

MULTIPLE CHOICE

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

SHORT ANSWER QUESTIONS**Question 1**

- (a)** An exchange rate is the value of one country's currency expressed in terms of another country's currency.
- (b)** An appreciation.
- (c)** An answer to this question may include any two of the following:
- A decrease in demand for imports
 - A decrease in the level of capital outflows from Australia
 - A decrease in Australia's interest repayments to overseas
 - Speculators' belief that the Australian dollar is about to appreciate
- (d)** An answer to this question may include any two of the following:
- Firms or individuals who import or export goods and services
 - Foreign investors
 - Government central banks which conduct currency transactions
 - Speculators
- (e)** The RBA could directly influence the exchange rate by entering the market as a buyer or seller of Australian dollars, known as "dirtying the float". By selling foreign reserves to buy AUD, for instance, it could offset a rapid depreciation. The RBA could also indirectly influence the exchange rate by raising interest rates. This would encourage foreign investment inflows, increasing demand for the AUD and leading to an appreciation.

Question 2

- (a) An example of a bilateral exchange rate is the value of the Australian dollar in terms of US dollars (AUD/USD exchange rate).
- (b) A bilateral exchange rate measures the value of a country's currency in terms of only one other country's currency. In contrast, the Trade Weighted Index measures the value of the Australian dollar against a basket of other currencies, weighted according to their importance in trade.
- (c) Under financial market deregulation, the AUD became a floating currency, increasing its volatility due to increased speculation. A floating exchange rate together with an increase in financial inflows and outflows means that the value of the Australian dollar better reflects the forces of demand and supply.
- (e) The AUD reached a trough in 2001 due to a global downturn. Foreign investment flows slowed throughout the world and demand for Australian commodity exports as inputs to production fell as global production slowed. The AUD has appreciated in recent years, staying above \$US0.75 over 2005 and 2006 and appreciating in 2007 due to a commodity price boom, which stimulated demand for the AUD. Australia's high interest rates compared to the US has also created increased demand for the AUD through foreign investors. As speculators heavily influence the value of the AUD, its recent appreciation indicates some confidence in the Australian economy's future performance.

Question 3

- (a) An appreciation is an increase in the value of a country's currency in terms of another country's currency.
- (b) To purchase Australian exports, overseas buyers must convert their currency into Australian dollars. Increased export sales creates demand for the Australian dollar, leading to an appreciation.
- (c) Exchange rate movements change the AUD prices of imported goods and services. A depreciation will create inflationary pressure because it will make imports relatively more expensive, which may trigger cost-push inflation because Australia imports many capital goods used in production. An appreciation will have the reverse effect.
- (d) A depreciation will make Australian exports more affordable for overseas buyers, while demand for imports will fall as they become relatively more expensive, improving the BOGS component of the CAD. A depreciation increases the size of Australia's foreign debt and servicing payments as Australia's foreign debt is largely valued in foreign currency terms. Increased servicing payments worsen the net incomes component of the CAD. A depreciation will make Australia a cheaper place to invest, increasing the capital and financial account surplus and worsening the CAD.