

Paper -IV

ECONOMY AND DEVELOPMENT OF INDIA

The Falling Indian Rupee: Causes, Consequences, and Defense Mechanisms

Context and Current Scenario

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Why is the Indian rupee falling?

How does a falling rupee affect India's economy? How does a currency's exchange rate shape its balance of payments? To what extent does Foreign Portfolio Investment influence demand for the rupee? What strategic role does the Reserve Bank of India play in preventing the rupee's depreciation?

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Rupee has fallen 7% so far in CY26, the highest in four years

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ASHOKAMITHRAN T.

FOREX

Rupee slumps as elevated crude, treasury yields support dollar

The rupee ended down 0.8% in its sharpest fall in four weeks to settle at 95.7075 per dollar

By Reuters

Updated - June 08, 2026 at 05:32 PM.

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OPINION

Why the rupee has fallen steeply

bl. PREMIUM

Despite the economy doing well, there was sustained foreign capital outflow which put pressure on the rupee and affected the sentiment around it

By Parthapratim Pal & Partha Ray

Updated - April 30, 2026 at 06:00 AM.



Premium

Explained: RBI's ban on speculative games in rupee through NDD, amid pressures on rupee

By eliminating a key avenue for speculative exercise, the central bank is attempting to stabilise currency movements, hit hard by the rising oil prices and capital outflows in the wake of the West Asia conflict.

- **Current Trend:** The Indian Rupee (INR) has witnessed a sharp depreciation, crossing the **₹96-97 mark** against the U.S. dollar in mid-2026 (down from ~₹85 a year ago).
- **Magnitude:** In Calendar Year 2026 (CY26) alone, the rupee depreciated by **over 7%**, marking its steepest fall since 2022.
- **Drivers:** A toxic mix of geopolitical shocks (Middle East tensions), global macroeconomic shifts (U.S. Fed policy), and volatile capital flows.

1. Reasons for the Falling Rupee

The exchange rate is determined by the demand and supply of foreign exchange. The current slide is driven by converging factors:

- **Geopolitical Tensions & Crude Oil Spike:** Ongoing Iran-U.S. tensions and threats to the Strait of Hormuz have pushed **Brent crude past \$110/barrel**. Since India imports >80% of its oil, this drastically spikes dollar demand from Oil Marketing Companies (OMCs).
- **Widening Current Account Deficit (CAD):** Persistent merchandise trade deficits mean dollar outflows for imports exceed dollar inflows from exports.

- **Speculative FPI Outflows:** Foreign Portfolio Investors (FPIs) are aggressively selling Indian equities (e.g., offloading ₹2,457 crore in single sessions) to move capital to safer havens.
- **U.S. Fed Policy & Strong Dollar:** Strong U.S. jobs data and expectations of Federal Reserve rate hikes have elevated U.S. Treasury yields. This narrows the interest rate differential, pulling "hot money" out of emerging markets.
- **Global Trade Headwinds:** Protectionist policies and global tariffs (e.g., U.S. tariffs under the Trump administration) have dampened Indian export prospects.

2. Consequences of a Falling Rupee

A. Negative Impacts (Macro & Micro)

- **Imported Inflation:** A weaker rupee makes essential imports (oil, electronics, fertilizers) costlier. This trickles down to transport and everyday commodities, disproportionately hurting the common man.
- **Widening CAD (The Inelasticity Trap):** Because India's demand for crude oil is inelastic, a falling rupee increases the total import bill without significantly reducing the volume of imports, widening the CAD.
- **Market Volatility:** FPI outflows trigger sell-offs in equity markets (Sensex/Nifty). If the RBI hikes rates to defend the currency, bond yields rise, hurting rate-sensitive sectors like real estate and banking.
- **Corporate Stress:** Indian corporates with foreign currency-denominated debt (ECBs) face a sudden spike in their repayment burdens.

B. Positive Impacts (Theoretical vs. Practical)

- **Export Competitiveness:** Theoretically, a weaker rupee makes Indian goods cheaper globally (e.g., a ₹1,200 shirt is cheaper for a U.S. buyer at ₹96/*than at* ₹80/).
- **Boost to Invisibles:** IT/Software export revenues and NRI remittances fetch more rupees when converted, providing a partial cushion to the CAD.
- **Mains Nuance - The "Falling" vs. "Weak" Rupee Paradox:**
 - A structurally *weak* rupee boosts exports.
 - A rapidly *falling* rupee does not. If foreign buyers expect the rupee to fall further, they delay orders to get even cheaper prices later. Furthermore, Indian manufacturing faces supply-side bottlenecks that prevent instant capacity scaling.

3. Defense Mechanism I: RBI Measures (Short-to-Medium Term)

The RBI's objective is not to defend a specific numerical target, but to curb extreme volatility and speculative overshooting.

1. Forex Market Intervention (Spot & Swaps)

- **Spot Sales:** Selling USD from the **\$691 billion forex reserve** buffer (10.8 months import cover) to increase dollar supply.
- **Dollar-Rupee Swaps:** Using Buy/Sell or Sell/Buy swaps to inject or absorb dollar liquidity without permanently depleting spot reserves.

2. Derivatives Clampdown (Curbing Speculation)

- **NDF Restrictions:** The offshore **Non-Deliverable Forward (NDF)** market (in Singapore/London) is heavily used to short the rupee. The RBI restricts domestic banks from participating in offshore NDFs and curbs excessive arbitrage between onshore and offshore markets.
- **Net Open Position (NOP) Limits:** The RBI strictly enforces limits on banks' open forex positions to prevent speculative dollar hoarding and forces banks to "square off" excessive short positions.
- *Mains Keyword:* "Containing speculative attacks through NDF market regulation."

3. Interest Rate Defense (Monetary Policy)

- Adopting a hawkish stance or hiking the Repo Rate increases yields on Indian bonds. This attracts foreign "carry-trade" capital and supports rupee demand, though it risks slowing domestic growth.

4. Easing Capital Inflows

- **FCNR(B) Scheme:** Offering hedging-cost support or lucrative swap windows on **Foreign Currency Non-Resident (Bank)** deposits to attract NRI dollars (Expected inflows: \$35–40 billion).
- **ECB Relaxation:** Easing norms and raising the all-in-cost ceiling for External Commercial Borrowings by corporates.

4. Defense Mechanism II: Government Measures (Long-Term & Structural)

The Government addresses the root causes of dollar demand and structural macroeconomic vulnerabilities.

1. Rupee Internationalisation & Bilateral Trade

- **Special Rupee Vostro Accounts (SRVA):** Allowing foreign banks to maintain rupee accounts in Indian banks. This enables bilateral trade settlement in INR (e.g., with Russia or UAE), directly reducing the structural demand for USD.
- *Mains Keyword: "De-dollarization of bilateral trade via SRVA."*

2. Deepening the Debt Market

- **FAR (Fully Accessible Route):** Expanding the FAR framework for long-term Government Securities (G-Secs), allowing foreign investors unrestricted access to Indian sovereign bonds, thereby attracting stable dollar inflows.

3. Attracting Stable Capital (FDI over FPI)

- Promoting **PLI Schemes**, Make in India, and Ease of Doing Business to attract Foreign Direct Investment (FDI). Unlike volatile FPI "hot money," FDI is sticky, long-term, and builds domestic capacity.

4. Export Promotion

- Implementing the **RoDTEP** (Remission of Duties and Taxes on Exported Products) scheme, pushing logistics reforms, and aggressively pursuing Free Trade Agreements (FTAs) to boost dollar earnings.

5. Energy Security & Import Substitution

- Aggressively pushing the **Ethanol Blending Programme (EBP)**, National Green Hydrogen Mission, Solar Mission, and EV adoption to structurally reduce the crude oil import bill.

Way Forward

1. **Shift the Capital Composition:** India must transition its reliance from volatile portfolio flows (FPI) to stable, long-term foreign direct investment (FDI) and NRI deposits.
2. **Fix Manufacturing Bottlenecks:** To truly benefit from a weaker currency, India must resolve domestic supply-side constraints (infrastructure, logistics, credit) so that export volumes can actually scale up when the rupee falls.
3. **Strategic Forex Management:** The RBI should maintain a "managed float," intervening only to smooth out volatility and prevent panic, allowing the currency to gradually adjust to fundamental macroeconomic realities.
4. **Aggressive Energy Transition:** The ultimate shield against geopolitical oil shocks is domestic energy independence through renewables and green hydrogen.

Conclusion

The defense of the Indian Rupee requires a synchronized, **two-pronged strategy**. While the **RBI manages short-term exchange rate volatility** through spot intervention, forex swaps, NDF restrictions, and monetary policy signaling, the **Government addresses long-term structural weaknesses** through export promotion, FDI attraction, rupee internationalization (SRVA), and energy security. Together, these measures ensure that India transitions from merely surviving external currency shocks to building enduring external sector resilience.

