

## Some Thoughts on the Monetary Model of Exchange Rate Determination - A Note

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In recent years considerable attention has been given towards developing monetary approach to exchange rate determination the main planks of which seem to be (i) a faith on strict purchasing power parity and (ii) focus on demand for and supply of money as being the main determinants of exchange rate between two countries. Any change in demand or supply condition of money in either country, if it is to generate changes in the exchange rate has to be accompanied by perfect mobility of capital which points to the requirement of an open economy. In the present paper an attempt will be made to show that even in the case of an open economy mere concentration on the stock equilibrium condition in the money market may not be adequate in understanding the mechanism of exchange rate determination. Government fiscal operations or increased desire to invest on the part of private sector either in the home country or abroad might alter interest rate parity condition and lead to changes in exchange rate. The plan of the paper runs as follows. In the first section essentials of monetary approach are discussed in detail in regard to both fixed and floating exchange rates. This part is obviously in the form of a survey of existing literature. In the second section the fiscal apparatus, its implications for exchange rate determination in an open economy - all these issues are discussed. The focus of the paper would definitely be upon this section which emphasizes the need to incorporate fiscal changes in a comprehensive theory of exchange rate determination.

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Equilibrium exchange rate determination has constituted an important topic in international trade theory. For a long time it was believed that foreign exchange was demanded for transactions purpose only. Surplus of exports over imports indicated greater inflow of foreign exchange in which case people will be offering progressively lesser units of home currency to obtain one additional unit of foreign currency. In the end exchange rate will appreciate. Exactly the opposite thing happened in the case imports exceeded exports. In order to pay for imports in foreign exchange, higher units of home currency were offered to procure one extra unit of foreign currency. This situation led to a depreciation of exchange rate.