CHAPTER II

BASKET PEG: CONCEPTUAL AND ANALYTICAL ISSUES

2.1 Introduction

In Chapter one, it was observed that floating is not feasible for the developing countries, and with diversified trade, the country should choose a basket peg. The implementation of a basket peg, however, requires the resolution of several theoretical as well as operational issues. Accordingly, this chapter deals with the objectives of a basket peg and identifies the issues that are relevant in the context of India's basket peg.

This chapter is important for two main reasons: First, the evaluation of the basket peg regime in India becomes difficult owing to the confidentiality of its operation and the lack of any publicly announced policy objective. However, once a general framework for working with a basket has been given, the necessary clue for evaluating India's basket can be abstracted from it. Second, the concept of a currency basket has been understood to mean the same thing as the effective exchange rate, as both are weighted averages of bilateral exchange rates. The effective exchange rate provides the trends in the overall value of a currency, which are relevant in all forms of exchange rate regimes.
2.2 Concept of a Currency Basket

Generally, a basket peg implies fixing of the value of home currency to an average value of the currencies of major trade partners. From among the currencies consisting of the basket, one is chosen as the numeraire against which the home currency’s exchange value is established through discretionary adjustments and all other rates of the home currency in the basket are correspondingly determined through cross rates. Thus, targeting the numeraire currency rate, all other rates are established. In this way, the basket-mechanism can mimic the Bretton Woods’ adjustable peg except that the margins around the present basket is large and the major currencies that are part of the basket move too often than the occasional par-value changes under the Bretton Woods. The second aspect is more important as the externally imposed disturbances on the home currency is very large in the present regime, which requires constant monitoring and alterations of the numeraire currency.

The currency basket has been understood to mean the same thing as the effective exchange rate (EER). This is because both EER and currency basket are some kind of weighted averages of bilateral exchange rates. The difference in them arises due to the choice of weights used in averaging the bilateral exchange rates. Typically, weights associated with an EER index represent trade shares or elasticity weights that are derived to maintain a trade balance goal. However, the weights for a currency basket can be decided for any type of macroeconomic objective, including the trade balance goal as a special case (more on weighting shortly). Therefore, the difference is mainly due to the computation of weights, which can be decided by the objective of exchange rate policy.
The currency basket rule can be interpreted by using the computation method of the EER as follows:

\[
\text{EER}_t = \prod_{i=1}^{n} \left( \frac{E_{it}^h}{E_{i0}^h} \right)^{w_i}
\]  

(1)

Where \( \text{EER}_t \) is the value of currency basket at time \( t \) measured by an index and expressed as a weighted geometric average of a set of bilateral exchange rates, which contains \( n \) currencies and for each currency \( i \) there is a corresponding weight \( w_i \), reflecting the country’s importance in the basket such that

\[
\sum_{i=1}^{n} w_i = 1.
\]

\( E_{it} \) is the exchange rate of the rupee against currency \( i \) at time \( t \) (so \( E_{i0} \) is the exchange rate at time \( o \)). Equation (1) can be rewritten in logarithmic form (with the lower case letters denoting the logs of the variables, and \( w_i \)’s are the parameters):

\[
\text{eer}_t = \sum_{i=1}^{n} w_i (e_{it}^h - e_{i0}^h)
\]

(2)

Without the loss of generality, the exchange rates at time \( 0 \), \( E_{i0} \), are scaled such that they equal 1. Therefore, it follows that \( \sum w_i e_{i0} = 0 \). So equation (2) becomes
If triangular arbitrage holds \( e_i^h = e_1^h + e_1^l \) i.e. say, the exchange rate of the rupee against currency \( i \) equals the exchange rate of the rupee against currency 1 (say pound sterling) times the exchange rate of the currency 1 (sterling) against currency \( i \). This implies that if \( e_1^h \) determined, given \( e_1^l \), all \( e_i^h \) are is determined. Taking that \( e_1^h \) as the home numeraire currency exchange rate (say the rupee-pound sterling rate which served as the intervention currency of the Indian basket), equation (3) can be expanded as follows (avoiding the time subscript):

\[
eer = (1-w_2-w_3-...w_n) e_1^h + w_2 (e_1^h + e_2^l) + \ldots + w_n (e_1^h + e_n^l) \tag{4}
\]

or

\[
eer = e_1^h + \sum_{i=2}^{n} w_i e_i^l \tag{5}
\]

Equation (5) provides the policy rule in a basket peg. If the monetary authority in the home country attempts to fix the exchange rate index, the authorities have to offset the movement of the sum of the weighted numeraire-bilateral exchange rate by an equal but opposite change in home-numeraire exchange rate. If the exchange rate is indexed and maintained at the base level (that prevailed in time 0), then \( \text{eer}_t = 0 \) and the policy rule can be identified as

\[
e_1^h = - \sum_{i=2}^{n} w_i e_i^l \tag{6}
\]
Equation (6) can be used for a discretionary change in the level of i, by manipulating the home-numeraire currency rate. It is to be noted here that the realized set of exchange rates under a basket peg become the product of two forces: the 'policy forces' as reflected in the adjustment of the home-numeraire currency rate, and the 'basket forces' as reflected in the transmission of free market induced changes of the currencies included in the basket. Failure to offset the free-market induced changes through numeraire currency would result in significant instability in the realised rates.

2.3 Methodological Issues

The determination of a currency basket can not be looked purely from a statistical angle. The methodological issues are determined on grounds of economic theory, with reference to the goals of exchange rate policy. Several methodological issues are raised in the literature: (i) choice of weights, (ii) selection of currencies; (iii) selection of base period; (iv) choice of averaging technique, and (v) choice of intervention currency. These issues are discussed in the following. Some of the operational features of the Indian basket are discussed in a subsequent chapter.

2.3.1 Choice of Weights

The choice of weights for the currency basket has been the most important issue, which is determined on the basis of the objectives of exchange rate policy. The literature consider several alternative objectives of exchange rate policy, depending upon how has the exchange rate instability been viewed to
have an impact on a particular macroeconomic variable. The choice of a peg, therefore, is concerned with insulating the target variable from the (exogenous) impact of exchange rate changes. The exogenous impact arises due to the movements between third currencies in the basket (in terms of

\[ \sum_{i=2}^{n} w_i e_i \] in equation 6),

which leads to alter the peg of the home-numeraire currency that has presumably been set at an optimum level. Choosing the basket peg has been viewed as to isolate the instability imposed by movements between third currencies that are in the form of exogenous shocks to the domestic economy.

The convention has been to stabilize the EER, which is also known as the basket-related parity, derived by attaching appropriate weights to a country’s bilateral exchange rates. The EER provides in summary measure of the net effect of exchange rate change on the target variable in a given time period. Wickham (1987) argues that pegging to a suitably choosing basket and making appropriate discretionary changes would avoid the burden of having to enter into judgements at future date about the persistence of currency appreciation or depreciation. In fact, once the home currency is pegged and the desired EER level is achieved through the operation of this peg, the authorities can look into other areas of policy maneuverability in correcting payments imbalances. In this sense, the basket peg becomes a strategic choice for a developing country in a world of generalized floating.
The objectives of basket peg and the choice of weights consistent with the peg differ if one examines the theoretical literature. Table 1 provides the summary of the previous studies. It is clear from the table that the literature does not reveal any consensus regarding the goal of exchange rate policy that should be achieved through the peg. In general, the following objectives are considered:

(a) minimizing the variance in real income (Flanders and Helpman, 1979);
(b) stabilizing the terms of trade (Branson and Katseli, 1981 and 1982);
(c) minimizing the level and variability of inflation (Connolly 1980 and 1981);
(d) minimizing the variability of short run exchange rate instability (Frankel 1975).
(e) minimizing the variability of traded goods prices and hence resource allocation and income distribution (Lipschitz 1979 and Black 1976); and
(f) stabilizing the real effective exchange rate (Bacha 1979, Lipschitz 1979, Liptschitz and Sundararajan 1980 and 1982);

Williamson (1982) succinctly reviews these studies and rejects the first three objectives as unambiguously erroneous. He argues that stabilizing real income (a la Flanders and Helpman) and the terms of trade (a la Branson and Katseli) would lead to unnecessary sacrifice in times of prosperity and, indeed, forgo the potential windfalls that may arise due to terms of trade improvement. Recalling the consumption theory, Williamson argues that the aim of stabilizing real income is not to throw away any excess of potential income over the permanent income, rather to stabilize expenditure by saving more in good times and less in bad times. The other rejection is concerned with Connolly's objective
Table 1: Objectives of Currency Pegging and the Choice of Weights

<table>
<thead>
<tr>
<th>Author(s)</th>
<th>Objective of Peg</th>
<th>Determination of Weights</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Black (1976), Edison and Vardal (1987)</td>
<td>Minimise the variance of relative price of traded goods, by stabilizing the REER</td>
<td>Weights based on direction of total trade in goods and services. Elasticity weights for countries with market power</td>
</tr>
<tr>
<td>2. Cannolly (1980 and 1981)</td>
<td>Minimise the level and variability of inflation</td>
<td>Peg to the US dollar if the US inflation is a reasonable guide or peg to a trade weighted basket or even SDR</td>
</tr>
<tr>
<td>3. Branson and Katseli (1983 and 1982)</td>
<td>Stabilizing the effective exchange rate with an aim of stabilizing the terms of trade</td>
<td>Peg to basket with weight reflecting market power in export and import markets</td>
</tr>
<tr>
<td>4. Lipschitz (1979)</td>
<td>Minimize variations in resource allocation and income distribution by stabilizing REER</td>
<td>Peg to a basket with weights based on currency denomination of total trade when exports and import competing sectors are of similar size.</td>
</tr>
<tr>
<td>5) Crocket and Nsouli (1977)</td>
<td>Stabilize balance of trade and output by stabilizing effective exchange rate</td>
<td>Peg to import weighted basket. SDR peg suggested as a good proxy.</td>
</tr>
<tr>
<td>6) Flanders and Helpman (1979)</td>
<td>i) Minimise the variance of the balance of trade by stabilizing the effective exchange rate</td>
<td>Peg to elasticity weighted basket (special case with price inelastic imports and perfectly elastic export demand: export weighted basket).</td>
</tr>
<tr>
<td>Author(s)</td>
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<td><strong>Determination of Weights</strong></td>
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<td>7) Bacha (1979)</td>
<td>ii) Minimize variance of real income</td>
<td>Peg to a basket with large weights for export markets and small and even negative weights for import sources.</td>
</tr>
<tr>
<td>8) Lipschitz and Sundararajan (1980, 1982)</td>
<td>Stabilize real effective exchange rate</td>
<td>Basket peg</td>
</tr>
<tr>
<td></td>
<td>Minimize the variance of the REER</td>
<td>Peg to a basket with elasticity weights, with weights modified by the covariance between relative prices and exchange rates.</td>
</tr>
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</table>

of minimizing the level and variability of inflation. This policy becomes suboptimal as it leads to the sacrifice of autonomy in conducting domestic monetary and fiscal policies in order that the fixed parity is defended. This is indeed the classic 'discipline' argument in a fixed exchange rate system i.e. the maintenance of a stable parity such that the domestic inflation is always in line with foreign inflation. As already observed in chapter one, strict money supply rule may involve loss of domestic output and employment in times of deflation. Second, there is no rationale to tie one's own inflation when the industrial countries themselves do not adhere to any rational inflation target.

The issue has been resolved by keeping separate the two aspects of exchange rate policy i.e. choosing a peg and changing the peg once chosen. The rational policy would be to choose a peg based on any specific objective and adjust the peg in line with inflation differential between home and abroad. This is known as real exchange rate targeting in which the peg becomes variable over time. If the domestic monetary pressures lead to higher inflation than the international norm, the appropriate policy response will be to adjust the money supply rather than distorting the competitive relationship with the rest of the world that has been established through the exchange rate. On the other hand, if the domestic inflation is higher as compared to the prevailing international norm (due to recession), a depreciation is called for to preserve the competitiveness. Appropriate policy requires the examination of the current account position, reserve level and the level of exchange rate already reached. Nevertheless, the option of a rigid inflation stabilization to defend the peg does not seem to be a convincing.
Rejection of the first three objectives indeed narrows down to the near consensus on the view that a basket peg should be chosen with the objective of stabilizing the effective exchange rate (EER). However, the disagreement with the remaining studies arises as to the appropriate concept of EER that should be stabilized and whether the target EER should be based on nominal or real. Frankel (1975) brings attention to the time dimension of exchange rate fluctuations and argues that the choice of peg should be to neutralize the short run volatility of nominal EERs. This is because short run exchange rate instability can have an adverse impact on trade flows, as it increases the uncertainty of profit streams of the traders. For a developing country, most of the external trade is denominated in highly volatile currencies like the dollar or the pound and there are limited opportunities to protect exchange risks through the use of hedging instruments such as forward covers.

Black (1976) does not approve Frankel’s objective by stating that the currency contract risk is essentially a short run phenomenon and the short run exchange rate fluctuations are reversible in nature, which can also be hedged by taking a forward cover (indeed Frankel argued that such covers do not exist in sufficient depth in the developing countries). The decision to trade, as opposed to the production for home markets, depends on the long run variance of the prices of traded goods. Exchange rate swings over medium and long run will generate trade bias, according to Black, and which will inhibit decisions relative to the structure and level of output and investment. Stability of the prices of traded goods becomes important in the long run to eliminate any trade bias due to currency fluctuations, as resources would otherwise move to non-tradables and
create balance of payments worries. Black, therefore, argued in favour of choosing a peg that should stabilize the real effective exchange rate with the objective of minimizing the variance of the prices of traded goods.

Black (1976) was probably the eye opener for most of the later studies which also argued in favour of stabilizing the REER. However, these later studies emphasized that the choice of peg is to consider broader considerations than those related to the short run currency fluctuations. The emerging consensus was about the preservation of both external and internal balance criteria. External balance criteria required a medium term current account target consistent with a sustainable level of capital flows. Internal balance required stabilizing the output of non-traded goods, employment and resource allocation. (Lipschitz 1979, Crocket and Nsouli 1977, Lipschitz and Sundararajan 1980 and 1982). Fluctuations in third-currency exchange rates in a regime of generalized floating constitute a random shock disrupting the economy’s external and internal imbalances. The peg should chosen so as to preserve the economy’s internal and external balance.

Thus, the preference for the real exchange rate peg was accepted by most of the studies and the policy makers should aim at maintaining an appropriate REER, also simultaneously eliminating any transitory shocks to it. Lipschitz (1979) decomposed the variance of the REER into three parts: to changes in the NEER, to changes in the relative inflation rates between home and abroad (ERP), and a term representing the covariation between NEER and ERP:

$$\text{Var (REER)} = \text{Var (NEER)} + \text{Var (ERP)} + 2 \text{Cov (NEER, ERP)}$$
The significance of this decomposition is that exchange rate policy under a basket peg should be such that to minimize the variance of REER. In the limit, policy makers can offset the relative price movements between home and abroad by the nominal exchange rate changes, in which case the sum of the two variance terms and the co-variance term will be identical in magnitude but opposite in sign, such that the variance of the real exchange rate will be zero. Lipschitz (1979) cautioned that "changes in the real exchange rate should not be the only indicator used to judge the necessity for a change in the NEER. Various other indicators such as reserve developments and the transitory or permanent nature of the shocks buffeting the economy, are important. Second, no simple formula that fixes the real exchange rates should be followed. Such a formula could serve to exacerbate the impact of transitory real shocks by impeding the normal reserve cushioning function of a fixed exchange rate system" (p.447).

Two issues are becoming obvious from this and the previous review. First, the country aiming for an REER peg needs to offset the inflation differential between home and abroad to preserve external balance. Second, the choice of a REER peg need not be a rigid peg, rather changing overtime in response to various real shocks. For instance, a country needs to even depreciate the REER, i.e. the NEER could be depreciated more than what is warranted by the inflation differential, in response to an once-for-all terms of trade deterioration. In which case the REER peg need not remain constant over time. We take this up for discussion in chapter in the context of real exchange rate targeting and show that the real exchange rate depends on several structural and macroeconomic policy variables, including the relative inflation factor.
2.4 Relevant Issues in The Choice of Weights

Thus the general conclusion emerging from the previous review is that a developing country should adopt a basket peg in order to insulate the domestic traded goods sector from the instability of third-currency fluctuation. The issue then is concerned with the actual computational aspect of the basket. The literature reveal several such issues: (a) whether the basket weights be based on the direction of trade or the currency of denomination; (b) whether weights be based on exports, imports or total trade; (c) whether weights be based on bilateral, elasticity based or some kind of multilateral weighting scheme. These are important issues, as the impact of exchange rate changes on trade competitiveness can be complex in a multi-country and multi-commodity world.

The case for the weighting structure based on the currency of denomination was made by Liptchitz (1979), as the immediate impact of an exchange rate change on payment flows will be determined by the currency of denomination of trade. Destination of trade could be more diverse, where as transactions are settled in a few vehicle currencies. Weights based on the destination of trade would understate the importance of the vehicle currencies, thus, their impact on payments flows and, at the same time, overstate the importance of currencies which do not figure in the trade contract. Therefore, in the calculation of an EER index for the purpose of assessing the competitiveness of trade, the relevant weighting scheme be based on the currency of denomination of trade rather than their geographic direction.
The objection to this view comes from the fact that trade competitiveness depends on the currency in which costs and prices are fixed and not in which contracts are actually denominated. A major proportion of imports from Japan, for instance, could be invoiced in the US dollar, although the prices are fixed in yen terms and the dollar price determined purely by taking the yen-dollar exchange rate prevailing on the transaction day. Clearly, this calls for the inclusion of the Japanese yen, rather than the US dollar in the currency basket. Second, the prices of most of the primary commodity exports in the world markets may be fixed daily in terms of the US dollar. But the prices of such homogenous commodities would depend on the demand and supply of major competitors, and not on the United States alone. Thus, the basket most appropriate for the purpose would be weighted by the currencies in which traded goods’ prices are fixed and the destination of trade remains the most relevant weighting pattern.

In some circumstances, the destination of trade becomes irrelevant if the goods are priced and invoiced in a third currency. Weights based on the destination of trade implies that no country whose currency is included in the index prices its goods in a third country’s currency such that in the event of an exchange rate change of the home currency, its export prices are constant in terms of the third country’s currency. For instance, the prices of petroleum which are priced and invoiced in the US dollar, an exchange rate change of the US dollar against the rupee will affect their import prices, but a change in the, say, rupee-dinar rate will have no impact. One way to take account of this is to reduce the weights of those countries whose products are priced in the third
country currencies and, finally, drop these countries if the adjusted weights are too insignificant, and increase the weights of the concerned currencies accordingly. This kind of situation arises if one were to compute an EER index for imports and the effects of import prices on domestic prices.

The weighting structure in a currency basket can be based on exports, imports or total trade. Although an import weighted EER would provide an indicator of import price movements, in the Indian context, it would be insensitive to the volume of imports as well as to the production of import substitutes. A sizeable portion of imports are price inelastic, which were mainly determined by the import control regimes and the availability of foreign exchanges. Since the import weighted EER is not considered, the total trade weighted EER cannot be considered as well for the same reason. The export weighted EER would be more relevant to determine the competitiveness of exports. The reservation against the effectiveness of export weighted EER is that the Indian firms price their exports on the basis of comparable international prices and enjoy no leeway to set their own prices. This line of argument is not acceptable, as a significant portion of India's exports are becoming processed primary goods and manufactured goods, whose prices are indeed formed domestically. Secondly, even in the case of primary products whose prices are set in the world markets, third country exchange rate changes affect the domestic exports. For instance, depreciation of deutschmark against the US dollar raises the price of Indian cotton in terms of deutschmark, thereby reducing India's cotton exports to Germany. The problem is not, therefore, with the export weights per se, but how to capture such third country exchange rate impacts.
As regard the choice between bilateral or elasticity or multilateral weighting schemes, the predominant opinion is in favour of the multilateral weights. If the country in question is too small in the global markets, in all the commodities it trades, a bilateral weighting structure will be the appropriate one. However, if certain commodities enjoy a degree of market power, an elasticity based or multilateral weighting scheme is preferred. Crockett and Nsouli (1977) does not favour elasticity weights as there is rarely an adequate statistical basis on which the elasticity can be estimated. This study computes the basket-weights through a commodity-country specification, to reflect the true competitive relationships. This is attempted in Chapter 3.

2.5 Other Computational Issues

Although the choice of weights remain the basic issues, other operational matters have been considered important that determine the value of the basket: (a) selection of currencies; (b) based year, and (c) method of valuation.

2.5.1 Selection of Currencies

The number of currencies included in the basket is an important operational issue. An extensively broad index, of course, would entail measurement errors that may arise due to the problems of timely collection of data and reporting. In principle, the weights of small countries can be set to zero, with the assumption that their combined values would follow the weighted average of the currencies included in the basket. For certain operational convenience, certain currencies need to be excluded:
i) Exclusion of a currency may be due to its inconvertibility. This requirement leads to the exclusion of all East European currencies from the index, as these countries do not report exchange rate data to the IMF and India had bilateral trade arrangements with them. However, once their currencies become fully convertible and start reporting data to the IMF, their inclusion needs to be considered.

ii) Some countries have very high inflation rates relative to India and her other trading partners. The inclusion of hyper-inflating currencies in the index will create distortions such as price level measurement error in the index.

iii) In case of countries practicing multiple exchange rates, say official and free-market rates, it becomes difficult to collect data and determine appropriate weighting pattern to arrive at a composite rate. Therefore, these countries can be safely omitted.

Basically, a multilateral weighted EER should include the major competitors in the global markets and a bilateral weighted EER the home country's major bilateral trading partners. The countries included in both the weighting schemes need not be the same. For, countries with similar commodity composition of exports and imports will trade very little with each other, although they can effectively compete in third markets. Thus, India can compete with Indonesia in the US market for certain categories of products, although India's exports to or imports from Indonesia remains insignificant as compared to other major trade partners.
2.5.2 Selection of a Base Period

In the context of selecting a base period, two issues are important: (i) the choice of an appropriate base year in which index is be based; and (ii) the choice of the base period for the trade flows from which the weights are derived. As regards to the first issue, the usual practice is to identify a normal year, reflecting a reasonable level of current account balance and a level of capital inflows consistent with this balance. The latter aspect is important because with the passage of time, the actual trade shares deviate from the initial trade shares, and a given level of bilateral exchange rates will give different EERs, depending on whether the current or base year trade flows are considered. The question, therefore, is should an index use fixed weights or should weights be continuously updated to reflect the current trade pattern. Conventionally, weights are derived from a fixed base period, that reflect the current pattern of trade. Although, continuous updating of bilateral weighting may be simple, the updating of multilateral or competitive weights derived form a commodity-country specification becomes difficult.

2.5.3 Valuation of the Basket

The choice of a particular weighting scheme does not itself determine the value of the EER. It depends on an appropriate method of valuation. Depending on whether geometric, arithmetic or harmonic averaging is adopted, a given set of weights can yield different values of the EER. The general preference is for a geometric average method. There are two important properties of the geometric averaging. First, the geometric averaging index treats depreciating and
appreciating currencies in an entirely symmetric manner. This property follows from the fact that a geometric average index is a linear function of the component bilateral exchange rate indices. So that "equivalent" depreciations and appreciations cancel one another (Brodsky 1982, p.549). Recalling the formula in equation (1):

\[
\log \pi (E_{it}/E_{i0})^{w_i} = \sum_i w_i \log (E_{it}/E_{i0})
\] (1)

On the other hand, the arithmetic average gives larger weights to currencies which have depreciated, while the harmonic average gives larger weights to currencies which have appreciated (i.e., with exchange rates expressed in indirect quotation). Second, as the importance is attached more to the relative changes in the level of EER indices rather than the level itself, the geometric averaged index provides an unique relative change, as changes calculated from these averages are independent of the base date chosen. This is particularly important as any single equilibrium exchange rate is difficult to find in practice, rather a path of equilibrium EERs are plausible, given the structural trend in the economy (see Chapter 6). On the contrary, both the arithmetic and harmonic averages provide biased estimates of the relative changes in the index since the actual weights go on diverging from the initially chosen weights (see Brodsky 1982). The use of geometric average is considered particularly relevant in almost all optimal weighting schemes as the actual (optimal) trade shares are maintained through time. In fact, usual practice is to use a single set of weights
for the entire period of computation, rather than changing the optimal weights as time passes.

2.6 Conclusion

The above review provides certain framework for the conduct of exchange rate policy in a developing country like India. The principal aim of exchange rate policy should be to preserve the export competitiveness and, towards this end, it is necessary to stabilize an appropriately defined real effective exchange rate (REER). The short run REER uncertainty is undesirable, which must be minimised through appropriate variance-covariance offsetting of the nominal exchange rates and inflation factors. The long run behaviour of the REER is of importance which, *ceteris paribus*, should be targeted by suitably adjusting the nominal rates. The *ceteris paribus* condition implies that the REER peg must be adjusted to accommodate other structural factors affecting trade and balance of payments.

The objective of the basket peg can be considered with as much importance as the computation of the basket, for different methodologies can give different values of the peg. This review narrows down to an export weighted geometric average of the bilateral exchange rates of India's principal trade partners as the basis for the EER calculation. The export weights should give sufficient attention to commodity-market orientation to obtain the true competitive relationships. The weights are to be based on the direction of trade in goods and services rather than the currency of invoicings or even elasticity based weights. In the Indian context, the import weighted EER will merely
provide an indicator of import price changes, but would be insensitive either to the volume of imports or to the production of import substitutes.

This review also raises several issues for the analysis of India's basket-peg: (i) How to determine an appropriate REER that will serve as the target of exchange rate policy? (ii) Whether the basket peg policy in India was successful in stabilizing the exchange rates of the rupees? and, (iii) Is the long run behaviour of the rupee consistent with the internal and external balance of the Indian economy? The discussion of these issues becomes important to have an indepth evaluation of Indian basket peg. This study attempts to examine them in the subsequent chapters.