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