**Describe the recent changes to the Australian exchange rate and their likely impact on the Australian economy. (20 marks)**

An exchange rate is the price of one currency expressed in terms of another currency or a group of currencies. For small, open economies such as Australia’s that actively engages in international trade, the exchange rate is a highly important economic variable. Movements in the exchange rate influences the decisions of individuals, businesses, and the government. The Australian economy has been impacted by several events, such as significant economic growth, the COVID-19 pandemic, and the US-China trade war. The exchange rate is an important mechanism for helping the Australian economy adjust to large economic events, having direct and indirect effects on the economy.

The exchange rate has been highly variable over the past 5 years, notably between our main trading partners. Between Australia and the United States, the AUD/USD exchange rate has maintained relatively stable (on average). In 2016, the average closing price was 0.74, 2017 was 0.77, 2018 was 0.75, 2019 was 0.70 and 2020 was 0.69. 2017 and 2018 are notable as the exchange rate reached its highest peak at 0.81. The AUD/USD exchange rate had depreciated steadily from about 0.80 in January 2018 to about 0.65 in February 2020. When the extent of the pandemic and the effect it would have on economies around the world became clear, the exchange rate depreciated rapidly to about 0.55c. However, as the economy recovered, the value of the Australian Dollar bounced back, appreciating by September 2020 to about 0.75c.

The exchange rate has not only been affected by the recession caused by the pandemic. Several significant economic events leading up to the pandemic took place. In the decade to 2011, there was a significant rise in global commodity prices that had resulted in an equally significant appreciation of the Australian dollar and a pickup in general price and wage inflation. Australia’s international competitiveness had been declining as production costs rose in comparison to those in other countries. Producers in non-mining areas of the economy that were exposed to foreign competition found it difficult to earn satisfactory profits.

Commodity prices had reached a peak in 2011, and the nominal exchange rate started to depreciate in March 2013. Inflation and wage costs began to fall back. The real TWI exchange rate depreciated by about 20% reversing roughly 35% of the appreciation in the mining investment boom period, leading to an improvement in Australia’s competitiveness. Although inflation in Australia had been relatively low since 2013, inflation was also low in most of Australia’s trading partners due to the slow absorption of spare capacity created during the global financial crisis. Between 2016 and 2020 recession, the value of the Australian dollar had closely following movements in the terms of trade and caused corresponding changes in Australia’s international competitiveness.

The US-China trade war began on the 6th of July 2018 with former US President Donald Trump announcing China specific tariffs valued at $34 billion USD. Actions taken out by both the US and China have compromised Australia’s economical position. The trade war has had significant impacts on Australia’s exports and imports, due to a currency depreciation. Due to the large number of Australian exports (30%) going to China worth ~$140bn AUD, the devaluation of China’s currency impacted significantly on Australia, decreasing the ASX (Australian Security Exchange) by $50bn AUD, impacting Australian exports as they became more expensive to import due to China’s weaker dollar.

Other things being equal, a weaker exchange rate will lead to an overall rise in aggregate demand resulting from a rise in net exports and a rise in foreign investment, offsetting a reduction in consumption due to a rise in the cost of living and a fall in aggregate supply due to a rise in the cost of imported capital equipment and intermediate goods. Our exchange rate became notably weak in the 2020 recession, dipping to 0.55c (AUD/USD).

A depreciation in our currency will affect three main macroeconomic objectives. Economic growth will become faster and will rise, assuming the shift in aggregate demand outweighs the shift in aggregate supply. Inflation will be impacted and see higher rates. Demand-pull and imported cost-push inflation will rise as a direct result of faster growth and higher import prices. Unemployment will see lower rates as demand deficiency unemployment will fall if growth increases. Structural unemployment may increase, however.

A depreciation in the Australian exchange rate will also have several impacts on different key sectors in our economy. The mining sector will see a rise in profits as their exports are usually priced in US dollars. However, imported capital equipment becomes increasingly expensive. The rural sector will also be impacted. Exports that are priced in Australian Dollars (for example wine, flowers) become more competitive in overseas markets. The impact on revenue is dependent on the price elasticity of demand for their products. As with the mining sector, any imported capital equipment becomes more expensive.

Mass-produced manufacturing will also see some impacts. Products (e.g., clothes) are priced in Australian Dollars and become more competitive, so exports may rise, and imports may fall. The price elasticity of demand for these products is likely to be relatively elastic, so export revenue will rise. Services will be impacted by a depreciation in the AUD. Exports (E.g., tourism, education) are priced in Australian Dollars, and as demand is likely to be relatively elastic, export revenue, ceteris paribus, will rise.