Exchange Rates

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Multiple Choice

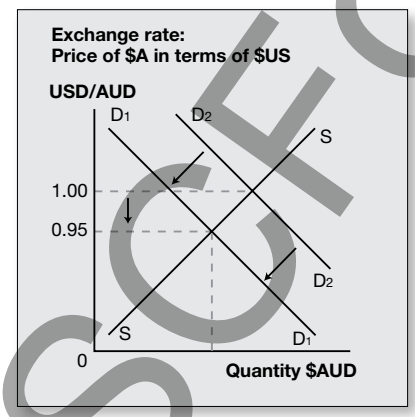
1	A	**6**	A	**11**	A	**16**	A
2	B	**7**	C	**12**	D	**17**	B
3	C	**8**	C	**13**	B	**18**	D
4	A	**9**	B	**14**	D	**19**	A
5	B	**10**	B	**15**	C	**20**	C

Short Answers

Question 1

(a) The price of one currency in terms of another

(b)



(c) The decrease in demand for Australian dollars could have been caused by the Reserve Bank of Australia decreasing interest rates relative to the rest of the world. This would make investments in the Australian dollar less attractive to speculative investors and would therefore reduce demand for the Australian dollar.

(d) In the long run, this would increase global demand for Australian exports, which would be paid for in Australian dollars. This would increase the demand for AUD, leading to an appreciation.

(e) A depreciation of the Australian dollar has mixed impacts upon the different components of the balance of payments over time. In the short term, a depreciation would increase the Australian dollar price of imports, increasing import expenditure and worsening the balance on goods and services. However in the long run, the lower Australian dollar should decrease the foreign currency price of Australian exports. This leads to an increase in demand for exports,improving the balance on goods and services. Also, the higher price of imports should encourage consumers to switch to domestic substitutes, lowering import expenditure and improving the balance on goods and services. On the other hand, a depreciation would increase the Australian dollar value of foreign debt denominated in foreign currencies, increasing the value of servicing costs on the net primary income account and worsening the current account. Against this, the Australian dollar value of income earned on foreign investments will increase, improving the net primary income account. While the overall impacts on the current account are complex, a depreciation should see the balance on goods and services improve, and the net primary income account worsen. A depreciation would also make it cheaper for overseas investors to invest in Australian firms, leading to an increase in direct investment inflows and increasing the surplus on the financial account.

Question 2

(a) A bilateral exchange rate measures the price of the Australian dollar in terms of another currency – for example, the United States dollar or the Euro. In contrast, the trade weighted index measures the value of the Australian dollar against a 'basket' of currencies of Australia's major trading partners, weighted according to their share of Australia's trade.

(b) The major advantage of the trade weighted index is that it gives a more accurate illustration of changes in the value of the Australian dollar against all currencies in general. However, a disadvantage of the TWI is that it is weighted according to volumes of trade with different countries, not the currency in which trade takes place. This underestimates the importance of the US dollar exchange rate since Australia often trades goods and services with other countries in US dollar prices.

(c) The Australian dollar fell sharply during the global financial crisis in 2008, from a peak of US95c in mid-2008 to a low of US65c in late 2008. The Australian dollar appreciated between 2009 and 2011, remaining above parity with the US dollar between early 2011 and early 2012, reaching a peak of US$1.10 in mid-2011.

(d) The most important factor influencing the trend appreciation in the Australian dollar during the past decade has been the historically large increase in the terms of trade. The Australian dollar's value has also increased because interest rates elsewhere have fallen much further than in Australia, creating a higher interest rate differential with the rest of the world. This meant that not only were overseas speculators investing in Australian financial assets were able to benefit from a rising currency, but they also received higher interest returns. The rapid depreciation of the Australian dollar in 2008 reflected the impact of the global financial crisis as investors retreated to the US dollar amidst uncertainty. Between 2009 and 2011, the Australian dollar experienced a prolonged appreciation, largely owing to Australia's rising terms of trade, a strong economic recovery in Australia's major export markets in China and East Asia and a large interest rate differential between Australia and financial markets in the US and Europe.

Question 3

(a) The market equilibrium is given by the intersection of demand and supply, where $A =$US0.90.

(b) Under a floating exchange rate, the value of an economy's exchange rate is determined by the equilibrium of demand and supply in the foreign exchange market, independent of government intervention. However, under a fixed exchange rate the central bank fixes the value of the economy's currency.

(c) One benefit of a fixed exchange rate system is that it reduces exchange rate volatility. A stable exchange rate provides greater certainty for businesses that are looking to engage in overseas transactions. It means that they will not be exposed to the risk of exchange rate fluctuations if they enter into foreign financial, trade or investment contracts.

(d) At US80c the exchange rate is undervalued. The demand for Australian dollars exceeds the supply of Australian dollars. To bridge this gap, the central bank could intervene directly by selling Australian dollars (Q1 to Q2) in the foreign exchange market and buying foreign exchange reserves, putting downward pressure on the equilibrium exchange rate.

(e) The Reserve Bank can influence the value of the Australian dollar directly or indirectly. If the Australian dollar is experiencing excessive volatility, the Reserve Bank may intervene directly by buying or selling Australian dollars to affect the value of the currency. This is known as 'dirtying the float'. However, the size of the Reserve Bank's foreign exchange reserves is relatively small, and this type of intervention is generally done only in response to extreme exchange rate movements, such as the depreciation to $US0.48 in April 2001. The Reserve Bank may also affect the exchange rate indirectly by changing the level of interest rates in Australia through monetary policy. A change in domestic interest rates alters the interest rate differential between Australia and the rest of the world. If the Reserve Bank increased interest rates, this makes Australia a relatively more attractive investment destination. This would increase financial inflows into Australia, increasing demand for the Australian dollar, causing an appreciation.

Class Activity

Increase in demand,	Appreciation
Increase in demand/Decrease in supply,	Appreciation
Increase in demand/Decrease in supply,	Appreciation
Increase in supply,	Depreciation
Decrease in supply,	Appreciation
Increase in supply,	Depreciation
Increase in demand,	Appreciation
Decrease in supply,	Appreciation
Increase in demand,	Appreciation
Increase in supply,	Depreciation
Increase in supply,	Depreciation
Decrease in demand/Increase in supply,	Depreciation
Increase in demand,	Appreciation
Decrease in demand/Increase in supply	Depreciation

Skills Revision

Diagram 1:

- The central bank would sell $A and buy FOREX reserves to lower the equilibrium price to $US0.70. This is illustrated by a rightward shift of the supply curve to give an equilibrium at $US0.70.
- The central bank would be accumulating FOREX reserves.
- An undervalued exchange rate has the benefit of improving the international competitiveness of exports, but it makes imports relatively more expensive, adding to inflationary pressures. Also, NPI may deteriorate as interest payments on foreign loans increase in $A terms

Diagram 2:

- The central bank would buy $A and sell FOREX reserves to increase the equilibrium price to $US0.90. This is illustrated by a rightward shift of the demand curve to give an equilibrium at $US0.90.
- The central bank would be depleting its FOREX reserves.
- An overvalued exchange rate has the effect of making imports relatively cheaper, reducing inflationary pressures, but it worsens export competitiveness. Also, NPI may improve as interest payments on foreign loans decrease in $A terms