



Increasing Real Effective Exchange Rate in India

[Source: IE](#)

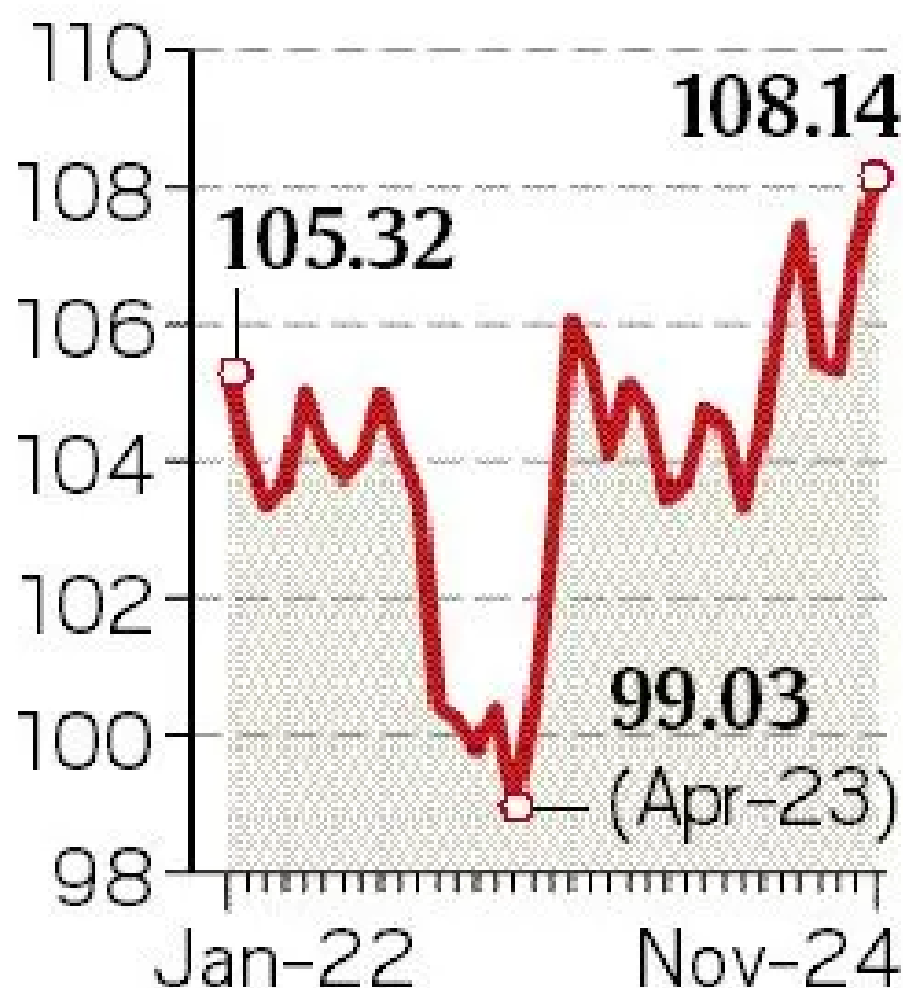
Why in News?

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.

₹ 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.

INTERNATIONALISATION OF RUPEE

MEANING

- Increasing the use of Indian rupee in cross-border transactions

INVOLVES

- Rupee for **import** and **export**
- Rupee for **current** and **capital account** transactions

Indian Rupee is fully convertible in current account, but partially in capital account (BoP)

NEED

- Weaponisation of USD by US (for **sanctions**)
- Wave of **de-dollarisation**
- Increasing **internationalisation** of Chinese Renminbi
- India's **minimal share** in global forex market turnover (1.7%)

RBI'S EFFORTS

- Indian currency in cross-border trade - key component in **Foreign Trade Policy 2023**
- Mechanism introduced for **rupee trade settlement with 18 countries**
 - Banks from these countries allowed to open **Special Vostro Rupee Accounts (SVRAs)**
- Circular on "International Trade Settlement in Indian Rupees" (2022)
- External **commercial borrowings** in INR enabled

SIGNIFICANCE

- Reduced dependency** on USD
- Lesser need** for holding forex reserves
- Better bargaining power** of Indian business
- Less exposure** to currency volatility

CHALLENGES

- Rupee not fully convertible
- Less need for other countries to hold INR;
India's **low share** in global exports
- Rupee may become **more vulnerable** to external shocks
- India's **lesser control** on Rupee supply

STEPS THAT CAN BE TAKEN

- More **liberalised settlements** in INR (in India and overseas)
- India to **expand its reach** in the global financial market
- Transition to an **export-oriented economy** to **reduce trade deficit**



UPSC Civil Services Examination, Previous Year Questions (PYQs)

Prelims:

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

- An increase in Nominal Effective Exchange Rate (NEER) indicates the appreciation of rupee.
- An increase in the Real Effective Exchange Rate (REER) indicates an improvement in trade competitiveness.
- 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)

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