

MACROECONOMICS AT WORK EXERCISE

TRADE AND EXCHANGE RATES

REFERENCE: ‘Escalating trade deficit tipped to hit Aussie dollar’ (by Tania Bawden), *The Courier-Mail*, 31 January 2005, p.21.

CHAPTER RELEVANT TO THIS EXERCISE: 17

CONTEXT

The difference between the revenue received in an economy in aggregate from *exports*, and the amount spent in aggregate on *imports* gives the *balance of trade*. If imports exceed exports ($M > X$) there is a *trade deficit*. The lower are exports, the lower is the demand for Australian dollars needed to pay for these exports in relation to the supply of Australian dollars. This demand and supply relationship is one of the major factors determining the *exchange rate* (the other being the level of interest rates – the higher the prevailing level of interest rates in a country the larger will be the demand for its currency from financial investors seeking the highest rate of return on their funds). Thus the higher the trade deficit (the more that exports are exceeded by imports), the lower will be the demand for the currency and the more will be the tendency for the exchange rate to fall. This is the situation discussed in the article.

QUESTIONS

1. What is the recent history of the Australian balance of trade?
2. What is the cause of the trade deficit; how might it be corrected?
3. Is this likely to happen in the near future?
4. What is meant by the reference in the article to ‘the big cost of servicing high levels of foreign debt’?
5. What is meant by the expression in the heading: ‘hit Aussie dollar’?
6. Explain the suggestion that ‘as 2006 unfolds some further interest rate tightening is likely to be necessary....’

7. Explain the 'caution' urged by one economist, quoted in the article, to 'investors in currency-sensitive assets'.