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Content Writer:-
Dr. Abhay Kumar Pathak
Deptt. of Economics,
Marwari College,
Darbhanga (LNMU)

Paper - IV

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Module :- 5

TOPIC :- ANALYSIS OF EXCHANGE RATE DETERMINATION

Determination of the rate of exchange in the foreign exchange market is occured by the interaction between the demand for foreign exchange and the supply of foreign exchange. The demand function for foreign exchange shows functional relationship between alternative rate of exchange and the corresponding amount of foreign exchange demanded. When the rate of exchange is low, the demand for foreign exchange tends to be high because there will be high inclination to import.

The supply function of foreign exchange represents the functional relationship between the rate of exchange and the amount of foreign exchange supplied. When rate of exchange is high, more foreign exchange supplied as there will be more export due to high foreign demand. Equilibrium rate of exchange is determined at a point where demand for foreign exchange equals its supply.

The country's imports of goods and services, investment in foreign country, that is, an outward movement of capital, and other payments involved in international transactions which may cause an outflow of gold in process of disbursement determine its demand for foreign exchange. On the other hand, the supply of foreign exchange depends or the country's export of goods and services to foreign countries, investment of foreign countries in this country constituting an inward movement of foreign capital and other receipts from the rest of the world which may embody an inflow of gold, too.

It is evident that if the rate of exchange is above or below the equilibrium point of interaction of demand or supply curves, ~~[illegible]~~ conditions of excess demand or excess supply would come to exist in the foreign exchange market. The excess of demand for foreign will push up its price. Hence, the rate of exchange will rise, demand for it will contract and its supply will expand. The process will continue till both demand and supply equal. Conversely, if there is excess of supply of foreign currency against its demand, the rate of exchange will fall.

Equilibrium Rate of Exchange:-

The equilibrium rate of exchange is the rate of exchange at which the par value of home currency with foreign currency is maintained at a stable level over a long period of time, which means it is neither undervalued or overvalued. The concept of equilibrium rate of exchange is analogous to the Marshallian concept of "normal price" in the theory of value. It is the normal rate in the sense that it is determined by the long-term equilibrium in balance of payments so that demand and supply of foreign exchange in the long-run are appropriately balanced at this rate and the foreign exchange reserves position of the country remains intact. In short, the exchange rate to be an equilibrium rate must be maintained at par with values of different currencies.

There are various theoretical explanations in respect to the par values and the equilibrium or normal rates of exchange are determined. Following are the three theories :-

(I) Mint Parity Theory :-

When the currencies of two countries are on a metallic standard, the rate of exchange between them is determined on the basis of parity of mint ratios between the currencies of the two countries.

(II) Purchasing Power Parity Theory :-

The rate of exchange between two inconvertible paper currencies tends to approximate the ratio of their purchasing power. This is known as purchasing power parity theory.

(III) Balance of Payments Theory :-

The balance of payments theory of exchange rate holds that the price of foreign money in terms of domestic money is determined by the free forces of demand and supply in the foreign exchange market.