

iv. a country may
experience temporary
and cyclical



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iv.

The theory is able to accommodate unilateral capital movements irrespective of their nature, duration and magnitude. Thus, it explicitly recognises the fact that rate of exchange is subject to diverse pressures, including for example, war reparations, servicing of outstanding foreign debts, speculative flights of capital and so on.

(ii) Demerits:

i. The theory, by itself, does not explain the entire field of forces which determine the flow of payments across countries and, thereby, influence exchange rates. ii. It appears to take the position that there is a one-sided cause-effect relationship between balance of payments and rate of exchange. It says that the balance of payments position of a country explains the sophisticated notion of equilibrium rate of exchange.

It ignores the fact that exchange rate and balance of payments are inter-dependent and that their cause-effect relationship can run from the direction of exchange rate variations to balance of payments, as well. According to one opinion, " Balance or imbalance in a country's external transactions, far from one-sidedly determining exchange rate, is largely a consequence of the relation between the exchange rate and relative price level." iii. As a theory of exchange rate determination, it does not help us in working out the equilibrium rate of exchange on a priori basis. On the other hand, a country may experience temporary and cyclical fluctuations in its balance of payments which may be absorbed through a variation in its gold and foreign exchange reserves rather than changes in exchange rate itself. " The

doctrine vaguely defines the equilibrium rate of exchange as one which, if fixed for at least several years”, would not cause chronic surplus or deficit in the balance of a country.

“ But it does not tell us how to calculate the rate even approximately, nor even set forth the general principles determining it.”