Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Budget Estimates

1 June – 3 June 2010

Question: BET 343

Topic: Interest Rates

Hansard Page: Written

Senator EGGLESTON asked:

1. In your view, would an increase in government expenditure put upward pressure on interest rates, all other things being equal?

Answer:

- The impact of government expenditure on interest rates depends, among other things, on the level of spare capacity in the economy.
- This is shown on page E26 of the Hansard for the Senate Estimates hearing on 2 June 2010:

> **Senator JOYCE**—I will go back to monetary policy in that case. Is there a trade-off between fiscal and monetary policy?
> **Dr Gruen**—There can be a trade-off, certainly.
> **Senator JOYCE**—There 'can be' or 'generally is' a trade off?
> **Dr Gruen**—Give me a specific example and I will try to deal with it.
> **Senator JOYCE**—If I jam a heap of money into the economy and stimulate it, will it have inflationary pressures?
> **Dr Gruen**—The answer to that question depends very much on whether there are unemployed resources in the economy. If you were to engage in fiscal expansion at full employment then that fiscal expansion would be crowded out by a combination of higher exchange rates and higher interest rates as applied by the central bank. So if you were to engage in discretionary fiscal stimulus at a time of full employment then the implications of that would be that monetary policy would likely offset it with higher interest rates. It is worth drawing the distinction. In a situation as we faced in late 2008 and 2009, when there was a very substantial retreat in private sector demand, both fiscal and monetary policy were acting extremely quickly to try to offset that decline in private sector spending, so they were both acting in concert to limit the extent of the economic downturn.