**EXCHANGE RATES IN-CLASS ESSAY ANSWER OUTLINE 2021**

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| 1. Answer should include the following:  * Definition of exchange rates and depreciation. * D/S diagram should be drawn correctly and fully labelled with the vertical axis labelled ‘Price of $A in $US’ and horizontal axis ‘Quantity of $A’. * Demonstration of a movement of the **demand curve** and the impact that would have on the $A either way. * Demonstration of a movement of the **supply curve** and the impact that would have on the $A either way. * Written description of what the diagram is showing and how the movements lead to changes in the $A. * Possible causes of the appreciation: * Increased demand for our X from China as their growth rate has improved. * Increased foreign investment due to interest rate differentiation. Bond rates compare favourably with other countries. * Increased price of commodities of our major exports, particularly iron ore. * Growth forecasts for Australia have been revised upwards. * Favourable movement in the Terms of Trade in recent months. * Australia’s Current Account Surplus may suggest increased confidence in the Australian economy. * Australia being relatively ‘covid-free’ and now introducing vaccines suggests an increase in both business and consumer confidence. * Diagram showing an increase in Demand for $A. | 1 mark  1 mark  1 mark  1 mark  2 marks  4 marks  2 marks |
| 1. Likely effects of an appreciation of the $A:  * X income falls immediately. Most trade agreements are denominated in foreign currencies such as the USD, so payments in forex immediately exchange into less $A. The CAD worsens. * A number of Australia’s exports (commodities/resources) are price inelastic in demand. In general, this implies increased revenue to these export industries in the short run, as demand is relatively unchanged. The CAD improves. * Overall, Exports become more expensive in foreign currencies. Australia is now less competitive. Foreign demand for X falls, especially ETMs and services. The CAD worsens. * Imports are less expensive. Australian demand for imports rises, there is less of a stimulus for M-competing industries which have a competitive disadvantage due to appreciation. The CAD worsens. * The Terms of Trade tends to improve, particularly in the short run. The CAD improves. * An appreciating $A will cause the size of the foreign debt to be repaid in a foreign currency to be revalued down. The CAD improves. * Interest payments on foreign debt are also revalued down with an appreciation. The CAD improves. * Overall, in the short run, the CAD improves due to the inelastic nature of demand for our X and M. In the long run, the CAD deteriorates due to a decline in competitiveness. This can also be described as the ‘Reverse J-Curve Effect’. | 6 points:  6 marks  Explanation:  2 marks |