

This of trade  
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This situation continues to hold so long as there NO change in demand and/or supply schedule(s) of the currency under consideration. Controlled Rate and Equilibrium: Rate of exchange may be chosen arbitrarily and prevented from responding to market forces by means of official regulation and control. However, such a rate may not be in equilibrium. How to judge whether it is in an equilibrium rate or not? The answer lies in finding out whether this is hiding a ' fundamental equilibrium' (that is, an inconsistency) between domestic and foreign cost-price levels.

A fundamental disequilibrium is indicated if: i. Removal of ' exchange control' (regulating payments in foreign exchange), and/or ii. Removal of trade restrictions Would generate a persistent tendency of a deficit (or a surplus) balance of payments. Stability of Exchange Rate: An exchange rate is said to be stable if, with given demand and supply schedules of the home currency in exchange markets, it has no tendency to change.

In other words, stability or otherwise of the exchange rate of a currency is determined by the nature of its demand and supply schedules. The demand curve for Rupees is assumed to be inversely related to its exchange rate; thus giving us a negatively sloped demand curve. i.

If the supply schedule is positively related to the exchange rate, then the equilibrium is necessarily a stable one. With reference to the point of intersection between demand and supply curves, the demand curve must be above (below) the supply curve to the left (right) of this point. ii. If the supply curve is downward sloping, the equilibrium will be stable if the demand is more elastic than supply (that is, the demand curve is flatter than the supply

curve). An exchange rate lower than OA makes the rupee so cheap that demand for rupees exceeds their supply, and this pushes the exchange rate upwards. Similarly, a rate higher than OA is a self-correcting one. iii.

The demand curve for rupees is less elastic than the supply curve. Here, a fall in external value of the Rupee below OA leads to an excess of its supply over its demand and pushes the exchange rate further down.

Correspondingly, an increase in the external value of the Rupee above OA leads to an excess of its demand over its supply and pushes the exchange rate further up.