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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

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 alternative[1] 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.