

Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Budget Estimates

1 June – 3 June 2010

Question: BET 348

Topic: Inflation Forecasts – Treasury & the RBA

Hansard Page: Written

Senator EGGLESTON asked:

1. I note that your forecasts for inflation are more sanguine than those of the Reserve Bank of Australia in its Statement on Monetary Policy. The Treasury have forecast inflation to return to 2.5 per cent by 2010-11. Whereas, the RBA has forecast both CPI and underlying inflation to be above this amount and to settle at 3 per cent in 2012. Given that the RBA's inflation forecasts now incorporate assumptions about the future path of monetary policy in response to expected inflation, does the Treasury believe that the interest rates will be higher than that expected by the RBA?
2. The currency has depreciated significantly since the Budget was handed down. Would a lower value of the Australian be expected to change these inflation forecasts?
3. The Australian dollar depreciated by over 10% over the past few weeks. Although other currencies of resource rich countries have also fallen, the Australian dollar has fallen by about double these currencies with respect to the United State dollar.
 - a) In your view, what are the factors impacting on this fall in the Australian dollar?
 - b) What are the likely effects on the budget of a lower exchange rate?

Answer:

1. It is a long-standing practice that members of the Government respect the independence of the RBA. Therefore the Government does not comment on the future direction of interest rates.
2.
 - A higher exchange rate influences prices faced by Australian consumers directly through imported retail goods and indirectly through imported components used by Australian producers of consumer goods.
 - Recent studies find that the pass-through of changes in the exchange rate to consumer prices in Australia occurs very slowly and is often difficult to detect,

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with the long-run impact of a sustained rise in import prices on consumer prices in Australia estimated to be quite small.

- Moreover, the inflationary impact of any movement in the exchange rate will depend on whether it is sustained, with most Australian businesses likely to look through short-term volatility when setting their retail prices.

3a.

- There are always a number of factors impacting on the Australian dollar at any point in time. The fundamental drivers of the Australian dollar include the outlook for the terms of trade (and therefore the health of the world economy) and interest rate differentials.
- For the period between 30 April to 3 June 2010, the Australian dollar depreciated by nearly 9 per cent against the US dollar. The decline of the Australian dollar during this period reflected heightened anxiety about the outlook for the global economy, driven by concerns over European sovereign debt and the potential overheating of the Chinese economy. As expectations regarding global growth were scaled back, this resulted in sharp movements in currency, equity and commodity markets. For example, between 30 April to 3 June 2010, the Commodity Research Bureau (CRB) index of commodities declined 8.2 per cent and the euro fell by more than 8.5 per cent – to reach its lowest level since April 2006.
- Domestically, expectations about the future movement of interest rates changed significantly over May 2010. As at 3 May 2010, financial markets were anticipating a cash rate close to 5.25 per cent by March 2011. By 20 May 2010 expectations about the cash rate had fallen, so that the market was anticipating a cash rate closer to 4.50 per cent.

3b.

- As one of the economic parameters that underpin the estimates and projections and flow through the forecast budget position, movements up or down in the exchange rate do impact on estimates of some receipts and payments. However, providing an estimate of what the effects on the budget would be if the exchange rate assumption was lower, and holding all other things equal, is unlikely to be meaningful. This is because macroeconomic variables are interrelated and do not move independently of each other.