Section A: Multiple Choice Questions

(2012:08)

1.

Consider a change in the exchange rate from US$1 = A$1 to US$1 = A$0.95. The **most** likely cause of this change is

(a) a reduction in interest rates in Australia.

(b) higher inflation in Australia than in the United States.

(c) a rise in commodity prices.

(d) strong productivity growth in the United States.

(2013:10)

2.

If Australia experienced a significant appreciation in the value of its currency, likely effects would include

(i) a loss of competitiveness for domestic import competing firms.
(ii) an increase in interest servicing costs on foreign debt.
(iii) an increase in foreign capital inflow as it becomes cheaper to invest in Australia.
(iv) a fall in the number of Australian tourists travelling overseas.

(a) (i)

(b) (i), (ii) and (iii)

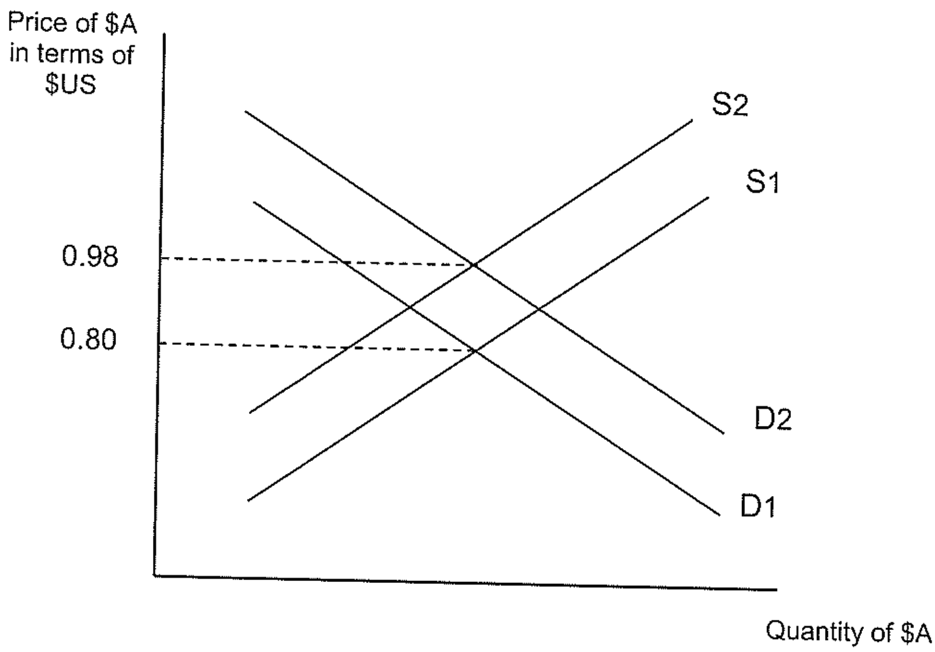
(c) (ii) and (iv)

(d) (i) and (iv)

3.

(2014:06)

This question refers to the diagram below.



Assuming a floating exchange rate, which of the following may have caused the value of the Australian dollar to change from $US0.80 to $US0.98?

(a) an increase in Australian interest rates and a decrease in imports into Australia

(b) an increase in Australian interest rates and an increase in imports into Australia

(c) a decrease in the interest rate differential between Australia and the United States

(d) a decrease in Australian interest rates and an increase in the prices of Australian exports

4.

(2014:10)

When the value of the Australian dollar increases this benefits

(a) exporters of Australian made cars.

(b) Australians investing overseas.

(c) farmers and rural regions that rely on export markets.

(d) foreign investors wanting to buy Australian assets.

5.

(2016:01)

A depreciation of the Australian dollar will **most** likely result in

(a) an increase in import prices in terms of the Australian dollar.

(b) a decline in exports of goods and services.

(c) making it harder for Australian firms to compete with imports.

(d) a fall in domestic prices.

(2016:03)

6.

If over a period of six months the value of the Australian dollar appreciates from $US0.69 to $US0.75, then, all things being equal, the **most** likely consequence will be

(a) an increased competitiveness of Australia's exports to Japan.

(b) a decrease in inflationary pressures in Australia.

(c) more expensive imports from Japan.

(d) an increase in demand for Australia's exports to Japan.

(2016:12)

7.

In relation to Australia's Trade Weighted Index (TWI), which of the following is correct?

(a) The TWI is comprised only of the currencies of China, Japan and the United States.

(b) The TWI is based only upon Australia's merchandise goods trade.

(c) The TWI is based only upon Australia's services trade.

(d) The TWI weights its currencies according to the volume of trade between Australia and its trading partners.

(2017:10)

8.

Assume the following exchange rate: $1 AUD = $0.70 USD. What will be the cost in AUD of an imported American aircraft valued at $1.5 million USD? (Round your answer to the nearest $100 000.)

(a) $1.1 million

(b) $1.5 million

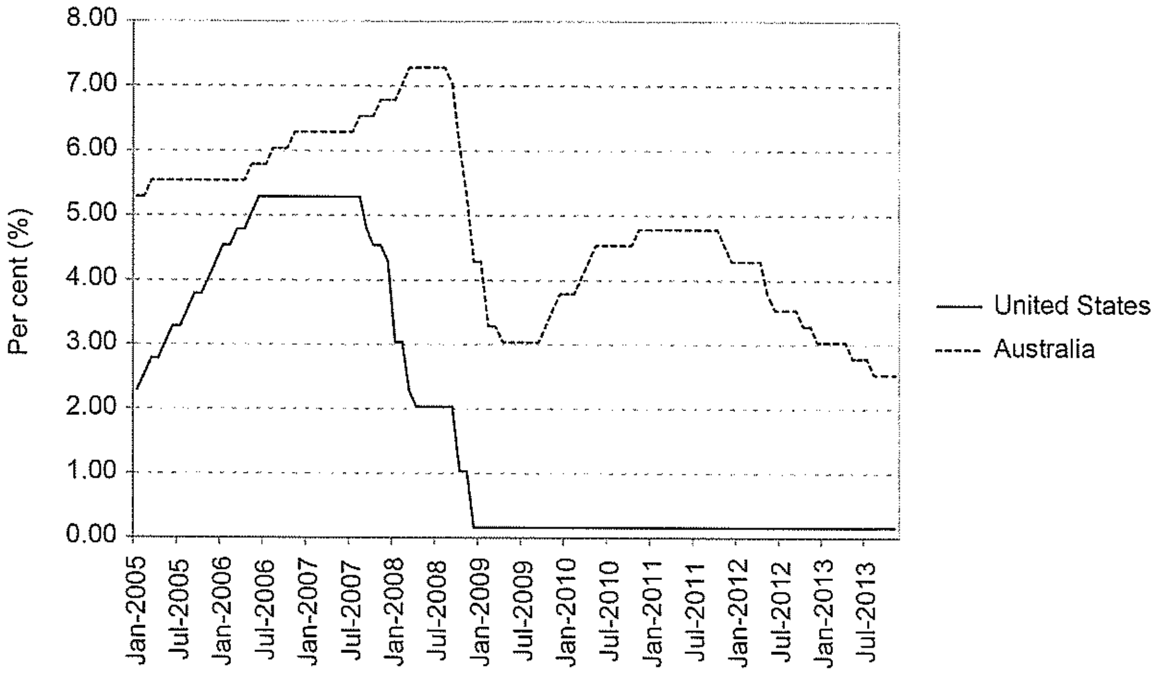
(c) $2.1 million

(d) $2.5 million

Section B: Data Interpretation Questions

1. [12 marks] *(2014:25)*

Official interest rates for Australia and the United States



(a) (i) What was the interest rate differential between Australia and the United States in March 2007? [1]

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(ii) Judging by the graph above, what phase of the business cycle was Australia in during early 2010? [1]

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(b) Explain what effect the interest rate changes in Australia and the United States from January 2012 onward would have had on the Australia/United States dollar exchange rate and explain why. [4]

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(c) Discuss the likely effects on consumption and investment of the interest rate changes in Australia in 2012 and 2013. [6]

Section C: Extended Writing Questions

NOTE: Lined pages are provided for each extended answer in the WACE exam paper. At the end of this section you will find planning grids which you can use in the preparation of a good extended writing answer.

1.

(2012:30)

From January 2009 to January 2012, the Australian dollar appreciated from US$0.64 to US$1.08.

(a) Using diagrams, illustrate and describe the **three** main causes of this appreciation of the Australian dollar. [8]

(b) Discuss the effects this appreciation is likely to have had on trade, foreign investment and the macro economy. [12]

2.

(2013:28)

(a) From early 2012 to mid 2013, the Australian dollar was strong against most other major currencies. Using examples, describe the impact this had on the Australian economy. [10]

(b) Explain why the value of the Australian dollar remained relatively strong in the second half of 2012, a period that saw a significant fall in commodity prices. [10]

3.

(2015:28)

From January 2013 to January 2015, the Australian dollar depreciated against some of its major trading partners.

(a) Using an appropriate diagram, outline the factors that may have caused this movement in Australia's exchange rate. [8]

(b) Discuss the effects of this movement in the exchange rate on international trade, businesses and Australia's macro economy. [12]

4.

(2017:29)

From February 2016 to February 2017, the Australian trade weighted index (TWI) changed from 61.30 to 65.70.

(a) Explain how the trade weighted index is calculated and, using a diagram(s), demonstrate and describe **two** causes of this change. [10]

(b) Discuss the likely effect of this movement in the trade weighted index on the Australian economy. [10]

Chapter 7: Exchange Rates

Section A: Multiple Choice Questions

1.(2012:08c) The way the exchange rate is quoted in the question is not how is normally given. This represents an appreciation or rise in the value of the AUD. The rise in the AUD is strongly linked with the rise in commodity prices.
2.(2013:10a) An increase in the value of the AUD make imports cheaper and, therefore, reduces the relative competitiveness of Australian producers of these products. The other options are incorrect.
3.(2014:06a) An increase in Australian interest rates shifts demand for AUD from D1 to D2. A fall in imports decreases the supply of AUD from S1 to S2.
4.(2014:10b) The AUD buys more in overseas markets. The foreign currency flow earned from the investment will be reduced, however.
5.(2016:01a) A fall in the exchange rate leads to imported cost-push inflation.
6.(2016:03b) A rise in the exchange rate reduces the price of imports.
7.(2016:12d) In 2016, the TWI was a trade-weighted index including 19 different currencies. These currencies financed about 90% of Australia's international trade.
8.(2017:10c) Work out the number of AUD for each USD (about 1.42) and multiply by 1.5b.

Section B: Data Interpretation Questions

1.(2014:25) (a) (i) 1% (Australian rate = 6.25%, US rate = 5.25%); (ii) Recovery or upswing—cash rate is rising towards a neutral level.

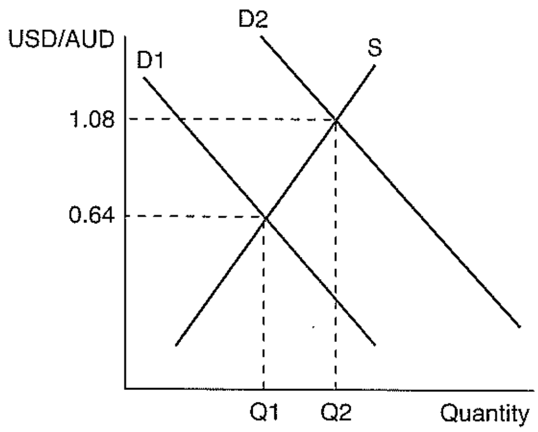
(b) The interest rate differential was falling (from 4% to 2.5%). Normally this would lead to a fall in the value of the Australian Dollar as investors switch some portfolio foreign investment from Australia to the US. This can be shown on a standard exchange rate diagram similar to the diagram provided for Question 2014:06. However, other factors were affecting the demand and supply for the currency at the same time, such as commodity export prices (which had started to fall), the relative strength of the Australian and US economies and investors perception of risk.

(c) Cash rates fell from 4.25% to 2.5% during this period. Normally a fall in cash rates causes a rise in consumption because saving is less rewarding and rising asset prices may be increasing household wealth. However, the effect was quite weak as household and business confidence or expectations remained low due, for example, to government instability and the carbon and mining taxes. A fall in the cash rate would normally increase planned investment because it is now cheaper to raise investment finance. Draw an investment demand curve diagram to show this. However, as business confidence was low, planned investment was largely unresponsive to the fall in cash rates.

Households did, however, borrow more to finance housing investment. The weak response of both consumption and planned investment to the cut in cash rates is consistent with a long outside or effect lag of monetary policy in a slump or early stages of a recovery.

Section C: Extended Writing Questions

1.(2012:30) (a) Draw DD/SS diagram to show an appreciation of exchange rate. Demand for AUD depends on exports, income inflows and foreign investment inflows. Supply of AUD depends on imports, income outflows and foreign investment outflows.



Three main reasons for the rise in demand for AUD are:

(i) Interest rate differentials (Australian interest rates have been relatively high compared to those in other economies)

(ii) Commodity price rises/higher terms of trade (profitable opportunities attract foreign investment)

(iii) Fundamental strength of the economy (Australia is a safe place for investment given AAA rated banks, and low sovereign debt)

(b) Effects of the appreciation include:
(i) It is harder for service and manufacturing sectors of the economy to sell exports

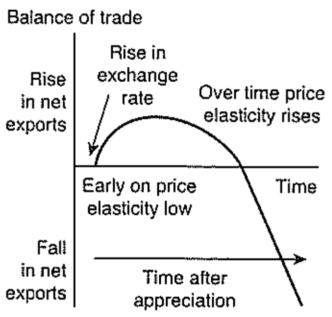
(ii) It is more attractive for domestic consumers to buy imported manufactured goods (such as cars, electrical goods)

(iii) Assets become more expensive for overseas buyers. But profits in mining sector might offset extra cost.

(iv) A high AUD creates unbalanced growth (a two-speed or patchwork economy) with sectors like mining coping well because they are highly competitive and sectors such as services and manufacturing doing less well.

(v) The rise in the AUD contributes to structural change in the pattern of production and leads to structural unemployment.

(vi) The high AUD reduces inflationary pressure (both imported cost-push and demand-pull).



Following a rise in the exchange rate the balance of trade may improve for a little while as the response to the price changes caused by the exchange rate appreciation will be small. The price elasticity of demand for imports and exports will be low.
However, as time passes, people react more the price changes. It becomes harder to sell exports and more attractive to buy imports. The sum of the price elasticities of demand for exports and imports will rise above 1 and the balance of trade will worsen.

2.(2013:28) (a) The impact of the strong Australian Dollar can be described in two ways, firstly by describing its impact on different sectors within the economy and secondly by looking at its impact on macroeconomic objectives.

Consumers benefitted from the strong dollar. For example, the price of imported products such as electrical goods and cars fell. Also producers that had to import capital equipment, such as oil rigs and trucks, experienced decreased costs.

However, exporters in manufacturing and rural industries became less competitive. For example, Australian wine became relatively expensive in overseas markets. Workers in these industries faced uncertain times as sales and hence production levels fell. For example, car workers were retrenched as car production fell.

On a macroeconomic level the strong dollar meant reduced inflation. For example, the rate of inflation for products traded internationally was actually negative during this period. There was deflation in the prices of traded goods and services. Although the mining boom led to strong growth in the mining states of WA and Queensland, the strong dollar held back growth and increased the level of unemployment in other states where manufacturing and rural production dominated. This led to unbalanced growth and the creation of a so-called 'two-speed' or 'patchwork' economy.

(b) There are three main medium-term factors that affect the value of the Australian Dollar. The first of these is the level of commodity prices, reflected in changes in the terms of trade. Other things being equal, there is a positive relationship between the terms of trade and the exchange rate value of the Australian Dollar. But during the first half of 2013 the dollar stayed strong despite a fall in the terms of trade.

This was because other factors were supporting the dollar. The first of these other factors was the difference between Australian interest rates and interest rates in other countries. Australian rates were sufficiently above overseas rates to encourage an inflow of foreign investment and hence demand for our dollar.

The second factor supporting the dollar was the relative fundamental strength of the economy. While US, Europe and Japan experienced various economic problems (e.g. debt issues, recession) Australia's growth performance was relatively strong and underpinned by a strong banking sector and low levels of sovereign debt.

Finally, several other countries were engaged in what became known as 'currency wars', aiming to keep the value of their currencies down as a way of combatting their slow growth and high unemployment. US, the Eurozone, UK, Japan and China used policies such as quantitative easing, zero interest rate policies, credit easing and forward guidance in an attempt to 'out-depreciate' each other. Australia did not use any of these measures and as a consequence the dollar remained strong at least until May/June 2013.

3.(2015:28) (a) The depreciation of the exchange rate was linked with:

(i) A fall in commodity prices and the terms of trade. The AUD is considered to be a commodity currency.

(ii) The fall in Australian interest rates towards the end of the time period stated in the question. The change in relative interest rates has an effect on net foreign investment inflows.

(iii) People expected the exchange rate would fall. The Reserve Bank tried to talk the exchange rate down by indicating it thought that the rate was overvalued.

(iv) Poor performance of the Australian economy and the difficulty economic managers faced in their attempts to bring the budget back to surplus and introduce economic reform measures.

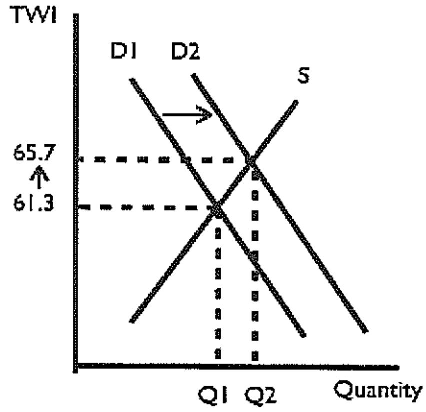
(b) The depreciation should encourage exports by reducing the price of exports in overseas markets and increasing the price of imports into Australia. The impact on the trade balance depends on the price elasticity of demand for exports and imports. If the sum of the elasticities is greater than one the trade deficit will narrow. Other factors e.g. slowdown in Chinese growth make it difficult to isolate the effect of the exchange rate.

The effect on business will depend on whether products are priced in US dollars or AU dollars. Commodities are often priced in US dollars so the fall in the exchange rate affects the AUD value of earnings rather than the volume of sales. Other businesses such as those in niche manufacturing markets or traded services such as tourism and education will benefit from the lower dollar. Businesses that import machinery or components will have to pay more for these.

The macro-economy should, other things being equal, benefit from a lower dollar in terms of higher growth and employment, but suffer from higher inflation. There will be structural change in the economy as demand for our exports recovers.

4.(2017:29) (a) The trade-weighted exchange rate is a weighted average of its bilateral exchange rates with our major trading partners, expressed as an index number. The weights used for each currency reflect the amount of trade undertaken by Australia with each country. The trade weighted index (TWI) is known as its effective exchange rate. For example, if Australia's TWI is 65.7, the weighted average of the bilateral exchange rates for Australia's 19 biggest trading partners is 65.7% of its value in May 1970, the current base year for the calculation of the index.

The exchange rate value of the currency is determined by the demand and supply in foreign exchange markets. The diagram shows a rise in demand for the currency leading to a rise in the TWI from 61.3 to 65.7. Note the level of supply of the currency would change as well, and the model could be adapted to include this.



There are a number of factors that affect demand for, and supply of, the Australian Dollar. The main cause of the appreciation in the TWI was a rebound in commodity prices (such as iron ore and coal) and an improvement in the terms of trade. This rebound reflected a reduction in stock levels and a stabilisation and recovery in growth rates in a number of countries, including China, South Korea, Europe and the US.

The rise in demand was tempered by a narrowing of the interest rate gap between Australia and the US, as a result of monetary policy tightening in the US.

Also demand was dampened by a rise in geopolitical tension, with the US dollar acting as a safe-haven currency in such times.

(b) The appreciation of the exchange affects the economy in a number of ways. First it raises the price of exports in foreign currency terms making it harder to sell exports such as manufactured goods (such as medical equipment and aircraft parts) and services (such as education and tourism). A number of commodity exports are priced in US dollars so, while the price is unaffected, the value of earnings from these markets is. The impact of a currency appreciation on the balance of trade depends on the combined price elasticity of demand for imports and exports which changes over time and may cause a reverse J-curve effect. If the level of net exports falls ther aggregate demand falls, growth falls and unemployment rises.

Secondly, a rise in the exchange rate reduces th value of Australia's foreign debt, because some o our debt liabilities are fixed in overseas currencies.

Thirdly a currency appreciation reduces the level of imported cost-push inflation, as a rise in the Australian Dollar reduces the AUD price of imports.

Chapter 8: Foreign Investment

Section A: Multiple Choice Questions

1.(2013:11b) A fall in savings, other things being equal, wi increase the size of the investment–savings gaps Additional overseas borrowing is a way of fillin this gap.

2.(2014:07b) A reduction in national savings in Australia increases the need to 'import' savings from othe countries.

3.(2015:02b) An inflow of finance where the level of ownership is less than 10% of the total.

4.(2015:08c) The question asks about a 'negative outflow' which presumably is an inflow. It is needed to close the investment–savings gap.

5.(2015:10c) Borrowing requires regular payments of interest.

6.(2015:11d) Government borrowing is reduced. Some of the borrowing might have been from overseas.

7.(2015:12a) Australia's net foreign debt rose during the GFC.

8.(2016:07b) Strictly speaking it is private sector debt caused by borrowing by the private sector, especially banks.

9.(2017:11d) The level of net foreign equity is small due to the value of Australian superannuation funds invested overseas. See chart in briefing section o Chapter 8.

10.(2017:12b) Foreign investment closes the investment-saving gap.

Section B: Data Interpretation Questions

1.(2012:25) (a) (i) about $600b; (ii) 2008

(b) Public sector = government sector. The Federal government ran a series of budget surpluses up to and including 2008. The exchange rate appreciated which reduced the value of debt borrowed in foreign currency. Some government revenue had been put into special funds (e.g. Future Fund) that reduced overall debt levels.

(c) Australia has a savings–investment gap. Savings are relatively low due to our relatively small population and (until recently) low household savings rate. We are 'capital starved'. Investment needs are relatively high. These are mineral and energy industries. We are 'resource rich'. Sustained growth requires an increase in