## Practice Test

**Question 1 20 marks**

*Answer both parts of the question*

*Between March 2014 and March 2015, the Australian dollar fell from $0.92USD to $0.76USD.*

1. Use an exchange rate model to explain why the currency fell during this time period. (10 marks)

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b. Explain the effects a significant appreciation will have on the economy. (10 marks)

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**Marking Key**

**Question 1 (20 marks)**

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| a. Should discuss at least 3 factors for the fall in the $A   * falling commodity prices (e.g. iron ore & coal) have decreased the demand for $A * slowing Chinese economy has reduced demand for Australia’s exports reducing the demand for $A * interest rates in Australia have fallen, reducing the i/r differential, reducing capital inflow into Australia & decreasing the demand for $A * weakness of the Australian economy has reduced foreign investment into Australia * strength of the $US due to improving US economy * correctly labeled diagram showing a decrease in D($A) causing the exchange rate to fall in value against the $US | Can be flexible - up to 8 marks for 3 factors in detail  Or 4 factors x 2 marks  1-2 marks |
| b. Effects of the –**appreciation**!  1. Effects on the trade account – app will raise price of Australian exports to overseas buyers & decrease the price of imported goods & services to Australian buyers. This will make Australian goods & services less competitive – eventually reducing export income & increasing import payments. This should decrease the trade balance over time, however, there may be a lag. Initially the trade balance may increase if exports/imports are inelastic. | 1-5 marks |
| 2. Other macro effects  A appreciation will have an contractionary effect on the economy – the AD curve will shift to the left because net Xs are decreasing. At the same time domestic firms that compete with imports become less competitive & decrease sales – this should help to increase unemployment & lower real GDP  A appreciation will not help to rebalance the economy away from mining & expand other sectors of the economy.  An appreciation is likely to decrease inflation since price of imported goods & services will decrease causing the CPI to decrease | 1-3 marks  1 mark  1 mark |