Real Effective Exchange Rate (REER)

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Why in news?

The**rupee**has been hitting**record lows**against the US dollar but has simultaneously reached an**all-time high in real effective terms**. In November 2024, the**Real Effective Exchange Rate (REER)**index of the rupee touched**108.14**, strengthening by**4.5%**during the year, according to the RBI.

What is REER?

The **Real Effective Exchange Rate (REER)** is a measure of a currency's value relative to a basket of other major currencies, adjusted for inflation differentials between the country and its trading partners. REER provides a more accurate reflection of a currency's purchasing power and its competitiveness in international trade.

Key Points:

1. **Effective Exchange Rate (EER)**:

- **EER** measures the value of a currency in relation to a basket of foreign currencies, specifically those of its major trading partners.
- It is a **weighted average** of exchange rates, with more weight given to currencies from countries that are more important to the country's trade.

1. **Types of EER**:

- **Nominal Effective Exchange Rate (NEER)**:
- A weighted average of the currency's exchange rate with its trading partners' currencies, **without adjusting for inflation**.
- It represents only the **nominal change** in the value of the currency.
- **Higher NEER** indicates a stronger domestic currency relative to the basket of currencies.
- **Real Effective Exchange Rate (REER)**:
- REER **adjusts NEER for inflation** differentials between the domestic country and its trading partners.
- **REER > 100** indicates an overvalued currency, reducing the competitiveness of exports.
- **REER < 100** indicates an undervalued currency, enhancing export competitiveness.

REER and Its Impact on Exports:

1. **When REER > 100 (Overvalued Currency)**:

- **Exports**: Become **less competitive**, as Indian goods and services are more expensive in global markets.
- **Imports**: Increase, as foreign goods become cheaper compared to domestic goods.
- **Trade Deficit**: Likely to widen, as imports rise and exports fall.

1. **When REER < 100 (Undervalued Currency)**:

- **Exports**: Flourish, as Indian goods and services become **more competitively priced** in global markets.
- **Imports**: Decline, as foreign goods become more expensive relative to domestic goods.
- **Trade Surplus**: Can improve, supporting domestic industries and employment.

Example:

As of **November 2024**, the REER of the Indian rupee reached **108.14**, which indicates an appreciation of the rupee in real terms despite its depreciation against the US dollar. This signifies that the rupee is currently **overvalued** relative to the basket of currencies of India’s major trading partners, potentially making Indian exports more expensive and imports cheaper.

Conclusion:

REER is an important indicator of a currency’s international competitiveness. A **higher REER** (above 100) can hurt exports, while a **lower REER** (below 100) can boost exports by making the country's goods more affordable globally. This impacts trade balances and the overall economy.