Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Budget Estimates

1 June – 3 June 2010

Question: BET 344

Topic: **Fiscal/ Monetary Policy**

Hansard Page: Written

Senator EGGLESTON asked:

1. Is there a trade-off between fiscal policy and monetary policy?
2. Would a tighter fiscal policy allow the Reserve Bank to set lower interest rates, all other things being equal?
3. I refer to a Treasury staff paper titled "The effectiveness of fiscal policy in Australia — selected issues" written by Blair Comley, Stephen Anthony and Ben Ferguson in 2002. This paper investigated the 10-year bond rate real interest margin between Australia and the United States.
    a) The paper concluded that "In general, low values of the margin correspond to periods of fiscal consolidation in Australia (late 1980s and late 1990s) and high values during periods of fiscal expansion (early to mid 1990s)." How would you interpret the historical trend in interest margin and its link to the government's budget position?
    b) The paper further concludes that "The results suggest that a deterioration of the headline balance of one per cent of GDP is associated with an increase in the margin of around 20 basis points in the short run …" Would you generally accept that conclusion?
    c) The paper further concludes that "… an increase in public debt of one per cent of GDP is associated with an increase in the margin of around 15 basis points in the long run … " Would you generally accept the direction of that conclusion? That is an increase in spending and government debt would generally put upward pressure on interest rates?
    d) If not, what other evidence is there available on the link between interest rates, government spending and debt? Given that the cash rate in Australia of 4.5% is now much higher than in most other developed countries, what would be the advantages for Australia in having lower interest rates? Do you agree with the Reserve Bank governor that the GFC lasted for six weeks and was essentially a North Atlantic crisis?

Answer:

1. Dr Gruen answered this question at the Senate Estimates (See below answer in Hansard, page E26).

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.

2. The impact of government expenditure on interest rates depends on the level of spare capacity in the economy.

3.

a), b) and c) These questions were answered by Dr Gruen at the Senate Estimates (See below answers in Hansard, pages E29 and E30).

Senator JOYCE—I refer to a Treasury staff paper titled 'The effectiveness of fiscal policy in Australia— selected issues' written by Blair Comley, Stephen Anthony and Ben Ferguson. Are you aware of this paper?

Dr Gruen—Yes I am.

Senator JOYCE—This paper investigated the 10-year bond rate real interest margin between Australia and the United States. The paper concluded:

The results suggest that a deterioration of the headline balance of one per cent of GDP is associated with an increase in the margin of around 20 basis points in the short run …

The paper further concludes:

… an increase in public debt of one per cent of GDP is associated with an increase in the margin of around 15 basis points in the long run.

Would you generally accept the broad directions of this paper's conclusion?

Dr Gruen—We have taken another look at that paper with the benefit of further data. We find that when you update that paper the short-run effect becomes statistically insignificant and the longer run effect becomes smaller. It is obviously a question that we have considerable interest in. It is a question that is interesting a lot of countries at the moment. I would draw your attention to an IMF staff paper from November 2009 just so that you or your staff have a chance to look it up. It is titled 'The state of public finances cross-country fiscal monitor: November 2009' and is produced by the IMF. That comes to broad conclusions which I think are a little smaller than the ones that that Treasury paper came to. Nevertheless, it comes to the conclusion:

An increase in the overall fiscal deficit of 1 percent of GDP pushes up bond yields by about 20 basis points over the medium term.

They have a range of other conclusions, some of which are certainly of interest. For instance, if you have a large initial high stock of debt then the effect can be bigger; if you have a large initial deficit, the effect can be bigger. There is a range of things that can make the effect bigger.

The other point that they make, which I think it is extremely important, is that these effects are effects that you would expect to see over an extended period of time, and they are not effects that you would expect to see at a time when there is a huge amount of excess capacity in the global economy. So let me just flesh that out a little bit, because it is quite important. There has been, as you would be aware, a very substantial deterioration in fiscal positions of most of the advanced world, so there have been very big increases in fiscal deficits across the developed world and in debt levels.

Senator JOYCE—Believe me, Dr Gruen, I am aware of that more than most people.

Dr Gruen—Indeed you are. If you were to simply apply these rules of thumb then that would lead you to the conclusion that bond yields across the world should have gone up very substantially. In fact, if anything, in the advanced economies, putting aside the ones where solvency is becoming an issue—the peripheral European economies—in Germany, the UK, the US, Japan the bond yields in those countries have come down. Bond yields in Germany are currently the lowest they have been since the 1920s despite the very big increases in debts and deficits.

The point is, the reason I am expanding on this in some detail, is that at a time when there is a great deal of spare capacity in the global economy, or in other words at a time when the private sector has retreated very substantially and has raised its savings and reduced its investment, the big increases in government spending and big increases in government deficits have had almost no impact at all on long-term interest rates. So the results that you get out of these econometric studies, whether you are talking about the Comley et al one, or the ones from the IMF, those are results that you would expect to apply in the medium to long run when the private sectors have recovered.

The point of all of that is that it is therefore important for fiscal consolidation to occur at the same time that the private economies are recovering. That is precisely what is happening here, and is also what is happening increasingly around the world. Some countries are doing their fiscal consolidations earlier than others, but there is no question that if these levels of debt and deficit were allowed to continue into the indefinite future, they would have very substantial impacts of the sort that you have been talking about on long-term interest rates. They are just not having those effects now because of the huge amount of spare capacity in the global economy.

d) The empirical evidence on the link between fiscal deficits and interest rates is mixed. In an additional survey of the empirical evidence, Gale and Orszag (2003) report that of 59 papers reviewed, 29 found a significant effect of deficits on interest rates, 19 found a predominantly insignificant effect, and 11 had mixed results.

It is true that the acute phase of the Global Financial Crisis (GFC) lasted a relatively short time and was concentrated in the financial sectors of the North Atlantic economies. It did, however, take almost a year for interbank lending rates to fall to more normal levels.

While the acute phase of the GFC was short-lived, the crisis has had severe adverse flow-on effects on real economic activity and employment over a much longer time period. Furthermore, these adverse real economy and employment effects have been seen right across the globe, including in economies far removed geographically from the North Atlantic. For example, Japan, which had little exposure to sub-prime loans, has experienced a deep recession, and China's economy slowed sharply before substantial monetary and fiscal stimulus was injected. The global reach of the recession that followed the GFC is highlighted by the fact that 2009 was the first year in which global GDP fell since World War II.

The severe adverse real economy and employment effects of the GFC are likely to continue for some years yet, especially in the major advanced economies. On the latest available data (June quarter 2010), real GDP in the United States, in the euro area and in Japan remain below their pre crisis levels. In addition, unemployment rates in the United States and the euro area are still close to 10 per cent -- well above any plausible estimates of the unemployment rate consistent with full-employment in those economies.