

## New Frontiers of Research in Exchange Rate Analysis

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This paper attempts to present the progress of research work on exchange rates during the recent years. It has been divided into three sections. Section I presents the work that was carried on within the Keynesian framework. Section II presents a review of monetary models of exchange rate determination and frustrations met in that area. It also comments on the new emerging literature on macro-economic modelling. Section III presents a summary of the work on the effects of large exchange rate shocks on prices and quantities. Here, it first discusses the exchange rate pass-through to export/import prices and quantities and then takes up an analysis of new concept named as "hysteresis". The paper offers some concluding remarks.

### I

When the Bretton Woods system was being set up, the economics of the balance of payments and exchange rates was characterised by two distinct theoretical frameworks. One was the classical monetary theory of payments adjustment (i.e., the specie-flow mechanism) traceable to David Hume. The ascendancy of the Keynesian economics and the concern for domestic macroeconomic stabilisation turned this doctrine into an academic curiosity during the 1950s and 1960s. The other framework came to be known as the 'elasticity approach'. This approach was consistent with some of the assumptions of the Keynesian framework, (like infinite supply elasticities, export and import aggregation to form a two-goods framework), In this formulation, with supply prices fixed, a devaluation can change the relative price between export and import goods and bring about resource shifts and expenditure-switching to generate an improved trade balance, provided the Marshal-Lerner condition is satisfied in the neighbourhood of the initial zero trade balance. This derivation, which led to a large number of empirical studies on demand elasticities of exports and imports and the elasticity approach, became a part of conventional wisdom.

In the early '50s came some ad hoc modifications of this result in the form of foreign trade multiplier, the concept of absorption and the Laursen-Metzler Effect (1950). It was, however,