Exchange Rates

5

Multiple Choice Answers

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

Short Answer Questions

Question 1

a) An exchange rate is the price of one economy's currency in terms of another.

b) Appreciation

c) The diagram shows a decrease in supply which indicates a decrease in outflows of money from Australia. This could be caused by a decrease in Australian imports, which means that fewer Australian dollars are being exchanged for overseas currency, resulting in a decrease in supply of the Australian dollar in the FOREX market.

d) An improvement in export competitiveness should result in an increase in Australia's exports to overseas. This would increase demand for the Australian dollar, resulting in an appreciation of the dollar.

e) The Reserve Bank can influence the Australian dollar directly or indirectly. If the Australian dollar is experiencing 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. A change in domestic interest rates alters the interest differential between Australia and the rest of the world. If the Reserve Bank increased interest rates, the interest differential would widen, making Australia a more attractive investment destination. This would increase financial inflows into Australia, increasing demand for the Australian dollar, causing an appreciation.

Question 2

a) The Trade Weighted Index is a multilateral measure of the performance of the Australian dollar against a basket of currencies, weighted according to their importance to Australian trade.

b) The table shows that the Australian dollar has experienced a general depreciation both against the $US and the Trade Weighted Index (TWI) since it was floated. The Australian dollar has also moved in a volatile fashion against the $US. In particular, between 2001-02 and 2007-08 the Australian dollar experienced a substantial appreciation of almost 80 per cent against the $US. However, the Australian dollar has generally been less volatile when measured by the TWI, experiencing only a 40 per cent appreciation between 2001-02 and 2007-08.

c) An increase in Australian interest rates would increase the interest differential between Australia and the rest of the world, making Australia a more attractive investment destination. This would increase financial inflows, increasing demand for the Australian dollar and causing an appreciation.

d) A depreciation of the Australian dollar would have mixed impacts upon the different components of the balance of payments. In the short term, contracts for imports and exports are fixed, which prevents any change in the volume of exports and imports. However, the depreciation would increase the Australian dollar price of imports, increasing the cost of import expenditure, worsening the balance on goods and services. However, in the long run, the lower Australian dollar will decrease the foreign currency price of Australian exports, leading to an increase in demand for exports and an increase in export volumes, improving the balance on goods and services. Also, the higher price of imports would encourage consumers to switch to domestic substitutes, lowering import expenditure and improving the balance on goods and services. A depreciation would also increase the Australian dollar value of foreign debt denominated in foreign currencies, increasing the value of servicing costs on the net income account and worsening the current account. Hence, while the balance on goods and services may improve, the net income account is likely to 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 3

a) Fixed exchange rate.

b) The central bank would need to increase the supply of Australian dollars to ensure that equilibrium is achieved at $0.70. The central bank would sell Australian dollars and buy foreign exchange.

c) Changes in domestic and international interest rates affect the interest differential between Australia and the rest of the world. Australia tends to have interest rates that are higher than the rest of the world, reflecting the risk of holding Australian dollars. An increase in Australian interest rates, or a decrease in international interest rates would widen the interest differential. This would increase financial inflows into Australia, increasing demand for the Australian dollar and causing an appreciation. Conversely, a decrease in Australian interest rates, or an increase in international interest rates would narrow the interest differential. This would increase financial outflows from Australia, increasing supply of the Australian dollar and causing a depreciation.

d) A volatile Australian dollar affects trade and financial flows between Australia and the rest of the world. A volatile dollar is likely to cause extreme variation in export revenues. A sharp appreciation would cause a decrease in export revenues and a decrease in economic growth, whilst a sharp depreciation would increase export revenues and increase growth. A volatile dollar can also result in changes in import prices, leading to a higher inflation rate during periods of appreciation as the price of imports rises, increasing imported inflation. A volatile dollar is also likely to decrease foreign direct investment into Australia due to the uncertainty over the future value of the investment. Australia is particularly reliant on overseas financing for its investment, due to a low level of national savings, and so a decrease in direct investment inflows would lower economic growth levels. However, volatility in the Australian dollar is likely to encourage more speculation on Australia's financial markets due to the possibility of large changes in the value of the currency.

© Leading Edge Education | www.leadingedge.com.au

Class Activity

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

Skills Revision

Diagram 1:

- The central bank would sell $A and buy FOREX 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.

Diagram 2:

- The central bank would buy $A and sell FOREX 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.