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RBI Governor Says Indian Rupee is Undervalued Despite Depreciation, Highlighting Strong Macroeconomic Fundamentals and External Sector Resiliencev

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Recent Developments:

- **RBI Governor Sanjay Malhotra** stated that the **Indian Rupee** is **undervalued** in both **Nominal Effective Exchange Rate (NEER)** and **Real Effective Exchange Rate (REER)** terms despite depreciating by nearly **5.8%** against the **US Dollar** during 2026.
- The RBI maintained that the recent weakness of the rupee primarily reflects **global financial headwinds** rather than deterioration in India's domestic macroeconomic fundamentals.
- RBI data showed that the **40-currency REER** recovered from **89.08 in May 2026** to **91.26 in June 2026**, although it remained below the equilibrium benchmark of **100**, indicating an undervalued currency.

Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER):

Nominal Effective Exchange Rate (NEER):

- **NEER** is a **trade-weighted average index** measuring the **nominal (face value) strength of the Indian Rupee** against a basket of currencies of India's major trading partners.
- **NEER** reflects overall movements in the rupee rather than changes against a single foreign currency.
- The RBI publishes NEER using two trade-weighted baskets:
- **6-Currency Basket: US Dollar, Euro, Chinese Yuan, British Pound, Japanese Yen, Hong Kong Dollar**.
- **40-Currency Basket:** Covers around **88% of India's merchandise trade**, providing a broader measure of the rupee's external value.
- The **base year** for the index is **2015–16 = 100**.
- An **increase** in the NEER index indicates **appreciation** of the rupee, while a **decline** indicates **depreciation**.
- **Limitation:** NEER does not adjust for **inflation differentials** between countries and therefore cannot accurately measure international competitiveness.

Real Effective Exchange Rate (REER):

- **REER** is the **inflation-adjusted version of NEER**, measuring the value of the rupee after accounting for inflation differences between India and its trading partners.
- **REER** is considered a more reliable indicator of **external competitiveness**, **currency valuation** and **trade performance**.
- The RBI currently compiles REER using the **Consumer Price Index (CPI)** for inflation adjustment.
- Economists widely use REER as a proxy for assessing whether a currency is aligned with its **Purchasing Power Parity (PPP)**.

Interpretation of REER:

- **REER above 100:** Indicates the currency is **overvalued**, making exports relatively expensive and imports relatively cheaper.
- **REER below 100:** Indicates the currency is **undervalued**, improving export competitiveness while making imports relatively costlier.

Limitations of REER:

- **REER** measures only **price competitiveness** and ignores **non-price competitiveness**, such as product quality, innovation, logistics efficiency, ease of doing business and technological capability.
- **REER** primarily reflects **merchandise trade** and does not adequately capture the growing importance of **India's services exports**.
- **REER** should therefore be interpreted along with other macroeconomic indicators rather than in isolation.

Exchange Rate Regime in India:

Managed Floating Exchange Rate System:

- Since **March 1993**, India has followed a **market-determined managed floating exchange rate regime**.
- The exchange rate is largely determined by **market demand and supply**.
- The **RBI intervenes** only to reduce excessive volatility and maintain orderly conditions in the foreign exchange market.
- The RBI does **not target any fixed exchange rate level**, but seeks to prevent disruptive fluctuations.

Importance of Exchange Rate:

- Influences **exports and imports**.
- Affects **capital flows** and foreign investment.
- Determines **inflation**, especially imported inflation.
- Impacts **external debt servicing**.
- Influences **foreign exchange reserves**, **current account balance** and overall macroeconomic stability.

Why Does the RBI Consider the Rupee Undervalued?

Shift from Overvaluation to Undervaluation:

- The rupee depreciated from around **?84.4 per US Dollar (November 2024)** to nearly **?95.5 (May 2026)**.
- During the same period:
- **NEER** declined from **91.68** to **77.19**.
- **REER** declined from **108.03** to **89.08**, before improving to **91.26** in June 2026.
- The movement of REER below **100** indicates that the rupee has shifted from being **overvalued** to **undervalued**.

Strong Macroeconomic Fundamentals:

- India's **GDP growth** remains above **6%**.
- **Inflation** has moderated.
- The **external sector** remains stable.
- **Foreign exchange reserves** remain sufficient to finance **more than eleven months of imports**.
- These indicators suggest that recent currency depreciation does not reflect deterioration in India's economic fundamentals.

Global External Headwinds:

- Higher **crude oil prices** increased India's import bill.
- A stronger **US Dollar** exerted pressure on emerging market currencies.
- **Geopolitical tensions** increased global risk aversion.
- **Foreign Portfolio Investor (FPI)** outflows increased demand for dollars, putting temporary downward pressure on the rupee.

REER-Based Assessment:

- RBI considers the rupee to be trading below its estimated equilibrium level based on **REER**, implying that the depreciation has exceeded what macroeconomic fundamentals would ordinarily justify.

Impact of an Undervalued Rupee on India's Economy:

Potential Benefits:

- Improves **export competitiveness** by making Indian goods cheaper in international markets.
- Encourages **domestic manufacturing** by making imported products relatively expensive.
- Supports the **Make in India** initiative.
- Can reduce the **trade deficit** if export growth exceeds import growth.
- Promotes higher **employment** in export-oriented industries.

Associated Risks:

- Raises the cost of **crude oil, fertilizers, electronics, machinery** and other imports.
- Increases **imported inflation**, particularly through higher fuel prices.
- Raises production costs for industries dependent on imported raw materials.
- Increases the repayment burden of **External Commercial Borrowings (ECBs)**.
- May widen the **Current Account Deficit (CAD)** during periods of elevated commodity prices.

Need for Structural Competitiveness:

- Sustainable export growth requires improvements in:
- **Productivity, logistics efficiency, infrastructure, technology adoption, manufacturing quality**.
- Exchange rate competitiveness alone cannot ensure long-term export success.

Related UPSC Concepts:

Purchasing Power Parity (PPP):

- **PPP** states that identical goods should cost the same across countries after adjusting for exchange rates.
- Persistent deviations between REER and PPP may indicate **currency overvaluation** or **undervaluation**.

Current Account Deficit (CAD):

- **CAD** arises when the value of imports exceeds exports of goods and services.
- A weaker rupee can reduce CAD if exports rise sufficiently, but higher oil imports may offset this benefit.

Foreign Exchange Reserves:

- Managed by the **RBI**.
- Used to:
- Maintain confidence in the currency.
- Meet external payment obligations.

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- Stabilise exchange rate volatility.
- Support financial stability.

Foreign Portfolio Investment (FPI):

- Sudden FPI outflows increase demand for foreign currency and often lead to depreciation of the domestic currency.

Conclusion:

- Short-term exchange rate fluctuations are an inherent feature of an open economy integrated with global financial markets.
- India's strong macroeconomic fundamentals provide a durable foundation for long-term currency stability.
- Maintaining a **market-determined exchange rate regime**, strengthening **manufacturing competitiveness**, diversifying **exports**, deepening **financial markets**, improving **energy security** and sustaining **macroeconomic stability** will remain critical for enhancing the long-term resilience of the Indian rupee.

Value Addition for UPSC:

Quick Revision Facts:

- **Exchange Rate Regime:** Market-determined **Managed Floating Exchange Rate System** (since **March 1993**).
- **NEER:** Trade-weighted **nominal** exchange rate index.
- **REER: Inflation-adjusted** trade-weighted exchange rate index.
- **Base Year: 2015–16 = 100**.
- **REER > 100:** Currency **Overvalued**.
- **REER < 100:** Currency **Undervalued**.
- **RBI Inflation Measure for REER: Consumer Price Index (CPI)**.

REER is a better indicator of **external competitiveness** than **NEER** because it incorporates inflation differentials

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