

Real Effective Exchange Rate Indices of the Rupee : A Comparison of the Selected Alternative Series

Pushpa Trivedi *

The indices of Real Effective Exchange Rate (RER) compiled by the RBI and the other researchers assume a static direction and/or commodity-composition of India's exports. These assumptions lose validity as the time-span for which the series is constructed is lengthened. In view of this, it is argued that use of a variable weighting method - based on the exports shares of the previous five years could be adopted to overcome the assumption of a static direction of exports. Moreover, exports of a country have to be globally price-competitive. Hence, the relative inflation rate of country should be measured with respect to the low inflation countries with sizeable share in the global real income. By including countries with very high and chronic inflation rates, the RBI series has underestimated India's relative inflation rate as also the extent of nominal depreciation. Though the extent of underestimation in the real exchange rate on account of this factor is marginal, yet the distortions in the component series can give wrong signals for the policy guidelines. It may lead to complacency for pursuing tight monetary and fiscal policies for the containment of inflation at home. Hence, excluding some of these countries is suggested. Lastly, in the economic literature these indices are compiled by using the modern definition, wherein the proxies of Wholesale Price Index (WPI) (for the rest of the world) and Consumer Price Index (CPI) (for the domestic economy) are used as the proxies for the prices of tradables and non-tradables, respectively. The RBI has not provided any theoretical justification for using these proxies in an exactly opposite manner.

1. Introduction

India's balance of payments crisis of 1991 seems to have convinced the policy makers that an improved performance of exports is essential for a sustainable balance of payments situation. Since July 1991, a number of trade and exchange rate policy measures have been undertaken for increasing export earnings. The major policies implemented towards this end include devaluation of the rupee in two stages in the first week of July 1991, the introduction of EXIM-SCRIPS on July 4, 1991,¹ the introduction

* Indian Institute of Technology, Powai, Bombay.

¹ EXIM-SCRIP was another label for the Replenishment (REP) licences. Under the REP scheme, exporters were entitled to foreign exchange of about 5 to 20 per cent of their export earnings for acquiring imported inputs needed for the production of exports. As compared to the REP scheme, EXIM-SCRIPS had a higher REP rate of 30 per cent. For import-intensive exports such as gems and jewellery, metal-based handicrafts, etc., the REP rates were set