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Navigating economic storms: Lessons from monetary and fiscal policy during COVID-19

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* With thanks to Daniel Wills and Julian Wood who co-authored this speech with me.

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Introduction

Kia ora koutou. I'd like to start by acknowledging the Traditional Custodians of the land we're meeting on today and pay my respects to their Elders past and present.

It's great to be here with you here in Sydney, a wonderful city that I was lucky enough to live in for a few years back in the 1980s, which was a massive amount of fun. Thanks to the organisers for inviting me back today.

I want to share some lessons on how monetary and fiscal policy can work alongside each other in both stable and turbulent economic times. Drawing on New Zealand's pandemic experience, I'll reflect on how the two sets of tools are used over the economic cycle and how that changes when the Official Cash Rate (OCR) reaches its Effective Lower Bound (ELB). I'll finish with some thoughts on how monetary policy can work alongside fiscal policy in a crisis while maintaining its independence.

I want to be clear up front that we do not expect to use additional monetary policy (AMP) tools again anytime soon. The OCR is our preferred tool for managing the level of monetary stimulus through economic cycles, provided it is above its ELB. Rather, COVID-19 gave us a crash course on the use of AMP tools and on how monetary and fiscal policy can interact in times of extreme economic turbulence. It's important that we learn from that and carry those lessons forward to be ready for the next major shock.

Also, I will not be revisiting the question of whether the right amount of monetary and fiscal policy stimulus was delivered during the pandemic. That's a topic that we have dealt with at length in two recent RBNZ reviews of pandemic-era monetary policy.[1]

So, what can we learn from our pandemic experience about how monetary and fiscal policy should work alongside each other? Here are some key lessons:

- Outside of crises, monetary policy stabilises the economy by keeping inflation low and stable over the medium term. Fiscal policy maintains long-run debt sustainability. Whether monetary and fiscal policies are moving in the same direction or apart, the economy can remain stable as each policy area pursues its objectives independently.
- During economic crises, the OCR can hit its effective lower bound. At that point, additional monetary policy tools and fiscal policy can help stabilise the economy. Objectives can briefly align in an 'all hands on deck' effort to steady financial markets, economic activity, employment, and inflation.
- Analysis by the Treasury finds that during the COVID-19 pandemic, fiscal policy tools provided crucial support to stabilise incomes and prevent mass unemployment. However, lags and persistence in fiscal spending highlighted the challenges of using these tools for economic stabilisation.

[1] This topic is dealt with at length RBNZ (2022), and RBNZ (2025).

On balance, the modelling suggests that LSAPs worked broadly as anticipated by the MPC and effectively paid for themselves. In short, LSAPs lowered long-term interest rates, which held down the exchange rate and supported exports (figure 7). In turn, this supported economic growth and prevented inflation from dropping further below the target midpoint in 2020 (figure 8).

By boosting economic activity during the pandemic, LSAPs increased government tax revenues. This higher revenue almost entirely covered the direct losses from LSAPs, leaving consolidated Crown debt virtually unchanged over the medium term (figure 9).

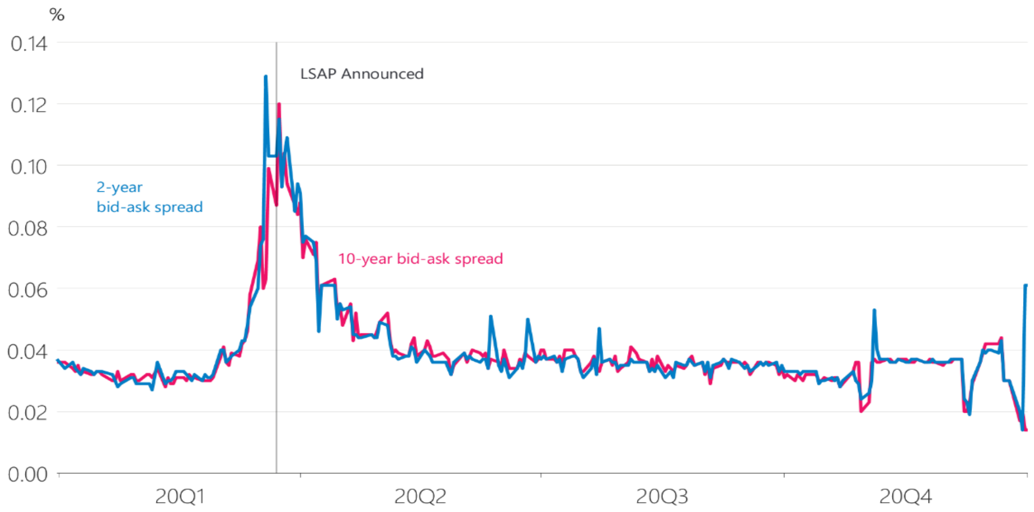
Overall, the model suggests LSAPs are a powerful macro-stabilisation tool. But like fiscal tools, they come with trade-offs. They allow for a faster recovery, with stronger growth and tax revenue, but also the potential for direct losses on bond sales. Moreover, our modelling to date suggests that they rely heavily on the exchange rate for transmission, rather than working through domestic channels. Judging these risks and trade-offs will be vital within the context of any particular crisis.

This model also allows us to explore the potential use of negative interest rates to support economic activity and keep inflation within target during a crisis. If moderately negative interest rates had been possible during the pandemic, our work suggests that could have delivered similar outcomes for growth and inflation as LSAPs, but at a lower cost to the Crown balance sheet (figure 10).

So, if negative rates had been operationally available to the MPC in 2020, they would have been a preferred tool for supporting the economy.[14] This is consistent with our view that the OCR is our preferred tool for managing the level of monetary stimulus through economic cycles, provided it is above its ELB. By extension, this implies that we would not use LSAPs outside of stabilising financial market dysfunction or of an acute economic crisis when the OCR is at its ELB.

Even so, there will always be an ELB for the OCR, even if it is slightly negative. Consequently, we need to remain ready to use LSAPs, in targeted circumstances, as and when required.

Figure 6: Bid-ask spreads in 2020



Source: Bloomberg, RBNZ estimates.

[14] (Orr, 2020)