Explain the domestic and global factors that influence Australia's exchange rate and the impact of exchange rates on the Australia's economy.

An exchange rate is the price of one country's currency in terms of another country's currency. Exchange rates can either be measured relative to other individual currencies or by the Trade Weighted Index (TWI). Under Australia's floating exchange rate system domestic and global factors influence the demand and supply of the Australian dollar. Changes in these domestic and global factors may cause the A$ to appreciate or depreciate. An appreciation or depreciation of the A$ can impact on the Australian economy both positively and negatively.

There a two ways of measuring exchange rates. The first, is one currency relative to other individual currencies. For example 1 A$ is worth 0.90 US$ or 1 A$ is worth 0.64 Euro. The second, is through the TWI. This gives an indication of how the value of A$ is moving against the currencies of Australia's major trading partners. The TWI is calculated by measuring the value of the A$ against that currencies of Australia's major trading partners compared to a base year. The currencies of the countries that are more significant in Australia's trade are given a higher weighting so that they have a greater influence on the TWI. The A$ exchange rate and TWI is always changing because of Australia's floating exchange rate system. Under a floating system the exchange rate is determined by the interaction of the supply and demand of the A$. This is, how many people are willing to sell and buy the A$ at a certain price. Australia's floating exchange rate system has opened up the Australian economy to global financial flows. However, the demand and supply of the A$ and thus the A$ exchange rate is now subject to changes in domestic and global factors.

The demand for the A$ is influenced by domestic factors. Changes in commodity prices and the Terms of Trade (TOT) influence the demand of the A$. For example, an increase in commodity prices and the TOT would increase the demand for A$ because there would be an increase in demand for Australian exports which means more people need to buy the A$ to purchase these exports. The international competitiveness of Australian exporters/domestic inflation rates influence the demand for the A$. For example, an improvement in international competitiveness of Australian industry/drop in domestic inflation rates would increase the demand for the A$ because it leads to cheaper prices and thus more demand for Australian exports which means more people need to buy A$ to purchase these exports.

The demand for the A$ is also influenced by global factors. The level of foreign investment into Australia influences the demand for the A$. For example, an increase in foreign investment would increase the demand for the A$ because more investors need to buy the A$ in order to invest in Australia. Australia's interest rates relative to overseas rates influences the demand for the A$. For example, an increase in Australia's interest rates relative to overseas interest rates would increase the demand for the A$ because more people are looking to put their money into Australian banks and in order to do so they must buy A$. Expectations of the future movement of the A$ influences the demand for the A$. For example, expectations of the A$ to appreciate would increase the demand for the A$ because more people want to buy it in order to then sell it at a higher price. The demand for Australian exports influences the demand for the A$. For example, an increase in demand for exports would increase the demand for A$ because more people need to buy the A$ in order to purchase the exports. Changes in global economic conditions influences the demand for the A$. For example, an improvement in global economic conditions would increase the demand for the A$ because it leads to more people buying Australian exports and thus more people need to buy the A$ in order to purchase these exports.