



RBI Governor Highlights Rupee Undervaluation Amid Exchange Rate Volatility and External Sector Developments

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Recent Developments:

- **The Governor of the Reserve Bank of India (RBI)** has stated that the **Indian rupee** is **undervalued** in both **Nominal Effective Exchange Rate (NEER)** and **Real Effective Exchange Rate (REER)** terms, indicating that its current market value is weaker than what India's macroeconomic fundamentals would ordinarily justify.
- **The RBI** has reiterated that it does **not target any specific exchange rate**, but intervenes in the foreign exchange market only to contain excessive volatility and maintain orderly market conditions under India's **managed float exchange rate regime**.
- **Recent movements in the rupee** have been influenced by geopolitical tensions in **West Asia**, elevated global crude oil prices, a stronger US dollar, and fluctuations in foreign capital flows, prompting calibrated interventions by the RBI.

Understanding Currency Undervaluation:

Meaning of an Undervalued Currency:

- A **currency** is considered **undervalued** when its prevailing market exchange rate remains below the level justified by a country's underlying macroeconomic fundamentals.
- **Economic fundamentals** include **economic growth, inflation, productivity, current account position, foreign exchange reserves, fiscal stability, external debt sustainability, and investor confidence**, all of which influence the long-term equilibrium value of a currency.
- An **undervalued currency** generally reflects that the domestic currency is trading at a weaker level than its estimated equilibrium value despite relatively sound economic conditions.
- **Temporary external shocks**, such as geopolitical conflicts, global financial uncertainty, or sudden capital outflows, may push a currency below its equilibrium value, resulting in temporary undervaluation.
- **Persistent undervaluation**, however, may also arise from structural weaknesses such as prolonged external imbalances, declining productivity, or weak capital inflows.

Why the RBI Governor's Statement is Significant:

- **The Governor's observation** indicates that the recent depreciation of the rupee does not necessarily reflect deterioration in India's economic fundamentals but is largely influenced by external global developments.
- **The statement** reassures financial markets that India's external sector fundamentals remain relatively resilient despite short-term exchange rate pressures.
- **It also signals** that the RBI considers recent exchange rate movements to be largely market-driven rather than indicative of long-term macroeconomic weakness.

RBI's Exchange Rate Management:

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Managed Float Exchange Rate System:

- **India follows a managed float exchange rate regime**, under which the value of the rupee is primarily determined by market forces of demand and supply, while the RBI intervenes only when necessary to reduce excessive volatility.
- **The RBI** does not maintain any predetermined exchange rate target or fixed exchange rate band for the rupee.
- **Foreign exchange market interventions** are undertaken only to prevent disorderly market conditions rather than to artificially maintain a particular exchange rate level.
- **The objective of intervention** is to preserve financial stability, ensure adequate market liquidity, and prevent speculative attacks on the domestic currency.

Role of Foreign Exchange Reserves:

- **The RBI** uses India's foreign exchange reserves as an important instrument for managing excessive exchange rate volatility.
- **During periods of sharp depreciation**, the RBI may sell US dollars in the foreign exchange market to moderate abrupt movements in the rupee.
- **Conversely, during periods of excessive appreciation**, the RBI may purchase foreign currency to prevent undue strengthening of the rupee while simultaneously augmenting foreign exchange reserves.
- **Such calibrated intervention** supports orderly market functioning without compromising the overall flexibility of the exchange rate regime.

Major Factors Responsible for Recent Rupee Depreciation:

Rise in International Crude Oil Prices:

- **India's heavy dependence on crude oil imports** increases the demand for US dollars whenever international crude oil prices rise.
- **Higher import payments** widen the import bill, increase demand for foreign currency, and exert downward pressure on the value of the rupee.
- **Elevated energy prices** also contribute to imported inflation, thereby affecting overall macroeconomic stability.

Geopolitical Uncertainty:

- **Conflicts in West Asia** have disrupted global energy markets, increased uncertainty, and intensified pressure on the currencies of oil-importing emerging economies such as India.
- **Heightened geopolitical risks** often trigger capital movement towards safer financial assets, thereby weakening emerging market currencies.

Strengthening of the US Dollar:

- **A stronger US dollar**, supported by relatively higher US interest rates and increased global demand for dollar-denominated assets, reduces the relative value of most other currencies, including the Indian rupee.
- **Appreciation of the US dollar** also increases the cost of servicing foreign currency-denominated liabilities for emerging market economies.

Higher Global Risk Aversion:

- **Periods of global financial uncertainty** encourage investors to shift investments towards safe-haven assets such as the US dollar and US Treasury securities.

- **Capital outflows from emerging markets** consequently increase demand for dollars and contribute to depreciation of domestic currencies.

Foreign Portfolio Investment (FPI) Outflows:

- **Foreign Portfolio Investors (FPIs)** selling Indian equity and debt investments convert rupee holdings into foreign currency before repatriation, thereby increasing demand for US dollars.
- **Sustained portfolio outflows** exert additional depreciation pressure on the rupee and may increase exchange rate volatility.

Nominal Effective Exchange Rate (NEER):

Meaning of NEER:

- **The Nominal Effective Exchange Rate (NEER)** is a **trade-weighted average index** that measures the value of the Indian rupee against the currencies of India's major trading partners.
- **Instead of comparing** the rupee with only one foreign currency such as the US dollar, **NEER** evaluates its movement against a basket of multiple currencies, thereby providing a broader assessment of exchange rate performance.
- **The RBI currently computes 40-currency trade-weighted NEER**, covering currencies that together account for nearly **88% of India's merchandise trade**.
- **The base year** for the present NEER series is **2015–16 = 100**, and the weight assigned to each currency is based on its respective share in India's external merchandise trade.
- **NEER**, however, measures only nominal exchange rate movements and **does not adjust for inflation differentials** between India and its trading partners, making it less suitable for assessing external competitiveness over the long term.

Real Effective Exchange Rate (REER):

Meaning of REER:

- **The Real Effective Exchange Rate (REER)** is the **inflation-adjusted version of the Nominal Effective Exchange Rate (NEER)** and measures the value of the Indian rupee against the currencies of India's major trading partners after accounting for relative inflation differences.
- **REER** reflects changes in both the nominal exchange rate and domestic price levels, thereby providing a more accurate measure of a country's international price competitiveness.
- **The RBI** currently publishes the **40-currency trade-weighted REER** with **2015–16 as the base year**, using relative consumer price indices to adjust for inflation differentials.
- **A rise in REER** generally indicates appreciation in real terms and a possible decline in export competitiveness, whereas **a decline in REER** suggests improvement in price competitiveness of domestic goods and services.
- **Among exchange rate indicators**, **REER** is regarded as the most comprehensive measure for assessing external competitiveness because it captures both exchange rate movements and inflation dynamics.

NEER and REER:

- **NEER** measures only the trade-weighted movement of the rupee against a basket of foreign currencies without considering inflation differences.
- **REER** adjusts **NEER** for inflation differentials between India and its trading partners, thereby providing a more realistic assessment of international competitiveness.
- **While NEER** primarily reflects nominal exchange rate movements, **REER** indicates the real purchasing power and competitiveness of the domestic currency in international trade.

- **Consequently, policymakers, economists, and the RBI** generally rely more on **REER** while assessing the external competitiveness of the Indian economy.

Economic Implications of an Undervalued Rupee:

Major Challenges:

- **An undervalued rupee** increases the domestic cost of imports, thereby raising India's overall import bill and widening pressures on the current account balance.
- **Higher import costs**, particularly for crude oil, natural gas, fertilisers, edible oils, and electronic components, contribute to **imported inflation** and increase production costs across multiple sectors.
- **Industries dependent on imported intermediate goods and raw materials** experience higher input costs, which may reduce profitability and competitiveness in the domestic market.
- **External debt denominated in foreign currency** becomes more expensive to service because larger amounts of rupees are required to repay the same foreign currency obligations.
- **Persistent depreciation**, if driven by structural weaknesses rather than temporary shocks, may weaken investor confidence and increase exchange rate uncertainty.

Potential Advantages:

- **A relatively weaker rupee** improves the price competitiveness of Indian exports in international markets by making domestic goods relatively cheaper for foreign buyers.
- **Export-oriented sectors**, including information technology services, pharmaceuticals, textiles, engineering goods, and agricultural exports, may experience higher demand due to improved international competitiveness.
- **Indian exporters** receive higher earnings in rupee terms for the same amount of foreign currency revenue, thereby improving profitability.
- **A weaker exchange rate** may also encourage import substitution by making domestically produced goods relatively more competitive than imported products.

RBI's Foreign Exchange Market Intervention:

Objectives of Intervention:

- **The RBI** intervenes in the foreign exchange market primarily to contain excessive volatility rather than to defend any predetermined exchange rate.
- **Its intervention strategy** seeks to prevent disorderly market movements that could adversely affect financial stability, trade, investment, and overall macroeconomic confidence.
- **The RBI** purchases or sells foreign currencies depending on prevailing market conditions while preserving sufficient foreign exchange reserves for external sector stability.
- **The intervention framework** supports India's **managed float exchange rate regime**, under which market forces determine the exchange rate while the central bank addresses abnormal fluctuations.

Way Forward:

Strengthening External Sector Stability:

- **Maintaining adequate foreign exchange reserves** remains essential for managing temporary external shocks and strengthening confidence in India's external sector.
- **Reducing dependence on imported crude oil** through renewable energy expansion, energy efficiency, and domestic exploration can moderate long-term exchange rate pressures.

- **Diversification of exports** towards high-value manufacturing and knowledge-intensive services would improve export resilience and reduce vulnerability to global demand fluctuations.
- **Stable capital inflows**, supported by a predictable policy environment and continued structural reforms, can strengthen the balance of payments and support exchange rate stability.
- **Prudent monetary policy, fiscal discipline, and sustained productivity growth** remain critical for preserving macroeconomic stability and maintaining the long-term strength of the Indian rupee.

Significance for UPSC:

Why the Topic Matters:

- **Currency valuation, NEER, REER, exchange rate management, foreign exchange reserves, imported inflation, current account deficit, and capital flows** are core concepts under **Indian Economy (GS-III)** and are frequently examined in both **Prelims** and **Mains**.
- **The topic** also has strong relevance for questions relating to **monetary policy, external sector management, inflation, balance of payments, and macroeconomic stability**.
- **The RBI's managed float exchange rate regime** is an important conceptual area for understanding India's exchange rate policy and financial sector governance.

Value Addition for UPSC:

Prelims Value:

- Reserve Bank of India (RBI)
- Managed Float Exchange Rate Regime
- Nominal Effective Exchange Rate (NEER)
- Real Effective Exchange Rate (REER)
- Foreign Exchange Reserves
- Foreign Portfolio Investment (FPI)
- Current Account Deficit (CAD)
- Balance of Payments (BoP)
- Imported Inflation
- Trade Competitiveness

Mains Value (GS-III):

- **An exchange rate should broadly reflect macroeconomic fundamentals while remaining flexible enough to absorb external shocks. India's managed float exchange rate regime, supported by prudent foreign exchange reserve management and calibrated Reserve Bank of India intervention, seeks to balance external competitiveness, price stability, financial market confidence, and long-term macroeconomic resilience.**