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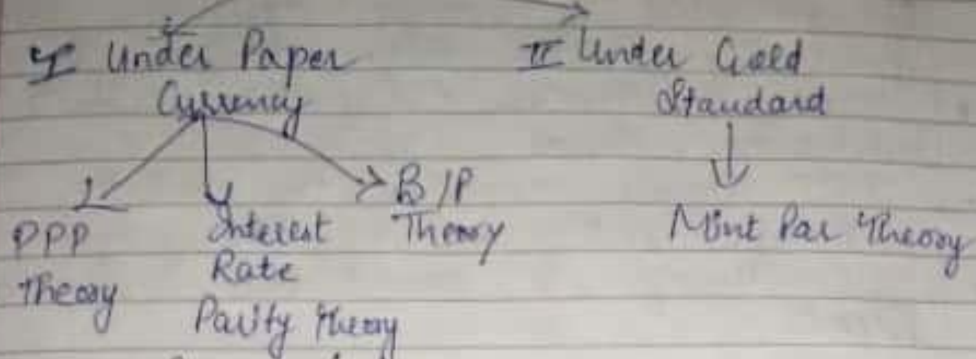
CLASS = M.COM. FINAL 4 SEM
TOPIC = EXCHANGE RATE THEORIES
PREPARED BY =SARIKA TANEJA

Exchange Rate Theories



(i) I Under Paper Currency

PPP Theory → This theories states that the equilibrium rate of exchange is determined by the equality of the purchasing power of two inconvertible paper currencies. It implies that the rate of exchange b/w two inconvertible paper currencies is determined by the internal price levels in 2 countries.

- Proposed by David Ricardo, 19th Century.
- Currencies are used for purchasing Goods & services.

(Popularized by Gustav Cassel in 1920s)

- Value of a currency (money) depends upon the quantity of goods & services that can be purchased by the currency.
- Thus, value of money is its Purchasing power.
- Exchange rate can also be mentioned on the basis of this purchasing power.
- Exchange rate is the expression of one currency in terms of another Currency.

Eg: INR 60 = $1

- Purchasing power of Currency changes due to Inflation or deflation.

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- When there is inflation, price level ↑, quantity of goods that can be purchased by one unit of currency declines, thus, the purchasing power also decline & vice versa.
- Thus, Inflation / Deflation affects the purchasing power.
- PPP Theory explains the relationship b/w exchange rates & Inflation.
- This theory is based on "Law of One Price".

→ "Law of One Price" states that any commodity cannot command two different prices in two different markets. If so profit can be taken by trading b/w these two markets. Ultimately the diff. will set off the price difference & prices of two markets becomes equal.

eg :- In India for 1 kg of Orange we have to pay ₹ 60 & at the same time to purchase the same quantity of orange in US one has to pay $ 1. In this case, Exchange Rate (₹) = Price of orange in [illegible] / Price of " "

= 60 : 1

Assumptions

(i) There exist Perfect Market Conditions.
(ii) Absence of transportation costs from one market to another (country to another)
(iii) Free trade across the International market.

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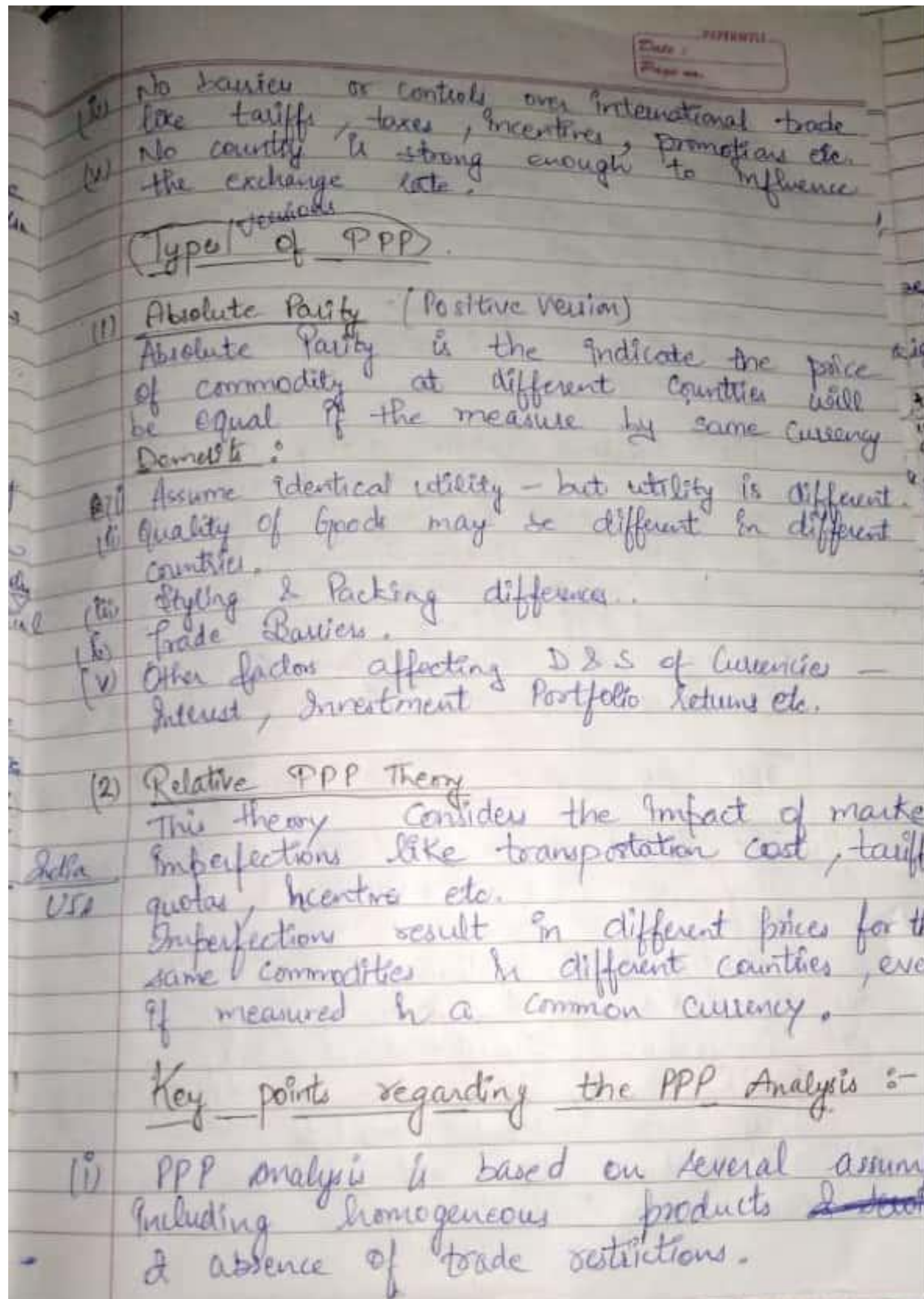

(iv) No barrier or controls over international trade like tariffs, taxes, incentives, promotions etc.
(v) No country is strong enough to influence the exchange rate.

(Types/versions of PPP).

(1) Absolute Parity (Positive Version)
Absolute Parity is the indicate the price of commodity at different countries will be equal if the measure by same currency

Demerits :
(i) Assume identical utility – but utility is different.
(ii) Quality of Goods may be different in different countries.
(iii) Styling & Packing difference.
(iv) Trade Barriers.
(v) Other factors affecting D & S of Currencies – Interest, Investment Portfolio returns etc.

(2) Relative PPP Theory
This theory considers the impact of market imperfections like transportation cost, tariffs, quotas, incentives etc.
Imperfections result in different prices for the same commodities in different countries, even if measured in a common currency.

Key points regarding the PPP Analysis :-

(i) PPP analysis is based on several assumptions including homogeneous products ~~& trade~~ & absence of trade restrictions.

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(ii) PPP analysis can be used only for tradeable goods & not for non-tradeable goods such as services.
(iii) In reality, only the prices of Internationally traded Goods tend to balance out
(iv) PPP analysis is useful for long-term currency valuation.
(v) There are significant divergences b/w currency valuations & PPP, ~~signi~~ especially in the short-term.

The Problems when using the PPP

PPP assumes that there are no barriers to trade. But in actual there are a lot of barriers ~~& other similar~~ in International Trade. Moreover, forex currencies can remain overvalued for long periods of time. For eg:- the Swiss Franc (CHF) remains overvalued, on a PPP basis, since the 80s.

These are some factors disturbing PPP analysis

(i) The traded goods are not perfectly homogeneous
(ii) There are several Barriers to International trade.
(iii) Restricting Govt. Policies (Such as tariffs)
(iv) Speculation on the prices of Goods.
(v) Transaction & Transportation Costs.
(vi) MNC usually delay the re-adjustment of prices across different markets.
(vii) PPP analysis may not hold for services & other non-tradeable Goods