DETERMINATION OF EXCHANGE RATES

- **Purchasing Power Parity Theory**

Assumption :

(a) Non - existence of tariffs and other trade barriers and

(b) Zero cost of transport .

The law of one price , the simplest concept of purchasing power parity (PPP) , states that identical goods should cost the same in all nations. Therefore , the prices of goods sold in different countries , converted to a common currency , should be identical . The equilibrium price rate between two currencies would be equal to the ratio of price levels in two countries as defined : $S_2 = Px / Py$ Se indicates spot exchange rate, and Px and Py indicate the price level in two different countries x and y . It is normally the inflation rate differential between two countries that influences the exchange rate between their currencies . The influence of inflation rate finds a suitable explanation in the PPP theory .

- **Fisher Effect Theory**

Establishing a relationship between the inflation and interest rates , the Fisher Effect theory states that the nominal interest rate ' r ' in a country is determined by the real interest rate ' R ' and the expected inflation rate ' I ' as follows :

Nominal interest rate= Real interest rate + Expected Inflation Rate

NOMINAL interest rate is used to assess exchange rate movements as it includes interest and inflation rates , both of which affect exchange rates .

- **International Fisher Effect (IFE)**

It is a combination of the conditions of the PPP theory and Fisher's effect . The PPP theory suggests the exchange rate is determined by

the inflation rate differentials , while the Fisher Effect states that the nominal interest rate is higher in a country with a higher inflation rate. Combining , these two propositions , the IFE states that the interest rate differential shall equal the inflation rate differential .