices if the stimulus is financed from debt or taxes). Trade openness and exchange rate effects can reduce fiscal multipliers (International Monetary Fund, 2019; Druedahl, Ravn, Sunder-Plassmann, Sundram, & Waldstrøm, 2024). This means the effectiveness of discretionary fiscal policy in future shocks will be

¹⁵ "A wide range of fiscal and economic factors influence the size of fiscal multipliers. (Batini, Eyraud, Forni, & Weber, 2014) and (Ramey, 2019) identify a range of the most important factors including: the persistence of the fiscal intervention, the type of spending or taxes that is changed, how the policy is financed, whether it is anticipated, how the policy is distributed across potentially heterogeneous agents, how monetary policy reacts (the degree of monetary accommodation to fiscal shocks), the state of the economy (business cycle) when the policy takes effect, the degree of labour market rigidity, the size of automatic stabilisers, the level of public debt, the exchange rate regime and degree of (trade) openness, the level of development, and the quality of public expenditure management and revenue administration" (Binning, 2024).

Lesson	Evidence
	influenced by the nature of the shock along these “spending behaviour” and “trade openness” dimensions.
Deficit levels and expectations of future monetary policy can also play a part in discretionary fiscal policy effectiveness.	<ul style="list-style-type: none"> • Expectations of future monetary policy tightening can dampen current expansionary effects of fiscal policy as economic agents anticipate higher interest rates ahead and curb spending and investment before policy tightening has occurred (Labrousse & Perdereau, 2024; Hills & Nakata, 2018). • While the importance of deficits in determining fiscal multipliers is acknowledged in the empirical literature, this importance has not been subject to extensive testing (Auclert, Rognlie, & Straub, 2024).
International fiscal alignment spillovers can't be relied on (see high levels of global debt below)	<ul style="list-style-type: none"> • The New Zealand economy benefits through the spillover effects of fiscal stimulus in key trading partners and other large economies around the world. Fiscal stimulus in these economies likely has positive spillovers directly and indirectly through trade channels, stimulating aggregate demand in New Zealand via export demand (International Monetary Fund, 2019). New Zealand as a small open economy was likely a recipient of these positive fiscal spillovers in the recent COVID-19 experience (especially given the synchronised nature of fiscal responses). Any localised future shock may not include these spillover effects.
High levels of global debt may hamper the use of fiscal policy in the future, even for a global shock	<ul style="list-style-type: none"> • High public debt levels constrain the ability of fiscal policy to provide stimulus (Jazbec & Banerjee, 2017). • Globally, levels of public debt have been rising as Governments have run sustained fiscal deficits. This has partly been in response to a succession of shocks including the COVID-19 pandemic and recessions (the GFC) but has also been due to fiscal slippage¹⁶ and structural trends such as demographic ageing, rising healthcare costs, and climate change. Public debt looks set to continue to rise (Bank for International Settlements, 2024; Gómez-Cram, Kung, & Lustig, 2024; Cao, Di Gregorio, & Dabla-Norris, 2024). • Should global debt reach risky levels, this may require countries to consider consolidation at the very time that stimulus is needed during a crisis. • The recent rises in government debt in advanced economies increases the risk that these economies move toward risky debt regimes (Gómez-Cram, Kung, & Lustig, 2024; European Central Bank, 2021).
Globally the fiscal discourse has become more expansionary making the timely	<ul style="list-style-type: none"> • Across the globe the fiscal discourse has become increasingly tilted toward higher government spending since the 1990s, in both advanced and emerging economies and across much of the political spectrum (Cao, Di

¹⁶ Fiscal slippage is defined by the IMF as “A situation where a government’s actual fiscal performance deviates from its planned or targeted fiscal targets, usually resulting in higher-than-expected budget deficits, increased public debt, or a combination of both” (International Monetary Fund, 2025)

Lesson	Evidence
rebuilding of buffers more difficult	Gregorio, & Dabla-Norris, 2024) ¹⁷ . Fiscal policy in advanced economies has echoed this discourse and has frequently been used in response to large negative shocks, with policy becoming less responsive to debt levels since the 2008 global financial crisis (Bolhuis, Koosakul, & Shenai, 2024).
Globally there is increasing tension between interest rates needed for price and public debt stability	<ul style="list-style-type: none"> Government debt-to-GDP ratios rose over the past few decades as neutral rates¹⁸, and debt financing costs, declined. Recently, sustained fiscal deficits have further increased government debt, reflecting the large COVID-19 response as well as longer-term structural issues related to the costs of demographic ageing, climate change, productivity and supply chain diversification (Gopinath, 2023). Alongside rising financing costs, this poses fiscal challenges as governments may need to reduce their debt-to-GDP ratios for fiscal sustainability. Otherwise, they risk a large 'fiscal-monetary gap' as the real interest rate that would stabilise the debt-to-GDP ratio falls below the real interest rate needed to stabilise inflation (Bolhuis, Koosakul, & Shenai, 2024).¹⁹

Overall lessons from the international literature on monetary and fiscal policy coordination, and implications for NZ

Ongoing support for monetary policy's primary role in cyclical stabilisation

The international literature contains no significant pushback on the 'consensus assignment' when operating outside the ELB. While alternatives to the consensus assignment exist, there is ongoing widespread agreement in the international literature with the consensus assignment.

This is an important finding in the context of a longer-term trend in the global fiscal discourse that has become increasingly tilted toward higher government spending (International Monetary Fund, 2024), and given a range of structural drags to building fiscal balances, associated with factors such as climate change, demographics, and rising geopolitical tensions.

As outlined by the Treasury there may be scope to prepare timely, temporary and targeted fiscal responses ahead of time, with clear exit strategies including a shared understanding of tools use and their impact on the economy. This would help set public expectations and could help the central bank make its monetary policy decisions (Treasury, 2025). The Treasury also proposed the formation of an independent fiscal institution to scrutinise and report on the sustainability of fiscal policy²⁰ (Treasury, 2025).

¹⁷ The research used data to analyse fiscal discourse in party platforms across 65 countries from 1960-2022. The authors construct measures of support for government expansion and fiscal restraint based on the share of election platform content devoted to these topics. They then use regression analyses and event study methods to examine how fiscal discourse responds to economic conditions and institutional changes, as well as how changes in discourse anticipate subsequent fiscal outcomes.

¹⁸ The neutral interest rate "is conceptually the rate that, on average over time, would be consistent with no over- or under-utilisation of resources and stable inflation" (Reserve Bank of New Zealand, 2024, p. 60)

¹⁹ The 16 advanced economies included in the research are Australia, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, Netherlands, Norway, Spain, Sweden, Switzerland, United Kingdom, and United States.

²⁰ See (Treasury, 2018) for a detailed discussion of the potential forms and roles this could encompass. See also (Reserve Bank of New Zealand, 2022).

Both fiscal and monetary policy may have a role at the ELB, depending on the shock

Understanding where the economy is at a given point in time is the first key step to developing an appropriate monetary and fiscal policy response. Better economic information provides a firmer foundation for both monetary and fiscal policy decisions in real time. There are both policy implementation and coordination benefits to improving macroeconomic data timeliness, quality, and completeness. High quality economic information should also help build an understanding of how a variety of slower-moving forces are changing the shape of the economy over a longer time frame. This includes understanding the impact of structural reforms, changes in productivity, demographics, changes to regulation aimed at improving financial stability and the resilience of markets, as well as the cumulative impact of policy stances and strategy over time. Selecting the most appropriate policy mix and tools for each shock is a second key step in effective coordination. This requires understanding how monetary and fiscal policy tools impact on the economy, as well as how they interact with each other over time.

Monetary and fiscal policy can be aligned or misaligned depending on the nature of the shock and the economic objective being pursued. For example, the most appropriate response might be a targeted fiscal response and no shift in monetary policy. The policy mix is likely to change as the macroeconomic shock plays out and unwinds and will evolve to fit within the longer-term economic context and set of stable policy options.

Recent historical episodes have highlighted that both fiscal and monetary policy have limits and varying effectiveness around the ELB depending on the type of shock and the wider economic context. As mentioned above, having a set of well-designed, readily executable tools to deliver a desired policy stance and specific macroeconomic or financial objective is likely to support the overall effectiveness and timeliness of the policy response in a crisis by each set of policymakers. It gives a clearer view of the possible interactions, risks, assumptions, trade-offs and uncertainties associated with the use of a given set of policy tools. It also provides a clearer platform for transparency and accountability for reviews of the role, objectives, and effectiveness of each policy area in the crisis response, alongside the transition back towards normal conditions. These findings provide support for forthcoming work in New Zealand on a high-level monetary-fiscal policy decision-making framework to help inform advice, deliberations, and decision making across monetary and fiscal policy.

The final step is ensuring an effective and fit for purpose exit strategy in place for each tool. Delineating between temporary measures and longer-term options is important at the ELB. Temporary monetary and fiscal actions (aimed at addressing financial instability or alleviating a distributional outcome for example) can carry longer-term risks if not unwound in a timely fashion once the original objective of the policy has been met. The key factor is understanding the objective behind using the tool, which might require balancing flexibility with the need for a strong commitment to markets. Generally, however, a failure to unwind monetary and fiscal actions in a timely way when objectives are met, having an insufficient emphasis on rebuilding fiscal buffers in

an upturn, or simply using time-based forward guidance can adjust peoples' medium-term expectations.²¹ This can result in:

- governments failing to meet their planned fiscal targets as conditions normalise after a shock (fiscal slippage);²²
- a deficit bias, which is the tendency of governments to allow continuing deficits, and consequently increasing public debt levels, over time (Irish Fiscal Advisory Council, 2012);
- households and firms increasingly undertaking risky financial behaviour when not facing the full costs of their actions (moral hazard concerns); and
- a loss of credibility and clarity over how the monetary authority will adjust the policy rate or how and when the Reserve Bank will transition back to conventional monetary policy in response to evolving economic circumstances (the MPC's reaction function).

Timely and consistent use of buffers is key to ongoing effective coordination

The effectiveness of both fiscal and monetary policy around the ELB is underpinned by the credibility and sustainability of public finances. Globally, higher government debt levels have further raised the importance of ensuring the timeliness and cost-effectiveness of fiscal interventions. Goal clarity and accountability for fiscal policy is an important component of fiscal prudence to support the long-term credibility and sustainability of public finances.

More specifically, the building of sufficiently strong public balance sheets and fiscal buffers in good times is an important component of effective monetary-fiscal policy coordination. In terms of the monetary-fiscal policy mix, robust public balance sheets enable the use of fiscal buffers without increasing the risk of fiscal dominance – that is, situations where excessive fiscal spending undermines the central bank's commitment to maintaining medium-term price stability. From the perspective of effective tool implementation, available fiscal space and credibility concerns ultimately places limits on AMP tool use. In this way, fiscal prudence can help safeguard monetary policy independence and flexibility in how it sets policy in response to economic shocks.

New Zealand currently appears some distance from its fiscal limits, given its relatively low public debt ratio (by international comparison). At the same time, consideration of the appropriate fiscal buffer needs to include a range of vulnerabilities facing New Zealand. In the specific New Zealand context these vulnerabilities include demographic ageing, "contingent liabilities, such as explicit or implicit guarantees of the financial sector, the risk and likely impact of natural disaster events²³, as well as the level of private sector debt" (Buckle & Cruickshank, 2012).

The effectiveness of monetary and fiscal policy is also supported by strengthening the resilience of private sector balance sheets. This includes the use of financial tools by financial system regulators. These tools constrain the build-up of financial imbalances like excessive asset price growth or

²¹ For example, time-based guidance (while providing a strong commitment to markets) can also place constraints on the central bank's future actions – trading off an optimal response with loss of credibility if unforeseen events occur and make the central bank reaction function less clear as it makes a promise to ignore new macroeconomic information. See (Heron, 2021) and (Sutherland, 2020) for more information on the types of forward guidance including for example Odyssean, Delphic, quantitative and qualitative and their respective uses.

²² Fiscal slippage is defined in footnote 11 above.

²³ A recent report by Intersec has found that New Zealand ranked ninth on the list of countries most impacted by natural disasters between 2000 and 2024 see [NZ among countries most impacted by natural disasters | Insurance Business Australia](#).

unsustainable debt levels, which help increase the likelihood that the private sector has sufficiently strong financial buffers in the event of a crisis (European Central Bank, 2022). These financial tools include prudential regulations aimed at promoting the stability of the financial system (such as capital and liquidity requirements for banks), and macro prudential tools to address other systemic risks to the financial system (such as maximum loan-to-value and debt-to-income ratios). Macroprudential tools are often associated with long policy horizons and large implementation lags. Given these timeframes and lags, they are best applied well in advance of stress emerging (Bank for International Settlements, 2022).

Coordination arrangements should emphasise transparency, flexibility and independence

Institutional arrangements around coordination need to be clear, cooperative and flexible. Uncooperative and overly rigid arrangements lead to suboptimal outcomes. Central Banks need to be able to 1) respond flexibly and quickly to shocks and 2) safeguard policy independence and credibility to anchor medium-term inflation expectations (International Monetary Fund, 2022). This includes being able to respond to the unknown with the best available information and policy tools, including knowledge of any likely fiscal responses. It also includes ensuring central banks provide ongoing clarity to financial markets, households and businesses around how they are likely to adjust interest rates in response to changes in macroeconomic and financial conditions after a negative macroeconomic shock.

Every AMP funding choice involves risk. There is no international consensus over how to best fund AMP tools, especially for small open economies. More explicit coordination and fiscal backing can spark political controversy and public criticism, which can place limits on discretion, start to undermine independence, and make central bank's more risk adverse. AMP funding with less explicit backing may raise credibility concerns, be limited by the ability of the Reserve Bank to raise seigniorage revenue, and raise costs associated with communication.

Similarly, there is no international consensus on exactly how much equity a central bank needs and there is no clear formula in the international literature for the optimal level. Overall, fiscal sustainability and credible fiscal backing for the central bank appear crucial for the sustained effective operation of alternative monetary policy tools. This appears to be relatively more important than the central bank's own capital position in underpinning both market and public confidence in the overall effectiveness of AMP tools during large macroeconomic shocks.

Conclusion

A range of emerging insights from the recent international literature on monetary and fiscal policy coordination include that:

- Monetary policy continues to have a primary role in cyclical stabilisation. However, discretionary fiscal policy can play an important role when monetary policy is constrained by the effective lower bound in some circumstances. Previously well-canvassed constraints on fiscal policy for macroeconomic stabilisation continue to preclude its regular use for managing the business cycle.

- The appropriate mix of monetary and fiscal tools used at the ELB will depend on prevailing economic and financial conditions. Good coordination does not preclude different policy stances working to solve different economic problems using different tools on different timeframes. As such, decision makers should be agile and adapt monetary and fiscal strategies as economic and financial conditions evolve. Decision makers should also have clear objectives and exit strategies for monetary and fiscal policy tools to ensure appropriate transparency and accountability for meeting their respective policy goals.
- The effectiveness of both monetary and fiscal policy at the ELB is underpinned by fiscal sustainability. Maintaining fiscal headroom limits the risk of monetary policy being overburdened, conflicted, or frustrated in achieving its price stability mandate by fiscal policy choices.
- Maintaining well-informed, independent decision-making between monetary and fiscal policy is paramount. Alternative monetary policy financing needs to balance monetary policy credibility, flexibility and transparency with government balance sheet control. Timely and accurate economic, financial, and policy information is essential for well-informed decisions by both monetary and fiscal policy.

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