**Introduction**

* A **trade-weighted index** is a ‘basket’ of currencies weighted according to their importance in trade flows with Australia
* An **exchange rate** is the price of one country’s currency in terms of another country’s currency
* The foreign exchange market is the market in which the currencies of different countries are bought and sold
* Foreign exchange is the currency of another country that is needed to carry out international transactions
* The foreign exchange market between Australian dollars and United States consists of two groups of people – those demanding USD and those demanding AUD
* If the exchange rate increases (increases in value), it is an appreciation
* If the exchange rate decreases (decreases in value), it is a depreciation
* If the exchange rate is set too high, the Reserve Bank of that country will have to buy their currency with other currencies over time (fixed exchange rate – market clearance needed)
* If the exchange rate is set too low, the Reserve Bank of that country will have to sell their currency for other currencies over time (fixed exchange rate – market clearance needed)

**International Transactions**

* The demand for, and the supply of, a currency is determined by the international transactions that are recorded in the balance of payments
* All transactions that result in an inflow of money into the Australian economy, in both the current account and the capital and financial account, represent a demand for a country’s currency
* Transactions that result in an outflow of money on the other hand represent the supply of a country’s currency

**Freely Floating Exchange Rate**

* A floating or free exchange rate is one whose value is determined by the market forces of supply and demand – its value can change daily and even by the minute as it reflects changes in the demand and the supply of its currency
* The demand and supply of Australian dollars is shown in the diagram (p110) – the price axis measures the value of 1 AUD in US currency while the quantity axis measures the volume of Australian currency
* The equilibrium value in terms of US dollars in this example is 1 AUD = 0.75 USD
* **Floating exchange rate** – The equilibrium price will change whenever the demand or supply curves shift
* If the demand for Australian dollars increases because there is an increase in the demand for Australian exports or there was an increase of foreign investment into Australia, then the value of the AUD will rise
* This means that the AUD will appreciate against the USD
* Panel A shows the effect of the increase in demand for $A with the exchange rate appreciating to USD 0.76
* If there was an increase in the supply of Australian dollars, due to an increase in imports or increased Australian investment to overseas countries, then the value of the Australian dollar would decrease – it would depreciate against the USD
* Panel B in figure 6.3 shows the value of the Australian dollar has decreased to USD 0.74
* As long as the value of the AUD is allowed to move in accordance with shifts in demand supply, then it is a free or floating exchange rate
* When the currency is allowed to float free from the interference of the central bank (In Australia, the Reserve Bank) then it is referred to as a ‘clean float’
* A managed exchange rate occurs whenever there is official intervention in the foreign exchange market by the Reserve Bank – the RBA can act as either a buyer or a seller of the currency, indirectly influencing its rate through the market system
* E.g., the RBA wanted to prevent the exchange rate from falling to too low a level, it would enter the market as a buyer of AUD and use its reserves of foreign exchange to bid up the price
* Conversely if the Bank wished to stop the currency from appreciating, it would sell Australian dollars, increasing the supply and hence reducing any upward pressure on the exchange rate
* Exchange rate value can be impacted by Monetary policy
* Monetary policy is used to set short term interest rates
* If interest rates are increased, then foreign investment will be attracted to the Australian economy increasing the demand for Australian dollars and appreciating the currency
* When the economy is in a contraction or a recession, then the RBA would prefer a lower currency than a higher one
* This is due to the fact that a lower AUD will have an expansionary effect on the economy by increasing net exports
* How could the RBA indirectly lower the exchange rate? By reducing interest rates, which would reduce the demand for the currency
* Whenever the central bank intervenes in the foreign exchange market to influence the movement of the currency, or to set its value in a particular ‘range’ then it is referred to as a ‘dirty float’
* The RBA claims that it only enters the foreign exchange market occasionally with a view to ‘testing and smoothing’ the underlying trend in the exchange rate – this is sometimes referred to as a ‘lightly managed float’