

Daily Mains Practice Answer 30-07-2026

Q. Why does the Reserve Bank of India assess the rupee as being undervalued? Discuss the role of the Real Effective Exchange Rate (REER) in assessing the value of the Indian rupee. What are its limitations? (250 words, 15 marks)

Direction: Intro---- Rupee is undervalued - RBI + Role of REER + Limitations----- Conclusion.

Introduction:

Define undervaluation/ Real Effective Exchange Rate (REER).

A currency is described as undervalued when its market exchange rate is lower than its true economic fundamentals.

The REER compares the rupee with the currencies of India's major trading partners after adjusting for inflation differences.

Main Body

Why RBI assess the rupee as being undervalued?

- Global shocks - Rising crude oil prices, geopolitical tensions (e.g., West Asia conflicts), and capital outflows have weakened the rupee beyond its equilibrium value.
- Strong US dollar - Global demand for dollar assets has reduced the relative value of emerging market currencies, including the rupee.
- Strong macroeconomic fundamentals - India remains one of the fastest-growing major economies - robust forex reserves, resilient external sector, inflation control, etc.
- Policy stance - RBI does not target a fixed exchange rate but intervenes to curb volatility.

Role of the REER in assessing the value of the Indian rupee

- Measures export competitiveness
- Assesses exchange rate misalignment
- Guides monetary and exchange rate policy
- Monitors external trade balance
- Supports macroeconomic analysis

Limitations of REER

- Captures an inflation-based measure only, not productivity growth.

- Sensitive to base year and currency basket, making comparisons imperfect.
- Ignores non-price competitiveness like technology, quality, etc.
- Does not account for capital flows, investor sentiment and financial market dynamics.
- Less effective in a services-led economy, as REER largely reflects merchandise trade rather than services exports.

Conclusion:

Give a balanced and way-forward-based conclusion.

