Faculty of Business and Economics
Department of Economics

ECON10003
Pre-Tutorial #10

Introductory Macroeconomics

Pre-Tutorial #10
Week Starting 17th May 2021

The Tutorial. This week's tutorial looks at exchange rates.

Note that your tutor is under no obligation to go through the answers to the pre-tutorial work in detail. The focus in the tutorial will be on the tutorial work itself – the questions here are preparatory.

Reading Guide. You should look carefully over lectures 19 and 20. You may also find Chapter 17 of BOFAH useful.

Key Concepts. Nominal exchange rates. Real exchange rates. Purchasing power parity. Fixed exchange rates.

Problems.

1. How would each of the following be likely to affect the value of the Australian dollar, all else being equal? Explain, using supply and demand analysis.
   (a) European computer firms switch from software produced in Australia to software produced outside of Australia.
   (b) The Australian government imposes a large tariff on imported automobiles.
   (c) Australian shares are perceived as becoming more risky.
   (d) Australian consumers increase their spending on imported goods.
   (e) The Reserve Bank reports that it is less concerned about inflation and more concerned about an impending recession in Australia.
2. What is the theory of purchasing power parity? What are some of the reasons for why this theory may not hold in the short run?
3. What does the theory of purchasing power parity predict will happen to the nominal exchange rate and the real exchange rate of a country that has a relatively low rate of inflation?
4. How does an increase in real interest rates affect the exchange rate? Describe how the change in interest rates affects the exchange rate using supply and demand analysis. How does this change in the exchange rate affect the macroeconomy? What is the mechanism responsible for this effect?
5. What is the policy trilemma in open economy macroeconomics? What goals are achievable under a flexible exchange rate? What goals are achievable under a fixed exchange rate without capital controls? What goals are achievable under a fixed exchange rate with capital controls? What have been some of the advantages of the adoption of a flexible exchange rate in the early 1980s by the Australian government?
6. Suppose the government decides to maintain a fixed exchange rate at a value that lies above the market equilibrium value of the exchange rate. What action does the government need to undertake to maintain such an exchange rate? What about if the value of the exchange rate lies below the market equilibrium value of the exchange rate?