Question: SBT 62

Topic: Currency Values

Senator Bushby asked:

(a) Are there risks that our current fiscal policy settings may put undue pressure on the exchange rate?

(b) What would be the outcomes for the Australian economy if we do not take pressure off the exchange rate?

(c) If the United Kingdom and the United States authorities continue to create vast amounts of new money, what will, or should in theory, happen to the value of those currencies?

Answer:

In relation to questions (a) and (b), the effects of fiscal policy settings on the exchange rate were addressed by Dr Henry in answer to a question at the Supplementary Budget Estimates hearings on 21 October 2010 (page E95 of the Hansard).

Senator BUSHBY—I had not noticed your arrival, Senator Faulkner, but I am enjoying having you here. The Treasury red book notes on page 4, in referring to the interaction between monetary policy and fiscal policy, that tighter fiscal policy and measures to boost labour force participation and productivity could play a useful role in complementing monetary policy, reducing the size of the required increases in interest rates and the exchange rate. Could you confirm that there is a trade-off between fiscal policy and monetary policy?

Dr Henry—It depends on the state of the economy. We have discussed this on numerous occasions in the past, I am sure you will recall, Senator. In an economy which is at some distance from full capacity, there is probably not a great deal of trade-off. That is to say, fiscal policy probably does not crowd out a lot of private sector activity and we were in that position not too long ago. But if an economy is close to full capacity then it is more likely that an expansionary fiscal policy—and, of course, that is not what is being envisaged by anybody—would to some extent crowd out some level of private sector activity because it would mean, other things equal, that interest rates would have to be higher. It would mean that the nominal exchange rate would be higher than it otherwise would be—indeed, the real exchange rate would be higher—and through those channels in particular there would be some crowding out of private sector activity.

We were also making the point that if an economy which is close to full capacity is experiencing a terms of trade shock then there is some trade-off between monetary and fiscal policy as well. An economy that is close to full capacity that experiences a positive terms of trade shock will have to have, some way or another, an increase in the real exchange rate. Fiscal policy will have an impact on the required size of the increase in the

real exchange rate and monetary policy will determine how much of that then comes through the nominal exchange rate and how much comes through domestic cost or domestic price level. So that, in a nutshell, is the sort of trade-off between fiscal and monetary policy that we were referring to.

Question (c):

When the monetary authorities of a country expand the money supply, this could be expected to cause a depreciation of the currency (other things equal).

In the circumstances faced by the UK and the US, an increase in the money supply could be expected to reduce the extent to which inflation falls by more than is desired by the Bank of England and the Federal Reserve. If this occurs then the nominal exchange rate would need to be lower than otherwise to maintain the same real exchange rate. The expectation of these outcomes would cause depreciation to occur ahead of the effect on prices.