Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Inquiry into the Government's Economic Stimulus Initiatives

9 October 2009

Topic: Economics Stimulus

1. Dr Henry, you said that there "are dangers in low interest rates". Is part of the reasoning for maintaining the roll out of the stimulus to raise interest rates?

No. The stimulus was designed to support aggregate demand during the global recession. The stimulus consists of a series of temporary measures that will be unwound as private sector demand recovers.

2. What options has or will Treasury assess, in the context of the next budget, in restoring future budgets to the black?

The Government's fiscal strategy is described in Statement 3 of the 2009-10 Budget.

As part of its overall fiscal strategy, the Government has already committed to taking action to return the budget to surplus as the economy recovers and grows above trend by:

- allowing the level of tax receipts to recover naturally as the economy improves, while maintaining the Government's commitment to keep taxation as a share of GDP below the 2007-08 level on average; and
- holding real growth in spending to 2 per cent a year until the budget returns to surplus.

Based on the projections presented in the 2009-10 Budget, the implementation of the Government's fiscal strategy is expected to see the budget return to underlying cash surplus in 2015-16.

3. What is Treasury's forecast for the earliest and latest date for the budget returning to surplus?

Based on the projections presented in the 2009-10 Budget and the implementation of the Government's fiscal strategy, the budget is expected to return to underlying cash surplus in 2015-16.

4. The Government has committed to holding "real growth in spending to 2% per annum, once economic growth is above-trend, until the budget returns to surplus." Should this 2% limit be reviewed and, if so, in what way and why? If not, why not?

The Government's commitment to hold real growth in spending to 2 per cent a year as the economy recovers and grows above trend was announced in the February 2009 *Updated Economic and Fiscal Outlook.*

The commitment is consistent with the medium-term fiscal strategy and is designed to assist with the return of the budget to surplus as the economy recovers.

Any decision to review this commitment would be a matter for the Government.

5. Do you think the recent appreciation of the Australian dollar will reduce inflationary pressure? And if so, why is now, when the economy is weak, a good time to put downward pressure on inflation? Wouldn't it be better to do that in a year or eighteen months time? Hasn't the recent appreciation of the dollar reduced the scope for the dollar to appreciate in the future and help to constrain inflation in the recovery?

Among other things, the recent appreciation in the exchange rate is likely to reflect future commodity prices and improved global economic sentiment, including improved sentiment about Australia's economic prospects.

While fluctuations in the exchange rate can have a noticeable effect on import prices in the short run, the effect of changes in import prices on domestic consumer prices has been limited over the past decade and a half. This conclusion has been strongly supported by empirical evidence in a number of countries including Australia.

The RBA has estimated (RBA 2004 Conference paper, 'Inflation in Australia: Measurement and Modelling') that there has been substantially lower pass-through of import prices to final prices in the post-1990 period compared with the pre-1990 period. The RBA also estimates that the pass-through in the post-1990 period has also been slower.

This result is considered to largely reflect the shift to an inflation targeting framework for monetary policy, and the fact that this framework has resulted in more stable inflation expectations and inflation outcomes. The RBA also notes evidence that the slowing in the pass-through of exchange rate movements into final prices has been correlated with the global trend towards relatively low and stable inflation.