

# **Busting the Myth of Rupee Over-Valuation**

### Why in news?

Recently RBI has released a new series of REER which is effective in depicting the rupee's over/under valuation.

#### What is REER?

- It is the standard measure to gauge the value of the home currency against the weighted average value of the currencies of its trading partners divided by a price deflator or index.
- REER above 100 denotes that the home currency is overvalued and more expensive compared to its competitors.
- During the global financial crisis in 2007-08, REER was around the 100 and it was moving close to 120 in 2017-18.
- This shows that the rupee was overvalued against its trading partners and is affecting India's exports.
- Now RBI has released new series for REER which reflects the true state of affairs.

#### How is new series different from earlier one?

- Earlier REER and NEER (not adjusted to inflation) was a basket of 6 and 36 currency index respectively with a base year of 2004-05.
- The new series of REER has the base year of 2015-16 and the basket has been expanded from 36 to 40 currencies.
- Countries like Angola, Chile, Ghana, Iraq, Nepal, Oman, Tanzania, Ukraine have been included while Argentina, Pakistan, Philippines and Sweden got removed.
- The new basket represents 88% of India's total trade as against 84% in the earlier 36-currency basket.

#### Is the new series better?

- The new series appears to be a vast improvement on the previous one in depicting the rupee's over/under valuation.
- It did not cross above 100 in the period between April 2004 and February 2015 and was around 90-100.

- Though the index has moved above 100 since then, the overvaluation was limited to 7%.
- Therefore the new series is far more in sync with the BIS values.

## What are the shortcomings in the new series?

- One, the selection of trading partners is based on overall merchandise trade.
- But it is better to consider trade in manufactured goods alone as it reflects the right amount of export competitiveness.
- Two, it is not clear whether the new series has addressed trans-shipment effect.
- If it was done, the weight for the UAE may have been lower.
- Market completion means weights are modified to take in to account countries that are trading partners as well as export competitors in other markets.
- Three, adjustments in third market completion will result in higher weights for Asian countries and lower weight for Euro region which will make rupee REER more effective.

#### What can we infer from this?

- It is clear that rupee is quite competitively valued and the reasons for sluggish exports lie elsewhere.
- RBI has maintained that its intention is to maintain stability in the rupee movement and not targeting any specific level for exchange rate.
- The new series of the RBI and coupled with inflation targeting can help the rupee to stay competitive in the export markets.
- But there are constant demands to weaken the rupee for helping the exporters which should not be heeded to.
- Weak currency will hurt the importers and their profit margins besides being inflationary.
- Also foreign investors tend to think twice about investing in a country with a currency that is on a downward spiral.
- Now it is probably the time to rethink the policy of allowing the rupee to slide indefinitely.

**Source: Business Line** 

