

Base and non-usable.  
price indices:  
estimating price index



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Base Period: It is highly difficult to identify a period when exchange rate was actually in equilibrium, and use it as the base period. Normally, no such base period exists because the trading economies happen to be dynamic and not static. As a result, an estimate of equilibrium rate of exchange also remains faulty and non-usable. Price Indices: Estimating price index numbers is patently characterised by several conceptual and practical difficulties. Consequently, an estimate of equilibrium rate of exchange is also rendered defective. Moreover, the fact that PPP theory has to compare two price index numbers makes it still less acceptable.

Goods and their Weight Maps: Logically, the price indices used by the PPP theory should be of those baskets of goods which are identical in composition and weight-maps. They should also be those commodities which enter international trade or have an immediate potential of doing so if exchange rate varies within very probable limits. But it is next to impossible to identify such a basket of goods. Covering Non-Traded Goods: Since it is not possible to satisfy the foregoing condition, the PPP theory uses separate price index numbers for each country, covering all goods and services which are produced and traded in it. This, however, is only a proxy solution and we cannot defend it on logical grounds. Flow of Funds: The theory compares the 'internal' purchasing power of currencies. It ignores the contribution of inter-country flows of funds affecting demand and supply of the transacted currencies.

These days, a variety of both short term and long term capital flows are taking place, including those caused by investments and speculative activities. There are also international capital flows for servicing external

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debts. All these capital flows exert a strong influence on the behaviour of rate of exchange.

Elasticity's of Demand and Supply: Trade flows are not dependent upon changes in commodity prices only. Equally important are the demand and supply elasticity's of traded commodities tastes and preferences of the buyers, and policies pursued by their authorities. Competitive Markets: A real limitation of this theory is its assumption of competitive markets. Its equilibrium rate is the outcome of unrestricted working of competitive forces in international trade as also within each trading country. Factually, however, the markets are imperfect. They are characterised, in varying degrees, by monopoly elements, trade restrictions in the form of quotas, tariffs, and exchange control, etc.