Increasing Real Effective Exchange Rate in India

Source: IE

Why in News?

Recently, the **Reserve Bank of India (RBI)** reported that the **Real Effective Exchange Rate (REER)** of the rupee reached **108.14** in November 2024 from 107.20 in October 2024, marking its highest level this year.

What are RBI's Findings Related to REER?

- **Record High REER Values**: The rupee's REER of 108.14 indicates overvaluation since 2015-16, undermining **export competitiveness**, despite **nominal depreciation** against the **USD**, revealing contrasting **Nominal Effective Exchange Rate (NEER) and REER indices**.
  - A REER above **100** signifies overvaluation relative to its base year (2015-16), reducing export competitiveness, while a value below 100 suggests undervaluation.
- **Volatility Trends**: The rupee experienced the **lowest volatility** (it has appreciated against other currencies) among major global currencies, even as emerging market currencies faced outflows due to rising US **bond yields** and a **strong dollar index**.
- **Trade Balance Implications**: **Overvaluation of the rupee**, as indicated by REER, makes **Indian exports** costlier, undermining competitiveness in global markets.
  - At the same time, it reduces import costs, potentially widening the **trade deficit**.
- **Capital Outflows**: The strengthening **US dollar**, fueled by higher **bond yields** and global demand for safe-haven assets, has caused **capital outflows from India**, pressuring the rupee.

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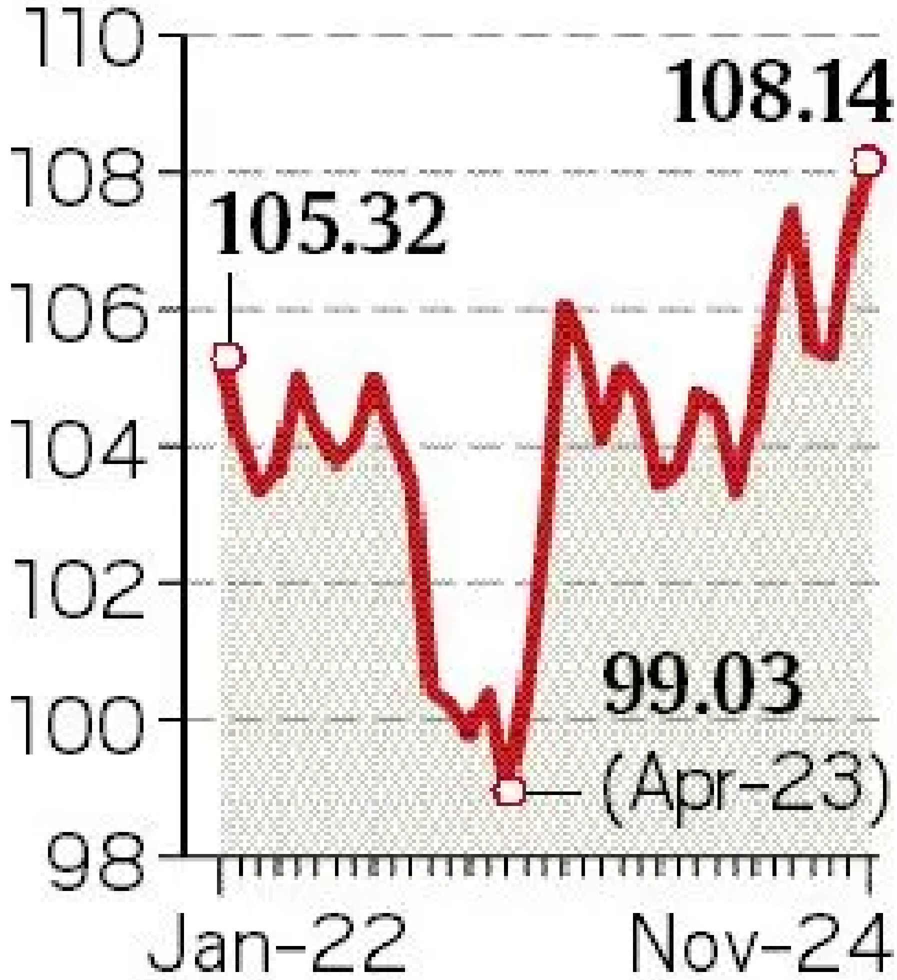
₹ REAL EFFECTIVE EXCHANGE RATE



**Trade-weighted against 40-currency basket; Base: 2015-16 =100; Source: Reserve Bank of India*

What is NEER and REER, and their Significance?

- **Definition:**
  - **NEER**: The **Nominal Effective Exchange Rate (NEER)** is a weighted average of a currency's bilateral **exchange rates** relative to multiple trading partner currencies.
    - It reflects nominal currency strength without accounting for **inflation** or price level differences between countries.
    - A rise in **NEER indicates** nominal appreciation, while a fall signals depreciation.
  - **REER**: The **Real Effective Exchange Rate (REER)** improves upon NEER by adjusting for **relative price levels (inflation)** between the domestic economy and its trading partners.
    - **REER** is calculated as the **NEER** multiplied by the ratio of domestic price indices to foreign price indices, making it a purchasing **power parity (PPP)**-adjusted measure.
  - **Indices of NEER/REER**: The **NEER/REER indices** for India includes **six currencies:** the US Dollar (USD), Euro (EUR), Japanese Yen (JPY), British Pound (GBP), Chinese Yuan (CNY), and Singapore Dollar (SGD).
    - The **NEER/REER indices** have been revised to include a broader basket of 36 currencies.
  - **Influencing Factors**: **NEER and REER** trends are influenced by **productivity differences** (affecting competitiveness), **trade terms** (affecting export/import balance), **inflation** (eroding currency value), and **fiscal spending** (impacting economic stability and demand).
- **Significance of NEER**:
  - **Trade-weighted Index**: NEER gauges a currency's nominal performance against multiple trading partners, reflecting broad external currency trends.
  - **Limited Insight**: Since it ignores **inflation differences**, **NEER** may not accurately reflect actual trade competitiveness or purchasing power.
  - **Macroeconomic Use**: Policymakers use **NEER** to understand trends in currency strength and plan nominal interventions when needed.
- **Significance of REER**:
  - **Indicator of Competitiveness**: REER measures a country's **external competitiveness** by accounting for inflation, with a higher value indicating reduced **export competitiveness** and **cheaper imports**.
  - **Policy Guide**: REER is critical for determining whether a currency is **overvalued or undervalued**, guiding **monetary policy** and **exchange rate** adjustments.
  - **Trade Balance Impact**: Depreciation of REER improves the **trade balance** more in the short term by enhancing export competitiveness.

UPSC Civil Services Examination, Previous Year Questions (PYQs)

Prelims:

Q. With reference to the Indian economy, consider the following statements: (2022)

1. An increase in Nominal Effective Exchange Rate (NEER) indicates the appreciation of rupee.
2. An increase in the Real Effective Exchange Rate(REER) indicates an improvement in trade competitiveness.
3. An increasing trend in domestic inflation relative to inflation in other countries is likely to cause an increasing divergence between NEER and REER.

Which of the above statements are correct?

(a) 1 and 2 only

(b) 2 and 3 only

(c) 1 and 3 only

(d) 1, 2 and 3

Ans: (c)

Mains:

Q. How would the recent phenomena of protectionism and currency manipulations in world trade affect macroeconomic stability of India? (2018)