

Exchange rates:

- An exchange rate is the price of one currency in terms of another.

Factors affecting the demand for Australian dollars

- demand for Australian exports, influenced by:
 1. Relative inflation rates
 2. changes in relative incomes
 3. tastes and preferences of overseas customers for Australian exports.
- Capital inflow - level of foreign investment, influenced by:
 - level of real interest rates
 - level of confidence in the Australian economy
- *Speculation* - based on *expectations*, which become self-fulfilling.

Factors affecting the supply of Australian dollars

- Demand for imports, influenced by
 1. relative inflation rates
 2. changes in relative incomes
 3. tastes and preferences of Australian consumers for overseas commodities.
- Capital outflow
- *speculation*

Determination

- fixed exchange rates 1930-1967 Bretton-Woods system
 - method: gold standard/gold exchange standard
 - £1 Aus = 113 grains of gold = £1 Stg
 - Price of gold was fixed at \$35US per oz.
- Advantage of the system:
 - CERTAINTY - the greatest advantage for contracts.
 - Promote trade
 - USA supplier
 - Europe - demander
- Main arguments for:
 - -would reduce exchange rate fluctuations of inter-war period and provide a new “dollar standard peg” for exchange rates following decline of UK and sterling.
 - - Dominance of %US aligned sensibly with US military dominance in defence of the West.
 - - Would enable governments to print more money easily as new noted did not require simple gold backing.
 - adjustment:
- how does the system cope with a country continually running balance of payments deficits?
 - Europe - importing too much, the economy will contract due to the outflow of money - unemployment.
 - The exchange rate was fixed and the adjustment occurred through domestic economic conditions.
 - Some attempts to allow European countries to pay for imports without leading to unemployment:
 - International Monetary Fund introduced the Gold Tranche (paper gold) and Special Drawing Rights (SDRs)

- Why Bretton-woods collapsed:
 - Worked best when USA dominated the world economy, but by late 1960s the resurgence of Europe and increasing competition from Japan challenged US hegemony
 - Encouraged countries to print more money as simple gold backing not required. Others, like France, stockpiled too much gold, claiming US the main beneficiary.
 - Vietnam war - Unpopularity forced US to finance the war by printing money and changing peg to \$38 = 1 oz gold. Other major countries responded by breaking the peg and floating their currencies.
 - Tension grew in the system. 1967-1972: currency chaos. UK devalued currency. Us retaliated. There were irregular large changes.

- Managed exchange rates: flexible pegs
 - *revaluation*: managed exchange rate value rises
 - *devaluation*: managed exchange rate value falls.
- two major features:
 - i) government sets exchange rates:
 - daily ‘small changes often’
 - removed the great volatility of exchange transactions
 - government examined a checklist in setting rate:
 - inflation rate
 - interest rates
 - unemployment
 - exchange rates of trading partners between themselves
 - *expectations*
 - government policy
 - ii) government, via RBA, guaranteed this exchange rate
 - RBA guaranteed to be the ‘other half’ of any transaction
 - Demand and supply analysis:
 - demand for Australian currency:
 - Australian exporters
 - Service credits eg tourists
 - Income credits
 - unrequited transfers
 - foreign capital inflow (speculators included)
 - supply of \$A:
 - Australian imports
 - service debits
 - income debits
 - unrequited transfer credits
 - foreign capital outflow
 - government was guaranteed to buy the other half of any transaction.
 - If exchange rate is set high, it will create excess supply. RBA will stand in the market to purchase this with foreign currency.
 - If the rate is set low - excess demand - the RBA sells this.

- Problems:
 - i) *speculation* - since government guarantees the rate, speculators can manipulate the government

- ii) effectiveness of monetary policy
 - situation of inflation
 - monetary policy attempts to reduce demand in economy by increasing interest rates and lowering the money supply
 - The RBA sells government bonds to achieve these objectives.
 - However, higher interest rates attract foreign capital inflow.
 - O/s sees higher interest rates in Australia
 - domestic borrowers are encouraged to go o/s for funds.
 - Ie creating a demand for AUD.
 - Government guarantees to supply AUD to meet demand
 - ie money supply increase
 - This is the reverse of the desired monetary policy action
- Floating exchange rates
 - *appreciation*: value of currency increase through market forces
 - *depreciation*: value of currency decrease through market forces
 - A currency floats to the extent that a country's central bank desists from pegging its price in foreign exchange markets. Ie. Not tied to gold or \$US.
- Main arguments for:
 - - Over time would reduce great trade imbalances between major powers as exchange rate movements encouraged capita and goods to move to where they most efficiently used.
 - - reduce importance of a nations gold holdings
 - - Force governments to free up other policy arms to enable freer flow of goods, capital and services.
- i) pure float, freely floating
 - The exchange rate is determined solely by the forces of supply and demand
 - There is no direct government influence on exchange rate (qualifications - 'smooth testing')
 - Some indirect influence is possible through the alteration of interest rates:
 - lower interest rates leads to lower capital inflow, lower demand and lower exchange rate.
 - Higher interest rates leads to higher capital inflow, higher demand and a higher exchange rate.
- (i) managed (dirty) float
 - A broadly floating exchange rate, though government stands in the market to buy-sell currency to support an exchange rate possibility through "intervention points"
- With a floating exchange rate, international currency changes have no impact on domestic money supply. Balance of Payments must balance.
- Similarly, monetary policy changes are not reduced by currency inflow/outflow (though exchange rate may change)
- Floating rates: History
 - 1973 major currencies floated against \$A
 - 1979 European Monetary System set up allowed 5% deviation from DM for most currencies.
 - 1985 & 1987 following sharp rises in %US, the Plaza and Louvre Accords agreed to a new policy of sharp and symmetrical interventions in the system to try and reduce fluctuations.
 - 1992-1993 EMS collapsed as sterling, the lira, then the franc floated out. Now allows 15%
 - 1994-1995: calls for a) return to Gold Standard or b) a new Bretton-Woods style system.

- Lessons from floating era:
 - Floating rates don't Eliminate serious currency fluctuations
 - Do not guarantee that other wages policies = eg. Wages and fiscal policy - will be adjusted accordingly
 - Do make small, commodity exporters more vulnerable to inflationary pressures
 - System not optimal.

- *Trade Weighted Index:*
 - method of quoting an exchange rate - an index of the value of the Australian dollar against a group of the currencies of Australia's major trading partners.
 - PIN (price index numbers)
 - - regimen
 - - weights
 - - collection of information
 - - base year/calculation.
 - $\text{Index} = (\text{Total of year } i \text{ consideration} / \text{total of base year})(100)$