

Navigating Economic Cycles: Interactions between Monetary and Fiscal Policy

Introduction

The impact of the COVID-19 pandemic was unlike any of the economic shocks experienced before. Many countries imposed strict lockdowns in dealing with the pandemic, which directly impacted incomes and growth. In response, central banks and fiscal authorities swiftly adopted expansionary monetary and fiscal policies. In some countries, the scale of policy stimulus reached unprecedented levels. Central banks reduced policy rates, many to record lows, causing the global median to fall from 1.5% in 2019 to 0.1% in 2021. Governments embarked on massive spending and transfers programmes, widening fiscal deficits from a global median of -0.9% of GDP to -5.1% of GDP during the same period (BIS, 2023). These resulted in an increase in public debt¹ while monetary policy approached its effective lower bound. Some countries, particularly advanced economies, resorted to unconventional policy measures such as quantitative easing and funding-for-lending schemes to further support the economic recovery.

While the synchronised policy action cushioned the economic downturn and facilitated recovery, the subsequent policy normalisation amidst high inflation faced challenges against an environment of uneven economic recovery and public pushback of policy tightening. By end-2022, most central banks in emerging market economies had normalised their policy rates back to pre-crisis levels. However, economies facing higher and more persistent inflation resorted to more aggressive rate hikes.² Particularly for advanced economies, this was mostly attributed to the strong consumption activity due to the accumulation of excess savings during the pandemic, bolstered by sizeable fiscal support (BIS, 2023).³ The task to unwind pandemic-related support also faced challenges from the simultaneous rise in global energy and food prices. For example, the high prices of global commodities warranted targeted support to vulnerable segments particularly those still severely affected by the aftermath of the pandemic crisis,⁴ resulting in further increase to the already historically high public debt (IMF, 2022).

The interactions between monetary and fiscal policy are complex given its mutual influence and impact, particularly on inflation, debt and economic growth. The COVID-19 pandemic has shed light on the importance of policy coherence without compromising respective policy objectives and mandates. This article dissects the roles of cyclical macroeconomic policies, namely monetary and fiscal policy: their similarities and differences, synergies and risks in their interactions, as well as implications for structural and financial stability policies. It also draws on Malaysia's experience and concludes with key takeaways in navigating the interactions between the two policies moving forward.

The synergies from monetary and fiscal policy interactions

Policymakers adopt different policies to achieve various macroeconomic objectives such as structural⁵ and macroeconomic policies. This article focuses solely on the latter, namely monetary and fiscal policy. While monetary policy has limited impact on long-run growth, the same cannot be said about fiscal policy, as tax and government expenditure can have impact on potential growth.⁶ Nevertheless, these policies can be particularly effective at managing short-run macroeconomic fluctuations when deployed in a counter-cyclical manner (Diagram 1). Thus, it is critical to have a coherent conduct of monetary and fiscal policy to avoid the costly damages from sharp boom-bust cycles.

¹ Global public debt has risen from 84.9% of GDP in 2019 to 92.4% of GDP in 2022 (IMF Global Debt Monitor 2023).

² This includes advanced economies such as the US and EU, as well as emerging market economies in Latin America.

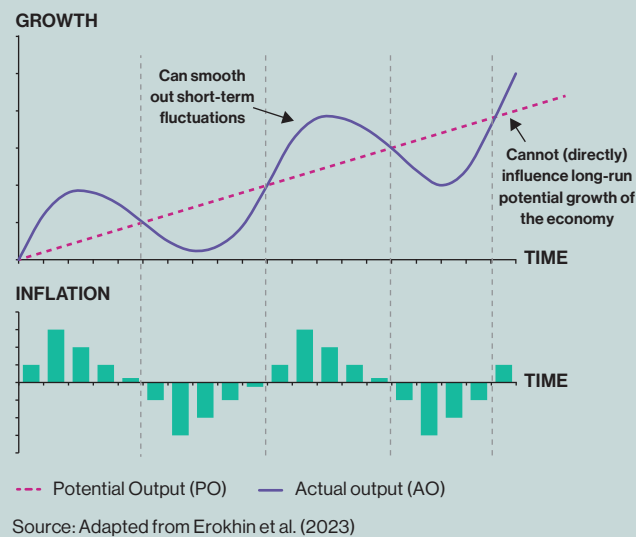
³ On top of excess demand, supply-related factors such as supply chain disruptions, logistical bottlenecks and labour shortages contributed to inflationary pressures. The conflict in Ukraine further worsened supply conditions by causing higher energy prices and affecting key industries such as utilities and transportation (WEF, 2022).

⁴ Over 700 measures were implemented related to revenue (e.g. reduction in excise rate) and expenditure (e.g. subsidies & cash transfers), below-the-line measures (e.g. loans or guarantees to state-owned energy companies) and non-fiscal measures (e.g. export bans) (IMF, 2022b).

⁵ Structural policies such as industrial, education, and labour policies are deployed to meet longer-term objectives such as increasing the potential output of the economy.

⁶ While tax and government spending measures can have long-term impact by incentivising or disincentivising certain activities or sectors, this article focuses solely on their short-term counter-cyclical application.

Diagram 1: Role of Monetary and Fiscal Policy



- Monetary policy:** Broadly, monetary policy tools can be categorised as either conventional or unconventional. Conventional tools such as changes in policy rates (e.g. the Overnight Policy Rate (OPR) in Malaysia) work by influencing the short-term interest rate, based on the outlook and balance of risks to growth and inflation. Beyond that, a set of unconventional tools such as large-scale asset purchase programmes (e.g. quantitative easing, QE) have also been adopted elsewhere. This is more prevalent in some advanced economies which have exhausted the space to deploy conventional tools and face issues surrounding the effective or zero lower bound⁷ (BNM, 2021). This involves large-scale purchases of financial assets to lower yields on long-term government bonds and other interest rates (also known as 'flattening the yield curve'), thereby reducing borrowing costs for households and corporates (Bank of England, 2022).
- Fiscal policy:** Plays a counter-cyclical role via 'automatic stabilisers' and 'discretionary spending'. Automatic stabiliser is a fiscal feature embedded in the design of taxation and expenditure policies. For example, governments would collect less tax (due to lower household and business incomes) and spend more (due to increase in social security claims) during economic downturns. Beyond automatic stabilisers, governments can also influence aggregate demand by using 'discretionary' spending, which can be either procyclical or counter-cyclical in orientation. In counter-cyclical use, government can increase discretionary spending during recessions or reduce them during economic booms (van den Noord, 2000). Examples include measures such as cash handouts, wage subsidies and tax incentives and reliefs to mitigate economic scarring during recession.

In performing their counter-cyclical roles, monetary and fiscal policies interact in two important ways, with various implications:

- Transmission channels:** Fiscal policy actions can affect monetary policy transmission through government debt issuances to finance fiscal deficits. More specifically, excessive government bond issuances can create distortions in financial markets by driving up yields. This could cause mispricing of other financial assets due the higher returns on this 'risk-free' asset, potentially triggering capital reallocation away from riskier assets. Additionally, the higher yield environment would result in interest rates being higher than levels warranted by the prevailing economic condition. Alternatively, excessive government bond issuances could cause yields to rise on riskier assets, making it expensive for the private sector to seek financing. This is called the crowding-out effect.⁸ Conversely, monetary policy could

⁷ The effective lower bound is characterised by a point below which policy rate cuts would result in net negative effects to the economy, with commonly cited symptoms including a contraction in lending and economic activity (Brunnermeier and Koby, 2019).

⁸ In certain circumstances, where there is a loss of confidence in the fiscal authorities, interest rates could spike up and trigger sell-offs in the financial markets leading to increased volatility.

have an impact on public finances in several ways. Changes in the central bank's policy rate affect yields on new government borrowing, impacting borrowing and debt servicing costs to fiscal authorities (BIS, 2023). Secondly, it can induce larger fiscal multiplier effects, when operating at the effective lower bound (ECB, 2021).⁹ The two policies are further intertwined through interlocking balance sheets arising from normal central bank open market operations (namely the purchase of government bonds in the secondary market) and remittances of profits from the central bank's operations (BIS, 2023).

- **Growth and inflation outcomes:** Contingent upon underlying causes and initial conditions, impact to growth or inflation induced by one policy may require a recalibration of policy stance by the other. In a scenario of high inflation and low growth, excessive fiscal expansion could necessitate a more restrictive monetary policy response to curb inflation, potentially negating the intended impact of fiscal policy to growth. Conversely, higher inflation induced by loose monetary policy can positively affect fiscal balances by boosting tax revenue and enlarging fiscal policy space by reducing the value of government debt (Amaglobeli et al., 2023). In the broader experience of advanced economies, progressive government spending and redistributive policies can reverse the decline in the natural interest rate,¹⁰ thereby increasing monetary policy space for central banks constrained by the effective lower bound.¹¹

Table 1: Stylised Facts on Monetary and Fiscal Policy

	MONETARY POLICY	DISCRETIONARY FISCAL POLICY¹²
Definition	Involves the use of policy instruments (e.g. interest rates, liquidity operations, etc) by central banks to manage inflation and support economic activity (e.g. growth or employment)	Refers to the use of government spending, taxation, and borrowing to influence the level of aggregate demand, promote growth, and meet various socioeconomic objectives
SIMILARITIES		
Orientation	Counter-cyclical tools impacting aggregate demand	
Time-horizon	Focused on short-run impact with a timeframe of 12–36 months, although fiscal multiplier impact can persist much longer ¹³	
Distributional effect	Pervasive distributional effect on income and wealth; Fiscal policy can transfer resources between sectors and segments while monetary policy can transfer resources between savers and borrowers	
DIFFERENCES		
Objectives	To control inflation and/or growth by influencing aggregate demand	Influencing aggregate demand and ensuring stability in aggregate supply towards achieving macroeconomic goals (e.g. sustainable growth, employment and price stability)
Transmission mechanism	Occurs through channels of interest rates, asset prices, credit, exchange rate and expectations	Occurs through channels of consumption and investment
Impact	Generally, a blunt tool with broad-based impact	Can be both broad-based or targeted to specific sectors or segments

Source: Staff compilation from Dong, Wei et al (2021), Hopper (2018) & Kopcke et al (2006)

⁹ At the lower bound, higher government spending increases expected inflation which subsequently lowers real interest rates. This boosts private spending thereby causing a larger multiplier effect (Christiano et al, 2011).

¹⁰ Refers to the level of interest rate that neither stimulates nor restrains economic growth. The decline in the natural interest rate, attributed to global savings glut (Bernanke, 2005), suggests that policies aimed at reducing aggregate savings could unlock higher aggregate demand and, consequently, facilitate a rise in natural interest rates through inflationary pressures (Michau, 2020).

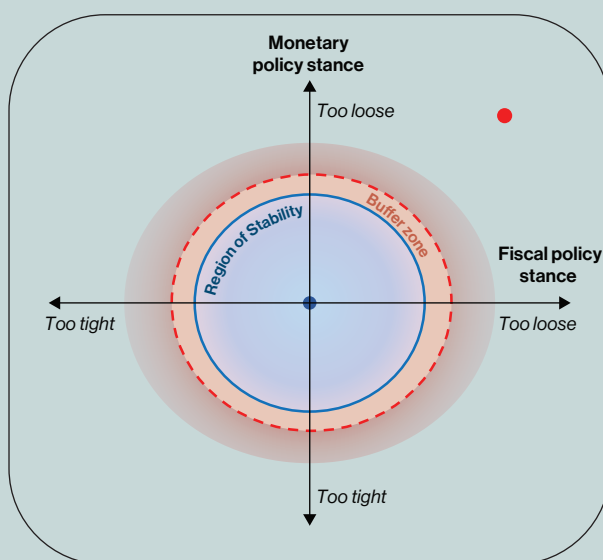
¹¹ This occurs via automatic stabilisers and progressive taxation which provide better protection against aggregate or idiosyncratic shocks to economic agents, thereby reducing the need for precautionary savings. Consequently, the fall in supply of total savings will increase the natural rate of interest (ECB, 2021).

¹² Of note, different types of fiscal policies can impact both aggregate demand and supply. However, macroeconomic stabilisation primarily relates to its influence on aggregate demand. Fiscal policies with objectives beyond short-run macroeconomic stabilisation are referred to as structural reforms.

¹³ Fiscal multiplier impact can persist up to several years based on state-contingencies (e.g. economic cycle and liquidity constraints) and type of instruments (e.g. revenue and spending measures) (Office for Budget Responsibility, 2013).

The interactions between monetary and fiscal policy create challenges in navigating the policy landscape for both central banks and governments. In the context of policy analysis, the so-called 'Region of Stability (ROS)' provides a framework to understand how different macroeconomic policies affect one another and how the interplay between the two policies could pose risks to the economy (BIS, 2023). Of critical emphasis, ROS is defined by its boundaries, whereby macroeconomic stability is at risk should monetary and fiscal policy operate outside of it (Diagram 2). These boundaries evolve, influenced by factors such as structural changes to the economy (e.g. ageing population) which can shift those boundaries, and cumulative policy choices (e.g. persistently high fiscal deficits) which further stress them. Similarly, prolonged periods of low interest rates could also create financial imbalances and encourage excessive leverage in the economy. Hence, risks from policy interactions may arise, compromising the ability to achieve respective objectives and threatening overall macroeconomic stability. This underscores the need for vigilance in policymaking and a steadfast approach in building adequate policy buffers. Importantly, it emphasises that monetary and fiscal policy cannot be operated in a vacuum, necessitating effective management of the interactions to ensure optimal outcomes.

Diagram 2: Monetary-Fiscal Interactions and Implications Towards the Macroeconomy



- **Operating within the Region of Stability:** A mix of monetary and fiscal policy that is consistent with macroeconomic stability
- **Operating outside the Region of Stability:** Characterised by poorly calibrated policies against prevailing macroeconomic conditions resulting in adverse implications towards financial stability & structural reforms
- ▶ **Factors influencing the borders of the Region of Stability:**
 - Macroeconomic fundamentals
 - Structural reforms
 - Sustainability of policy trajectory – where neither are excessively loose or tight
- ▶ **Buffer zone: 'Safety margins' preventing unraveling of macroeconomic stability**
 - Factors influencing the buffer zone:**
 - Macroprudential policies
 - Confidence

Source: Adapted from BIS (2023)

Understanding and mitigating risks from monetary and fiscal policy interactions

The high degree of interaction between monetary and fiscal policy creates the risk of 'fiscal dominance', whereby monetary policy decisions are unduly subordinated by fiscal considerations (Agur et al., 2022), particularly via public debt vulnerabilities. Importantly, concerns of fiscal dominance can even occur subtly, without direct influence from fiscal authorities, as extremely high government debt levels pose challenges to central banks needing to raise interest rates

as it could create financial instability and harm the real economy. For instance, Heinemann and Kemper (2021) argue this to be the case with individual members of the ECB Governing Council, which includes governors of the euro area national central banks (NCB) and the ECB board members. They show that there exists a positive correlation between the dovishness¹⁴ of each member and the indebtedness of the member states they are from.¹⁵ Similar concerns were also raised about central banks in Japan and the United States during the pandemic due to considerations about liquidity and sovereign solvency amidst high government debt levels (Bordo and Levy, 2021).

Beyond fiscal dominance, direct interference and deficit financing by the central bank are more extreme circumstances which significantly impact the conduct of monetary policy. Direct interference entails direct political interference on monetary policy decisions, compromising central bank independence. For instance, political pressure on the Federal Reserve to maintain low interest rates throughout the mid-1960s is cited as a contributing factor of the Great Inflation (Meltzer, 2003).¹⁶ On the other hand, direct financing of fiscal deficits by central banks can occur through direct lending to the government or direct purchases of government bonds by the central bank (i.e. debt monetisation) (Tobias et al., 2021). The outcome is a permanent and continued increase in the money supply, ultimately leading to risks of hyperinflation as observed in Zimbabwe in the early 21st century (Hooley et al, 2021).

Monetary and fiscal policy interactions can also exert implications towards financial stability. Given that monetary and fiscal policy interactions are linked via government debt issuances in financial markets, inconsistent behaviour on either policy can induce financial instability. This is highlighted by the 2022 gilt crisis in the United Kingdom. The unfunded nature of the fiscal package announced by the UK's Chancellor of the Exchequer raised concerns about rising government debt and potential inflation pressures. The subsequent market impact, particularly on UK pension funds, forced the Bank of England to temporarily reverse its balance sheet reduction programme by making temporary and targeted purchases of gilts to restore orderly financial market conditions (Leeper, 2023). This particular case illustrates the interconnectedness of different macroeconomic policies and highlights the importance of policy coherence.

Moreover, monetary and fiscal policy interactions can also affect the prospects for structural reforms. For instance, sound public finance will facilitate more effective reforms taking place as it provides budgetary room to finance mitigating measures and transition plans for those potentially disadvantaged by the reforms (IMF, 2004; Tompson, 2009). In a similar vein, combining reforms with fiscal incentives (e.g. tax cuts or credits) can facilitate or even expedite reforms by alleviating transition and social costs. However, this is conditional upon the fiscal support being targeted, time bound and tied to commitment towards other major reforms (Banerji et al, 2017).

In sum, understanding the risks arising from the interactions between monetary and fiscal policy is critical. Operating within the Region of Stability prevents over-burdening of any single policy in macro stabilisation, mitigates potential imbalances, and avoids hindering the effectiveness of either monetary or fiscal policy. The success in operating within the Region of Stability hinges on two critical factors:

- **Policy conduct:** Monetary policy must be focused on its price stability mandate in supporting other macroeconomic objectives of sustaining growth and financial stability. Fiscal policy should prioritise prudence, utilising fiscal space when needed and rebuilding buffers afterwards to ensure long-term debt sustainability. For both, the respective policy stance relative to the 'neutral' stance¹⁷ is critical to guide its operation in effectively playing the counter-cyclical role.¹⁸
- **Institutional framework:** A well-defined legal framework safeguards institutional and operational independence while establishing institutional arrangements to facilitate engagement between central bank and fiscal authorities.

¹⁴ Refers to the monetary policy preference for more accommodative or expansionary monetary policy alongside a greater tolerance of inflation, typically characterised by a general preference for lower interest rates. The findings from Heinemann & Kempel (2021) indicate that individuals from highly indebted member states tend to advocate for a more accommodative monetary policy stance.

¹⁵ The Transmission Protection Instrument (TPI) introduced in July 2022 has been highlighted as a potential case of subtle fiscal dominance by Leeper (2023), as it allows the ECB to purchase additional sovereign bonds in response to 'unwarranted' yield increases, which could be viewed as an attempt to influence the bond yields of highly indebted euro countries. Despite never being activated, the TPI functioned as a deterrent against disorderly and unwarranted increases in sovereign spreads and ensured the effective monetary policy transmission throughout the eurozone (Schnabel, 2023).

¹⁶ Refers to the period between 1965 and 1982 in the United States of America characterised by high inflation up to 15%.

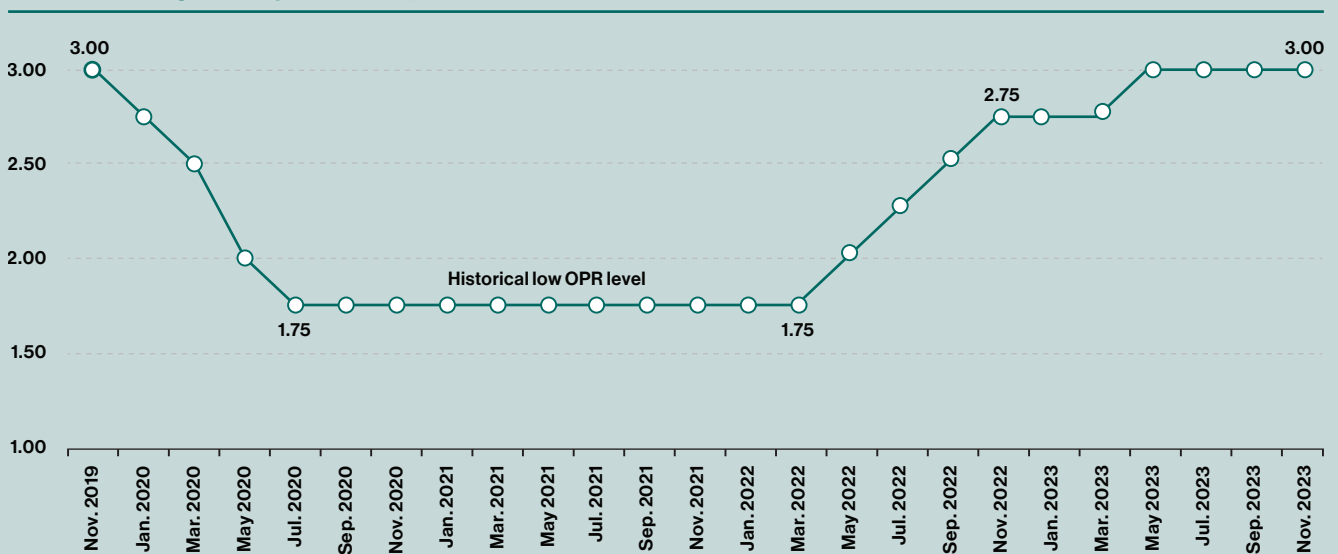
¹⁷ Refers to a policy stance that is neither expansionary (i.e. supportive) and contractionary (i.e. dampening) to the economy.

¹⁸ For fiscal policy, the cyclically-adjusted primary balance (i.e. fiscal balance minus cyclical components and interest payments, adjusted for the output gap) captures the use of 'discretionary' tax and spending in being expansionary or contractionary (Fedelino et al, 2009).

The Malaysian experience

The interaction between monetary and fiscal policy in Malaysia focuses primarily in the areas of macroeconomic stabilisation, debt management and economic development. The recent pandemic-induced recession presented a set of unique and unprecedented challenges to the country and provided us with a rich test case of the policy levers operating within the Region of Stability. Mirroring the global experience, Malaysia’s pandemic response saw greater monetary and fiscal policy interventions, which increased the interactions between the two. At the onset, Bank Negara Malaysia (BNM) reduced the Overnight Policy Rate (OPR) by 125 basis points, from 3.00% to a historical low of 1.75% between January and July 2020 (Chart 1), to provide support for economic activity during the unprecedented economic slowdown due to the lockdown. This was supported by a suite of financial stability policies to inject liquidity, facilitate intermediation activities, and ease cash flow pressures among borrowers.¹⁹ Likewise, the fiscal response was also sizeable and wide-ranging, encompassing eight stimulus and assistance packages totalling RM530 billion of both fiscal and non-fiscal measures.²⁰

Chart 1: Overnight Policy Rate (OPR, %)



Source: Bank Negara Malaysia

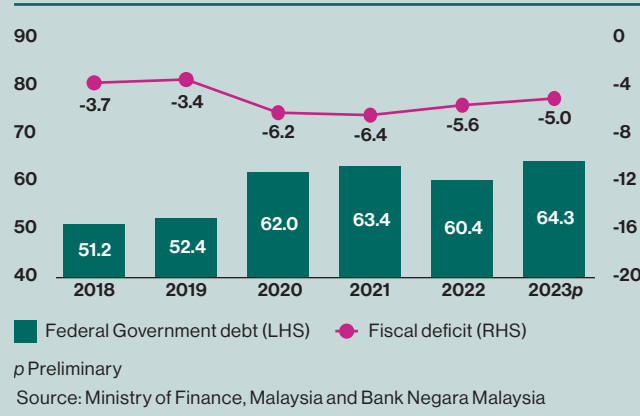
As the economy recovered, BNM’s gradual and measured approach to monetary policy normalisation saw the OPR steadily raised from May 2022, returning to the pre-pandemic level of 3.00% by May 2023. Alongside that, financial stability measures shifted from broad-based towards targeted repayment assistance. In parallel, the sizeable increase in government debt from 52.4% of GDP in 2019 to 64.3% of GDP in 2023 necessitated fiscal policy to adopt a less expansionary stance. This is reflected in the gradual fiscal consolidation from -6.4% of GDP in 2021 to -5% of GDP in 2023 (Chart 2). The 2024 Medium-Term Fiscal Framework (MTFF) reinforces this commitment, with an average fiscal balance target of -3.5% of GDP between 2024 and 2026. Additionally, the recently approved Public Finance and Fiscal Responsibility Act (FRA)²¹ imposes a maximum limit of federal government debt at 60% of GDP to ensure debt sustainability. Moving forward, a successful implementation of a more targeted approach to subsidies will further support fiscal consolidation efforts. These sets of policy actions proved to be coherent, as an over expansionary fiscal stance might necessitate a contractionary monetary policy stance to contain inflationary pressures, potentially negating the intended impact to growth. Importantly, this policy combination facilitated a strong economic recovery, culminating in a robust real GDP growth in 2022 and 2023 of 8.4% and 3.7% respectively, with inflation moderating from its peak of 4.7% in August 2022 to 1.5% by December 2023.

¹⁹ These include allowing banks to temporarily operate below the minimum liquidity coverage ratio of 100%, reduction of the Statutory Reserve Requirement (SRR) from 3% to 2% and the 6-month automatic loan repayment moratorium. Additionally, financial institutions were temporarily allowed to utilise the Malaysian Government Securities (MGS) and Malaysian Government Investment Issues (MGII) for the SRR compliance.

²⁰ This was partly financed by the establishment of the COVID-19 Fund under the Temporary Measures for Government Financing (Coronavirus Disease 2019 (COVID-19)) Act 2020. Notable measures include withdrawals from EPF savings, cash transfers (e.g. Bantuan Prihatin Nasional and Bantuan Khas COVID-19), wage subsidy programme (WSP), and the implementation of small-scale projects (Ministry of Finance, 2022).

²¹ The Act introduces four fiscal rules: A fiscal deficit ceiling at -3% of GDP; federal government debt limit at 60% of GDP; capping government guarantees at 25% of GDP, and a minimum annual development expenditure of 3% of GDP.

Chart 2: Federal Government Debt and Fiscal Deficit (% of GDP)



In playing its counter-cyclical role and managing risks of heightened interactions during the pandemic, two key elements guided BNM's approach namely clarity of mandates and a robust institutional framework. Firstly, the Central Bank Act of Malaysia Act (2009) establishes BNM's mandates and governs its relationship with the Government. Notably, the Act stipulates the principal object to promote monetary and financial stability conducive to sustainable growth of the Malaysian economy whilst providing advisory on economic and financial stability matters to the Government.²² Secondly, in ensuring the effective delivery of this mandate, two key safeguards are stipulated within the Act among others. The Act²³ formally assures the independence of BNM in monetary policy conduct, which is vital in ensuring monetary stability.²⁴ The Act²⁵ also imposes strict limits on BNM's ability to provide financing to the Government, defined by specific parameters of duration, limits, and permitting circumstances.

Robust institutional arrangements facilitated engagement and policy alignment between BNM and the Government. As a member of national-level policy platforms such as the Economic Action Council (EAC) and the Fiscal Policy Committee (FPC), BNM plays a proactive role in providing policy advisory on various economic issues encompassing from macroeconomic management, structural challenges to fiscal reforms. This is further bolstered by participation at various dedicated working-level platforms. In particular, this allows BNM to consistently provide insights on the economic outlook and emerging risks in the global and domestic economy.

In general, the legislative and institutional setup in Malaysia facilitated coherent monetary and fiscal policy responses while mitigating risks of adverse or excessive monetary-fiscal interactions. Still, the risk that could arise in the interaction between these policies needs to be managed proactively. Case in point is the proactive fiscal consolidation efforts by the Government as unsustainable government debt levels may complicate monetary policy considerations in responding to rising inflationary pressures. These risks could subsequently result in financial market instability and inadvertently result in a subtle form of fiscal dominance, which impedes macroeconomic stability and sustainable growth in the long run. Hence, sustained vigilance and continued enhancements to policy tools remain paramount.

To further safeguard the efficacy of monetary and fiscal policy and its interaction, several measures could be considered, which include:

Monetary policy:

A deeper understanding of structural shifts in the economy: Efforts to deeply understand ongoing and future structural shifts, whether arising from the pandemic crisis or prevailing economic megatrends (e.g. ageing population, digitalisation and climate change), continue to be part of BNM's agenda. This will enable BNM to undertake monetary

²² Refers to Section 5 and 70 of the Act.

²³ Refers to Section 22 of the Act.

²⁴ Arnone et al (2009) highlight the benefits of autonomous central banks empowered by a Central Bank Act on policy outcomes such as inflation.

²⁵ Refers to Section 71 of the Act.

policy effectively in ensuring price stability that is consistent with sustainable growth. Of paramount importance is the keen understanding of the evolution of inflation dynamics and monetary policy transmission mechanism in light of these structural shifts. Research will be focused on these areas.

Fiscal policy:

- **Alignment with economically sound indicators:** Commitment to enhanced fiscal policy conduct by targeting a fiscal deficit towards the Debt Stabilising Primary Balance (DSPB)²⁶ and the Cyclically Adjusted Primary Balance (CAPB) would preserve fiscal sustainability and boost its effectiveness as a counter-cyclical tool. The Public Finance and Fiscal Responsibility Act (FRA) lays the groundwork for this and would mitigate procyclical tendencies while also ensuring debt sustainability.
- **Steadfast fiscal policy reform:** In the short-term, the consolidation efforts should also be supported by revenue and expenditure reforms. These include measure to broaden and diversify revenue base and prioritising expenditure items with high multiplier impact.²⁷

Lastly, structural reforms play a crucial role in mitigating risks arising from monetary-fiscal interactions. It expands the Region of Stability and thus facilitates macroeconomic strength and resilience. Key reform areas include increasing the economy's growth potential, ensuring the workforce is future-ready, transitioning towards a low-carbon economy, ensuring effectiveness of social protection as well as building fiscal resilience by broadening the revenue base and optimising expenditure with a focus on high multiplier spending. Such reforms expand the Region of Stability by boosting potential growth and minimising volatility, thereby reducing pressures on monetary and fiscal policy to support economic activity. Recent announcements of major national economic masterplans²⁸ and reforms to the social protection system²⁹ are steps in the right direction. The former is essential for securing sustainable growth engines by boosting innovation and productivity meanwhile the latter provides resilience against economic shocks. Thus, it is imperative that these masterplans and other structural reform measures are executed well and in earnest.

Summary and way forward

Increased interaction between monetary and fiscal policy is not inherently detrimental to the economy. However, imprudent policy conduct could complicate a country's overall ability to operate within the Region of Stability. Malaysia's recent experience during the pandemic pointed to both policies working well within the Region of Stability. Nevertheless, it is recognised the post-pandemic landscape presents possible future vulnerabilities in the form of elevated fiscal risks due to high debt levels as well as more permanent shifts in the structure of the economy.

Moving forward, proactively building monetary and fiscal policy buffers is therefore crucial to mitigate these potential risks. Monetary and fiscal authorities must also be vigilant in enhancing their surveillance toolkits to better understand the evolution of the economy. For monetary policy, the immediate task is to ensure that risks to price stability are contained. For fiscal policy, it is important that the risks arising from the vigorous fiscal exertions during the pandemic are steadily unwound. Adherence to the ongoing fiscal consolidation plan will be key and would support debt sustainability over time. Taken together, this ensures the readiness of both policies to effectively play a counter-cyclical role in a coherent manner and solidify macroeconomic stability in a sustainable manner.

²⁶ Refers to the primary balance (i.e. fiscal balance minus interest payment) at which government debt starts to moderate.

²⁷ Empirical estimates of fiscal multipliers indicate that expenditure on supplies and services and fixed assets exhibit the highest multiplier effects (Lau et al, 2022).

²⁸ Refers to the National Industrial Masterplan (NIMP) and the National Energy Transition Roadmap (NETR).

²⁹ Encompassing social safety nets, social insurance, and active labour market policies (ALMPs), these policies provide the social protection floor, mitigate life-cycle risks and enhance economic opportunities. This would be supported by overarching reforms such as a centralised database (i.e. Pangkalan Data Utama (PADU)).

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