UPSC / APSC STUDY MODULE

GS PAPER III | INDIAN ECONOMY | EXTERNAL SECTOR

The Rupee Under Pressure

Understanding India's Currency Depreciation

A Comprehensive 14-Section Analytical Framework

Topics: Exchange Rate Dynamics • Balance of Payments • Monetary Policy • CAD • FPI Flows • Fiscal Policy • 1991 & 2013 Comparison

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For UPSC CSE & APSC CCE 2026 Aspirants

SECTION 1 KEY TERMS AND EXPLANATIONS

Exchange Rate & Currency Depreciation

The exchange rate is the price of one currency expressed in terms of another. When the Indian Rupee weakens against the US Dollar — meaning more rupees are needed to buy one dollar — that process is called depreciation. It is important to distinguish this from devaluation, which is a deliberate, government-declared reduction in a currency's official value. Depreciation happens organically in market-determined systems, which India has followed since 1993. The rupee's exchange rate today is set by market forces of demand and supply, with the RBI intervening only to manage excessive volatility.

Nominal vs. Real Effective Exchange Rate (REER)

The nominal exchange rate is the raw INR/USD figure that makes newspaper headlines. The REER is analytically far more powerful — it adjusts the nominal rate for inflation differentials across India's major trading partners and expresses the result as an index relative to a chosen base year. When REER rises above 100, the rupee is overvalued in trade terms, making Indian exports relatively expensive. When it falls below 100, the rupee is competitively undervalued, boosting export competitiveness. REER is the lens through which economists assess whether a currency is genuinely aligned with trade fundamentals.

Current Account Deficit (CAD)

India perpetually imports more goods and services than it exports, resulting in a structural Current Account Deficit. This means India is always a net demander of foreign currency — it needs dollars more than the global economy needs rupees. When CAD widens — often due to rising crude oil prices, gold imports, or electronics — pressure on the rupee intensifies. A CAD of up to 2.5% of GDP is generally considered manageable without alarming markets. Beyond that threshold, investors begin to price in currency and sovereign risk.

Capital Account and Foreign Portfolio Investors (FPIs)

The capital account records all cross-border financial flows — equity investments, government bonds, external commercial borrowings, and remittances. Foreign Portfolio Investors (FPIs) are foreign entities investing in Indian equity markets and government securities. When global risk appetite falls or Indian assets seem overvalued, FPIs sell, converting rupees back into dollars. This drains dollar supply from the domestic system, creating downward pressure on the rupee. FPI behaviour is driven by algorithmic models, global interest rate differentials, and index composition decisions — not always by India-specific fundamentals.

India-US Yield Spread

This is the difference between the interest rate on Indian 10-year Government Securities (G-Secs) and the equivalent US Treasury yield. Historically, this spread has been around 3.5 to 4 percentage points, compensating foreign investors for India's higher inflation and currency risk. When this spread compresses — as has happened recently, falling to around 2.5% — the relative attractiveness of Indian bonds declines. Foreign fixed-income investors receive a smaller premium for holding rupee-denominated assets, reducing inflows and making the currency more vulnerable during global dollar-strengthening episodes.

Systematic Investment Plans (SIPs) and the Liquidity Put

SIPs are periodic investments into mutual funds, which in turn buy equities. EPFO (Employees' Provident Fund Organisation) and NPS (National Pension System) are institutional channels that similarly funnel domestic savings into capital markets. Together, these create a structural and consistent domestic demand for equities — a floor of sorts under market prices — often called the liquidity put. This means that even as FPIs exit en masse, domestic institutional buyers absorb the supply, preventing sharp equity market crashes. The same dynamic, however, complicates currency correction, as explained in Section 2.

Balance of Payments (BoP)

The BoP is a comprehensive record of all financial transactions between India and the rest of the world — trade in goods and services, financial flows, income transfers, and changes in official reserves. A BoP deficit implies that overall outflows exceed inflows, requiring India to draw down its foreign exchange reserves. The RBI manages this through reserve deployment and, in crisis situations, through emergency borrowings or IMF arrangements.

Foreign Exchange Reserves

These are assets held by the RBI — primarily US dollars, gold, and Special Drawing Rights (SDRs) — serving as a buffer against external shocks. At approximately $690 billion, India's forex reserves represent enormous import cover and crisis-management capacity. They signal to global markets that India can defend the rupee against speculative attacks and service its external obligations without distress.

Taper Tantrum (2013)

In May 2013, the US Federal Reserve signalled it would begin tapering its bond-buying programme. Global capital immediately fled emerging markets in search of higher dollar-denominated returns. India was particularly exposed because its CAD had ballooned to 4.8% of GDP and forex reserves were thin. The rupee fell sharply from Rs.54 to Rs.68 within weeks, and India was branded one of the 'Fragile Five' emerging economies. The crisis was eventually contained through an emergency FCNR-B sovereign bond scheme under Governor Raghuram Rajan, which raised $34 billion.

Atmanirbharta

Literally meaning self-reliance, this is India's strategic vision of reducing dependence on imports and building domestic capability across sectors. In the financial context used here, the domestic mutual fund and pension ecosystem — channelling household savings into equity markets — represents India's most successful self-reliance experiment in capital formation. It has reduced dependence on external capital for funding domestic equity valuations, though it has introduced the unintended tension described in Section 5.

SECTION 2 MAIN ARGUMENTS AND SUBSTANTIVE PARTS

Core Thesis

India's rupee depreciation, while real and visible, is not a harbinger of macroeconomic crisis comparable to 1991 or 2013. The depreciation is driven by technical, structural factors in currency markets — not by fundamental weakness in the Indian economy. Appropriate responses are targeted policy tools, not austerity or sweeping reform packages.

India's Macroeconomic Fundamentals Are Sound

- GDP growth at 6.5% makes India the fastest-growing major economy in the world, providing a strong underlying narrative for foreign investors despite short-term portfolio outflows.
- CPI inflation at 3.5% is below the RBI's 4% target, meaning the inflation targeting framework is working and domestic purchasing power is relatively protected.
- The Current Account Deficit stands at 0.9% of GDP for FY2026, with a worst-case estimate of 2% for FY2027 — comfortably within the 2.5% threshold considered safe by markets.
- The fiscal deficit commitment of 4.3% of GDP is on track, backed by a government with a credible record of fiscal consolidation.
- Forex reserves at $690 billion provide enormous cushion — roughly 10 years of cover against the projected annual BoP deficit of $60–70 billion. This is qualitatively different from 1991, when reserves barely covered two weeks of imports.

The Comparative Evidence: Why Simple Narratives Fail

Popular commentary blames India's rupee weakness on lack of reforms, low domestic capex, or promoter capital exiting India. These concerns have genuine merit as long-term structural issues. But they are poor explanations for a currency movement that is happening right now — because they have been present for decades without triggering the current depreciation.

- South Korea has a structural trade surplus, is home to leading AI hardware companies, and has attracted strong FPI interest. Yet the Korean won has depreciated more against the dollar than the rupee since 2024, despite its equity index (KOSPI) delivering strong returns. This falsifies the 'India-specific reform failure' narrative.
- Pakistan's rupee has marginally appreciated despite the country transitioning from one IMF bailout to another — suggesting currency movements in this period are driven by global dollar dynamics, not domestic fundamentals.

The Two Real Structural-Technical Causes

- India-US yield spread compression: The spread has narrowed from a long-period average of 3.5–4% to around 2.5% today, partly because India's inflation has improved significantly — it is now actually lower than the US's. This is a macro success, but it has reduced the premium India pays to foreign investors, making rupee assets less attractive during dollar-strengthening episodes.
- The SIP/liquidity put paradox: The domestic mutual fund and pension ecosystem has created a structural floor under equity valuations. When FPIs sell, domestic flows absorb the selling without letting equity prices fall proportionately. FPIs see Indian valuations remain high, continue selling, squeeze the capital account further, and push the rupee lower — a feedback loop where the equity market's resilience actually amplifies currency pressure.

Counterarguments and Their Resolution

- The 'austerity' prescription is rejected: Austerity depresses consumption, which is 60% of India's GDP. Suppressing the primary driver of growth would reduce the very narrative that attracts foreign capital. Austerity is the wrong tool because the problem is technical, not fiscal.
- 'Sweeping reforms' are also rejected: These require extraordinary political economy execution — what the analysis calls 'Bolshoi Ballet-level finesse' — and are structurally slow. They cannot address a currency market problem that requires rapid technical intervention.

SECTION 3 HISTORICAL EVOLUTION OF THE ISSUE

Period	Key Development
Pre-1966	India operated under the Bretton Woods fixed exchange system with the rupee pegged to the pound sterling and then the dollar. Exchange rate management was entirely administrative — the RBI's role was largely regulatory and clerical.
1966 Devaluation	A severe BoP crisis triggered by the 1965 war, drought, and declining US aid forced a dramatic 57% devaluation under Prime Minister Indira Gandhi. It was politically traumatic and remained a cautionary political memory for decades, making future governments extremely reluctant to allow visible rupee weakness.
1975–1991: Import Substitution Era	India maintained a managed, fixed exchange rate pegged to a basket of currencies. The economy was heavily protected, imports were controlled by licensing, and external balance was maintained through administrative rationing rather than market mechanisms. Chronic fiscal deficits, oil shocks, and import-dependent industry slowly built up macro vulnerabilities.
1991: The Defining Rupture	India's worst-ever external crisis: CAD above 3% of GDP, forex reserves down to two weeks of import cover, and political instability. A two-step 18% devaluation in 48 hours, pledging of gold with the Bank of England as collateral, and an emergency IMF loan followed. The crisis forced structural liberalisation — the LPG reforms under Narasimha Rao and Manmohan Singh transformed India's economic architecture.
1993: Market-Determined Exchange Rate	Following liberalisation, India transitioned to a Unified Exchange Rate, making the rupee market-determined on the current account. By 1994, the rupee was fully convertible for current account transactions. This was a foundational shift in external sector management.
1997: Asian Financial Crisis	India largely escaped contagion because capital account convertibility remained restricted — speculative attacks on the rupee were not possible. This vindicated India's cautious approach and deepened the institutional commitment to gradual capital account opening.
2008: Global Financial Crisis	FPI outflows were significant, but relatively controlled capital account and growing forex reserves cushioned the rupee. A sharp but recoverable depreciation occurred.
2013: Taper Tantrum	India's most dangerous crisis since 1991. CAD at 4.8% of GDP, rupee falling from Rs.54 to Rs.68, dwindling reserves. India was classified among the 'Fragile Five.' The FCNR-B bond scheme raised $34 billion and stabilised the currency. This period is the benchmark against which the current episode is being compared — and found to be dramatically different.
2016: Inflation Targeting Framework	India formally adopted Flexible Inflation Targeting (FIT), anchoring monetary policy to a 4% CPI target with a 2–6% band. This framework is why India's inflation today is better controlled, why the yield spread has compressed, and why the current depreciation reflects macro success in some measure.
2022: US Rate Hike Cycle	The Federal Reserve's aggressive hiking cycle pushed the dollar sharply higher globally. The rupee depreciated from Rs.74 to Rs.83 in an orderly manner, cushioned by strong reserves and credible macro fundamentals.

Period	Key Development
2024–Present: The Current Episode	The rupee has depreciated over 10% in the past year despite 6.5% GDP growth, 3.5% inflation, and $690 billion in reserves. The depreciation reflects technical factors — yield spread compression and the SIP liquidity put — not a macroeconomic crisis. REER now suggests undervaluation, even as equity markets remain near all-time highs.

SECTION 4 LOGICAL AND PHILOSOPHICAL BASE

The Empirical-Rational Framework

The analysis rests on a rigorously empirical foundation — it insists on looking at comparative data before drawing conclusions. The South Korea and Pakistan comparisons are not rhetorical decoration; they are methodological tools for distinguishing genuine causal factors from coincidental associations. If India's depreciation were caused by reform failures, countries with the opposite conditions — like Korea — should not be experiencing worse depreciation. They are. This demonstrates falsifiability, one of the hallmarks of sound scientific reasoning.

The Anti-Narrative Epistemology

There is an implicit epistemological critique running through the analysis: popular commentary confuses correlation with causation. Reform deficits, low capex, and promoter exits have been present in India for decades. Attributing the current depreciation to these factors violates the basic logical requirement that a causal explanation must account for what has changed, not merely what is chronically present. This is an important lesson in analytical discipline for UPSC aspirants.

Keynesian Logic Against Austerity

The argument against austerity draws from Keynesian macroeconomics — specifically, the consumption multiplier and the risk of a self-reinforcing contractionary spiral. When household and government consumption (60% of GDP) is suppressed, GDP growth falls, investor confidence deteriorates, capital exits, and the currency weakens further. Austerity as a cure for currency weakness can thus be worse than the disease — a classic fallacy of composition at the macroeconomic level.

Hayekian Insight: The Information Role of Prices

The 'liquidity put' problem illustrates a Hayekian insight — prices are not merely clearing mechanisms, they are information signals. When the SIP ecosystem suppresses equity price falls, the market signal that would normally communicate overvaluation to FPIs is muted. FPIs continue selling, but equity prices don't fall enough to attract buyers, so the pressure reroutes entirely into the currency. Interfering with price discovery in one market creates distortions in another.

Game Theory and Confidence Capital

The recommendation for a sovereign dollar bond issuance is rooted in signalling theory from game theory and behavioural macroeconomics. Governments and central banks often need to demonstrate commitment to stability not merely through policy actions but through symbolic, credible interventions that shift market expectations. The announcement effect of a well-structured bond issuance can be as powerful as the actual capital raised.

Structural vs. Cyclical Distinction

The analysis is philosophically disciplined in separating structural factors (long-term, slow-moving, systemic) from cyclical-technical factors (short-term, market-specific, correctable through targeted tools). This distinction matters enormously in policy design — treating a cyclical problem with structural solutions (reforms) creates delays, and treating a structural problem with cyclical tools creates recurrence. Correctly diagnosing the nature of the problem is the first and most important step.

SECTION 5 NEW FEATURES AND UNIQUE IDEAS

The 'Liquidity Put' Paradox — An Emergent Systemic Tension

The most intellectually original contribution is the identification of an unintended consequence of India's most celebrated financial success. The SIP revolution is universally praised for democratising wealth creation and deepening capital markets. But its scale has now created a structural paradox: the same ecosystem that prevents equity market crashes also prevents the currency correction that would restore equilibrium. When FPIs exit, SIPs and EPFO absorb the selling without letting prices fall proportionately. FPIs see valuations remain elevated and continue exiting. The capital account bleeds. The rupee falls. The price-correction mechanism is short-circuited.

Yield Spread as a Currency Vulnerability Indicator

Framing the India-US yield spread compression as a structural currency vulnerability — not just a monetary policy signal — is analytically novel. As India's macro quality improves and its inflation converges with advanced economies, the risk premium it offers naturally narrows. This is fundamentally good news for India's integration into global financial markets, but it creates vulnerability during episodes of global dollar strengthening, because the compensation for holding rupee assets is reduced.

3Fs Framework: A Practical Diagnostic Tool

The 3Fs formulation — Fertiliser, Fuel, and Foreign Exchange — is a compact, policy-relevant framework for tracking India's external sector pressure points. Fertiliser import dependence affects CAD and the fiscal cost of agricultural subsidies. Fuel imports are India's largest single import item and the primary driver of CAD. FX (foreign exchange) dynamics capture the capital account and currency equilibrium. Together, they map the three dimensions of India's external vulnerability into a single, communicable structure.

Capital Gains Tax as a Currency Stabilisation Tool

The suggestion that capital gains tax rationalisation can serve as a currency management tool is unconventional and policy-creative. If India's LTCG rates on equity are significantly higher than peer emerging markets — as revised upward in the 2024 Union Budget — FPIs face a higher net cost of investing in India, reducing inflows and worsening the capital account. Rationalising these rates connects equity market taxation to macroeconomic external sector management in an integrated way.

Feasibility Assessment

- Yield spread widening through rate hikes: Feasible but costly — would slow domestic credit and investment.
- Sovereign dollar bond issuance: Low-risk, well-precedented, and rapidly implementable. High feasibility.
- Capital gains tax reform: Politically sensitive but technically straightforward. Moderate feasibility.
- Fuel price pass-through: Economically optimal but politically extremely difficult during election cycles. Low near-term feasibility.

SECTION 6 SUSTAINABILITY OF THE IDEAS AND PROPOSALS

Economic Sustainability

The targeted policy tools — yield adjustments, sovereign bonds, capital gains tax reform, fuel price pass-through — are all market-compatible and work with economic incentives rather than against them. They do not require permanent subsidies or distortionary controls. However, their benefits are temporal. Widening the yield spread through higher interest rates is unsustainable if it consistently conflicts with domestic growth imperatives. Dollar bond issuances provide confidence at a moment of stress but not permanent solutions to structural CAD. Fuel price deregulation, once implemented, must be maintained consistently to be credible.

Environmental Sustainability

Fuel price pass-through has an underappreciated environmental dividend. When consumers pay the true market price for petrol and diesel, demand naturally moderates, reducing India's oil import bill and associated carbon emissions. Artificially suppressed fuel prices are a hidden fossil fuel subsidy that directly conflicts with India's net-zero commitments and its stated energy transition ambitions. Removing this subsidy would align external sector management with climate goals — a rare instance where macroeconomic and environmental policy reinforce each other.

Constitutional and Legal Sustainability

India's exchange rate framework is governed by the Foreign Exchange Management Act (FEMA), 1999, which replaced the more restrictive FERA (1973) and institutionalised a market-determined approach with RBI oversight for volatility management. All proposed measures — monetary policy recalibration, sovereign bond issuance, capital gains tax reform — fall within the existing constitutional and legal framework. Capital gains reform would require an amendment to the Income Tax Act; the sovereign bond scheme would operate under FEMA and external commercial borrowing regulations.

Societal Sustainability

The explicit rejection of austerity is the most important societal commitment in the analysis. Austerity — cutting public expenditure to reassure currency markets — falls disproportionately on those who depend on government services, subsidies, and public employment: the poor, the rural, and the economically marginalised. Maintaining growth-oriented policy while addressing currency pressures through technical tools is not just economically superior; it is socially more equitable.

Ethical Sustainability

There is an ethical dimension to artificial fuel price suppression that is often ignored in macroeconomic debate. Suppressing prices transfers the cost of international oil market volatility to the public exchequer — funded by taxpayers and future generations through higher fiscal deficits. A market-linked pricing system is more ethically defensible in inter-generational and distributive terms, provided adequate direct benefit transfers protect Below Poverty Line households from the adjustment burden.

SECTION 7 CHALLENGES RELATED TO THE ISSUE

Structural Challenges

- India's trade deficit is deep-rooted and driven by crude oil (roughly $150 billion annually), electronics, gold, and capital goods. No short-term policy intervention can eliminate this structural demand for dollars. CAD will remain a permanent feature of India's external sector — the policy challenge is to manage it within safe thresholds.
- The India-US yield spread compression is paradoxically a consequence of India's improved macro quality — better inflation control and responsible monetary policy. Widening the spread through higher interest rates reverses this progress and comes at the cost of slower credit growth and investment.
- The domestic SIP and pension ecosystem is now large enough — monthly SIP inflows crossed Rs.26,000 crore by 2025 — to be systemically important. Any policy aimed at dampening these flows to restore price discovery would undermine India's financial deepening goals and break faith with millions of retail investors.

Implementation Challenges

- A sovereign dollar bond issuance requires extremely careful calibration to avoid signalling desperation to global markets. The timing, tenor, coupon rates offered, and accompanying RBI communication must all align to make the operation a confidence-building exercise rather than a crisis signal.
- Capital gains tax reform must navigate bilateral tax treaties, domestic income tax law, SEBI regulations, and market participant psychology simultaneously. A poorly designed reform risks being seen as panicked tinkering without solving the underlying problem.
- Fuel price deregulation is politically impossible during election cycles — and in India's federal democracy, some state is always in election mode. This creates a structural window problem for implementing what is economically the most important adjustment.

Stakeholder Resistance

- Retail consumers and agricultural constituencies have come to treat subsidised fuel as an entitlement. Visible pump price increases face intense political resistance, particularly in opposition-governed states where energy pricing is a live electoral issue.
- Exporters benefit from a weaker rupee and have limited commercial incentive to advocate for currency stabilisation. Their lobbying interest partially conflicts with macroeconomic stabilisation goals.
- FPIs — whose behaviour is at the heart of the problem — are globally distributed, algorithmically driven, and respond to index inclusions, global risk-off sentiment, and cross-asset relative value models as much as to India-specific policy signals.

Epistemological and Communication Challenges

- The distinction between structural and technical causes is analytically robust but politically difficult to communicate. Policymakers who say 'everything is fine, it is a technical currency issue' risk losing credibility if the depreciation continues or accelerates. Managing the narrative without triggering a self-fulfilling confidence crisis is a delicate communications challenge that requires institutional credibility of the highest order.

SECTION 8 MULTIDIMENSIONAL ANALYSIS

Social Dimension

- Currency depreciation raises import costs, feeding through to higher prices for edible oils, medicines, electronics, and fertilisers. Since the poor spend a higher proportion of income on these necessities, depreciation is inherently regressive in its distributional impact.
- Artificial fuel price suppression protects consumers in the short term but deprives the exchequer of revenues that could fund health, education, and rural welfare — creating a significant opportunity cost for social sector investment.
- Inflation targeting has delivered real social good. CPI at 3.5% means real wages are not being eroded as they were during 2012–14, when India suffered both high inflation and currency weakness simultaneously.
- The SIP revolution is a genuinely transformative social achievement — it has democratised equity wealth creation for tens of millions of middle-class households and reduced their dependence on physical gold and real estate as savings vehicles.

Political Dimension

- Fuel price pass-through recommendations inevitably collide with electoral arithmetic. The political economy of energy pricing in India means that increases are always timed with extreme caution relative to state and national election schedules.
- The 'reforms' narrative — beloved of domestic opposition and international institutions alike — is a political minefield in India. What counts as reform in a country of such diversity is deeply contested, and treating reform as a magic wand for currency stability is a category error.
- The 3Fs framework (Fertiliser, Fuel, FX) has direct political resonance because all three touch rural livelihoods — farmer input costs, transportation costs, and remittance values. Managing all three requires unusual inter-ministerial political coordination.
- Opposition parties instinctively weaponise currency weakness as evidence of government mismanagement, making bipartisan consensus on technical solutions structurally difficult.

Legal Dimension

- India's foreign exchange framework under FEMA 1999 gives the RBI considerable discretionary power to manage volatility without requiring legislative sanction — a crucial operational flexibility during crisis moments.
- Capital gains tax reform requires careful navigation of bilateral double taxation avoidance agreements (DTAAs), domestic income tax law, and SEBI investment regulations. The 2024 Budget's revision of LTCG rates created FPI nervousness, illustrating the legal sensitivity of this tool.
- A sovereign dollar bond issuance would need careful structuring under Article 292 of the Constitution (Parliament's guarantee of central government borrowing) and relevant FEMA provisions governing external commercial borrowings.
- Full capital account convertibility — allowing free cross-border movement of financial capital — remains a live legal and policy debate. India's cautious approach has been justified by past crises; legally formalising the current hybrid approach would provide greater regulatory clarity.

Ethical Dimension

- The explicit rejection of austerity carries significant ethical weight. Austerity policies historically fall disproportionately on the poor, who depend most on public services, subsidies, and government employment. A growth-preserving adjustment is both economically superior and more ethically equitable.
- There is a distributional asymmetry in the FPI exit dynamic: sophisticated foreign investors exit Indian markets on valuation concerns, and their exit is absorbed by domestic retail investors through SIPs. To the extent retail investors are potentially left holding overvalued assets while FPIs exit with profits, there is a fiduciary and informational ethics concern worth examining.
- Transparency in policy communication is an ethical imperative. When governments obscure the real technical causes of rupee weakness and instead blame vague external factors, they erode public trust in economic institutions and deny citizens the information they need to make sound financial decisions.
- Artificial fuel price suppression is an inter-generational equity issue — the cost is deferred to future taxpayers through fiscal deficits or future import vulnerability.

International Dimension

- The rupee's movement is deeply entangled with US Federal Reserve policy — a reality that constrains the RBI's room to manoeuvre. When the Fed raises rates, the dollar strengthens globally, and every emerging market currency faces depreciation pressure regardless of domestic conditions.
- India's trade deficit with China is a significant structural feature of the currency story. China is India's largest goods trading partner, and the bilateral trade imbalance contributes directly to India's structural dollar demand.
- The BRICS dedollarisation discourse — trade settlements in local currencies, exploration of alternatives to SWIFT — has limited near-term impact on the INR/USD equation but signals India's long-term strategic interest in reducing dollar dependence.
- Global crude oil prices, determined by OPEC+ production decisions and geopolitical events in West Asia, directly shape India's CAD and currency dynamics. India's status as a price-taker in oil markets — importing over 85% of its crude — makes it structurally exposed to geopolitical shocks in the Gulf and Russia.

Economic Dimension

- The fundamental economics is a structural demand-supply mismatch for dollars — India consistently demands more dollars than it generates, and when global risk appetite diminishes, the gap widens and the rupee weakens.
- The REER undervaluation that has emerged is paradoxically a macroeconomic positive for exports — a competitive rupee makes Indian goods cheaper for foreign buyers and should, over time, contribute to narrowing the trade deficit through improved export performance.
- The growth-inflation matrix is currently optimal — 6.5% growth with 3.5% inflation. Preserving this combination requires avoiding both austerity (which kills growth) and reckless fiscal expansion (which would rekindle inflation and invite a rating downgrade).
- Interest rate management sits at the heart of the currency challenge. The RBI must balance domestic growth support against the need to maintain an adequate yield premium to attract foreign capital — the classic Mundell-Fleming external-internal balance dilemma in an open economy context.

SECTION 9 LINKAGES WITH NCERTS

NCERT Reference	Relevance to This Topic
Class 12 Economics — Introductory Macroeconomics, Chapter 6: Open Economy Macroeconomics	Directly introduces current account, capital account, balance of payments, exchange rates, and currency adjustment mechanisms. The entire analytical framework of this topic rests on these foundations. Students who have internalised this chapter will find currency depreciation debates intuitive.
Class 12 Economics — Indian Economic Development, Chapter 3: LPG Reforms	Covers the 1991 crisis and its aftermath, the shift to a market-determined exchange rate, and capital account opening. Understanding what 1991 actually looked like in macro terms is essential for evaluating why 2025 is fundamentally different.
Class 11 Economics — Indian Economic Development, Chapter 8: Infrastructure	India's energy infrastructure and oil import dependence — central to the CAD story — are connected here. Fuel pricing dynamics and energy import vulnerability tie directly to infrastructure investment challenges and energy security policy.
Class 10 Social Science — Understanding Economic Development, Chapter 4: Globalisation and the Indian Economy	Introduces trade flows, multinational capital, and India's integration into global financial markets. Provides the conceptual foundation for understanding why FPIs can move capital freely and what macroeconomic consequences follow.
Class 12 Political Science — Contemporary World Politics, Chapter 4: Alternative Centres of Power	The geopolitical backdrop of the dollar-centric monetary system, the US-China rivalry, and BRICS dedollarisation discourse have roots in this chapter's treatment of shifting global power. Connects currency dynamics to the larger international relations canvas.

SECTION 10 LINKAGES WITH UPSC CSE SYLLABUS

Paper	Specific Syllabus Linkages
GS Paper II	India and its neighbourhood — trade and economic interdependence; Bilateral and multilateral institutions (IMF, G20, BRICS); Government policies and interventions — RBI's monetary policy framework, fiscal consolidation path; Role of external actors in India's economic policy environment.
GS Paper III (Core)	Indian Economy — growth, development, planning; Mobilisation of resources; Effects of liberalisation; Inflation, monetary policy, fiscal policy, budget management; Infrastructure — energy, oil pricing; Investment models — domestic savings mobilisation via MFs, EPFO, NPS; Balance of payments and external sector management; Currency market dynamics and exchange rate policy.
GS Paper I	Social transformation — impact of inflation and currency dynamics on household welfare, poverty, and inequalities; Regional disparities (Northeast India's specific vulnerabilities to fuel and fertiliser price movements).
Essay Paper	'A strong currency is not the same as a strong economy'; 'The paradox of success: when solutions create new problems'; 'Markets are neither infallible nor dispensable'; 'Economic sovereignty in an interdependent world.'
GS Paper IV (Ethics)	Ethical dimensions of austerity vs growth-preserving adjustment; Transparency and institutional credibility in policy communication; Distributive justice in economic crisis management; Inter-generational equity in fiscal and environmental choices.
Optional: Economics	International finance — exchange rate theories, BoP adjustment, Mundell-Fleming model; Monetary policy — inflation targeting, Taylor Rule, central bank independence; Public finance — fiscal policy, deficit management, sovereign borrowing.

SECTION 11 BEST LINKAGES WITH SYLLABUS, PHILOSOPHY, AND EPISTEMOLOGY

Deepest Syllabus Connection: GS Paper III — Indian Economy

Currency dynamics sit at the exact centre of GS Paper III's external sector segment. Balance of payments management, monetary policy, capital account dynamics, fiscal consolidation, inflation targeting, and domestic savings mobilisation are all core topics. This is the epicentre of UPSC relevance for this module. Expect direct questions on BoP, CAD, exchange rate management, and RBI's role in every cycle.

Hayek and Keynes: The Central Philosophical Tension

The 'liquidity put' problem illustrates the Hayekian insight that prices carry information. When the SIP ecosystem suppresses equity price falls, the information signal that should communicate overvaluation to FPIs — and attract value buyers — is lost. The correction burden shifts entirely to the exchange rate. This is a powerful illustration of how market interdependencies create unintended consequences when price discovery is impaired in one segment.

Keynes enters through the austerity rejection. The consumption multiplier — every rupee of spending generating more than one rupee of GDP through chain effects — is the philosophical underpinning of the growth-preservation approach. These two thinkers, often seen as opponents, are here simultaneously relevant to different aspects of the same problem.

Rawlsian Lens on Austerity

John Rawls' difference principle holds that inequalities are justified only if they benefit the least advantaged members of society. Austerity in response to currency weakness typically imposes costs most heavily on the poor — through cuts in social spending, higher unemployment, and reduced public services. A growth-preserving adjustment that protects consumption and employment is far more consistent with Rawlsian justice.

Epistemological Discipline: The Method of Comparative Control

The South Korea-Pakistan comparison performs a crucial epistemological function — it controls for the variables being blamed for India's depreciation and tests whether those variables actually correlate with the outcome. Korea has the opposite profile (surplus, AI boom, FPI interest) and fares worse. Pakistan has abysmal fundamentals and marginally appreciates. This is the scientific method in macroeconomic analysis: insist on comparative evidence before accepting a narrative. For UPSC answer writing, this is a model of analytical rigour — always ask whether the cause varies with the effect across comparable cases.

SECTION 12 WAY FORWARD

Monetary Policy Recalibration

The RBI should assess whether a moderate 25–50 basis point increase in policy rates — well-communicated as currency-supportive rather than growth-restrictive — can improve the capital account balance. The communication strategy is as important as the decision itself: markets need to understand that this is a calibrated response to an external-sector issue, not a signal of domestic macro deterioration.

Confidence Capital Through Sovereign Dollar Bonds

A well-structured sovereign dollar bond issuance — on the model of the 2013 FCNR-B scheme — can raise $20–30 billion rapidly and demonstrate India's borrowing capacity to global markets. NRI-targeted instruments that leverage patriotic sentiment alongside competitive financial terms are particularly effective. The bond must be timed at a moment of relative market stability, not during a crisis, to signal strength rather than desperation.

Capital Gains Tax Reform

India should benchmark its equity capital gains tax rates against peer emerging markets — Brazil, Indonesia, South Africa, South Korea — and rationalise where India is a significant outlier. The 2024 Budget's upward revision created FPI uncertainty; a considered review can demonstrate that India's tax policy is calibrated to capital attraction without sacrificing domestic equity revenue needs.

Fuel Price Deregulation with Social Protection

India should return to automatic price revision mechanisms for petrol and diesel, tied to international crude benchmarks. To build political viability, deregulation must be paired with a clearly publicised direct benefit transfer scheme protecting BPL households from the impact. The public face of the policy should be protection of the poor, not removal of a subsidy.

Export Promotion Leveraging REER Undervaluation

With REER now suggesting competitive undervaluation, India has an export promotion window that should be seized aggressively. PLI (Production Linked Incentive) schemes across electronics, pharmaceuticals, textiles, and engineering goods need accelerated implementation. Port logistics, transaction cost reduction, and trade facilitation investment can convert the REER advantage into real export gains.

Deepening the Domestic Corporate Bond Market

To reduce structural dependence on FPI equity flows for capital account financing, India must deepen its corporate bond market. Enabling long-term infrastructure financing through domestic savings — via green bonds, infrastructure bonds, and corporate debentures — reduces exposure to global risk appetite cycles and provides the sovereign with more stable funding options.

Maintaining Capital Account Caution

India's cautious approach to full capital account convertibility has served as a crucial buffer in every global financial storm since 1997. This is not a reform failure — it is a prudent macro-financial architecture choice. Gradual opening, calibrated to domestic financial market depth, should continue. Premature full convertibility in the current environment of global financial volatility would dramatically increase India's vulnerability to speculative attacks.

SECTION 13 PREVIOUS YEARS' UPSC AND APSC QUESTIONS

UPSC Prelims — Representative Questions

Year	Question Summary / Theme
2013	Which one of the following is likely to be the most inflationary in its effect? Options included creating new money to finance a budget deficit. Tests understanding of monetary expansion and currency implications.
2015	Multiple-statement question on the Current Account Deficit of India — its components, measurement, and implications. Directly relevant to CAD analysis.
2016	In the context of India's balance of payments, which of the following constitute(s) the Current Account? Tests BoP literacy and classification of transactions.
2018	Questions on NRI deposits, FCNR accounts, and their role in the capital account. Directly relevant to the 2013 FCNR-B precedent.
2021	If the RBI decides to adopt an expansionist monetary policy, which of the following would it NOT do? Tests monetary policy tools — repo rate, CRR, SLR — central to yield spread analysis.
2023	Statement-based question on Special Drawing Rights (SDR) of the IMF and their role in India's reserves.

UPSC Mains — Representative Questions

Paper / Year	Question
GS III, 2013	Current account deficit and capital account surplus — explain the components and implications for India's external sector management.
GS III, 2015	What are the reasons for the depreciation of the Indian rupee? What measures can be taken to stabilise it?
GS III, 2018	Do you agree that the Indian economy has shown remarkable resilience in the face of global financial turbulence? Evaluate with reference to macroeconomic fundamentals.
GS III, 2019	Analyse the trends in current account deficit in India since 2014 and discuss its implications for the Indian economy.
GS III, 2020	Explain the concept of REER and its significance in assessing currency valuation. How does it differ from the nominal exchange rate?
GS III, 2022	Discuss the impact of the US Federal Reserve's rate hike cycle on emerging market economies, with specific reference to India.
GS III, 2023	Evaluate the role of foreign portfolio investment in India's capital account management and the risks associated with sudden capital reversals.
Essay, 2015	'Cooperative federalism: Myth or Reality?' — Indirectly connects through fiscal federalism and macroeconomic coordination on subsidies and fuel pricing.

Paper / Year	Question
Essay, 2023	'The crisis of the old order and the emergence of the new' — Applicable to the post-2020 global monetary order and currency dynamics.

APSC-Specific Questions (Assam / Northeast Angle)

Exam / Theme	Question
APSC — Economy	Discuss the impact of global commodity price movements on Assam's economy, with special reference to crude oil and fertilisers.
APSC — Economy	Explain the concept of Current Account Deficit and its implications for a developing state economy. How does the national exchange rate policy affect Assam's agricultural exports?
APSC — Economy	What are the key challenges facing Northeast India's export sector, and how can a competitive exchange rate help address them?
APSC — Social	Analyse the role of domestic savings and financial inclusion in India's macroeconomic stability, with reference to schemes like PM Jan Dhan Yojana and the SIP revolution.
APSC — Environment	How does fuel price deregulation connect to India's environmental commitments? Discuss with reference to Northeast India's transport dependence on fossil fuels.

SECTION 14 MODEL ANSWERS FOR SELECTED QUESTIONS

MODEL QUESTION

What are the reasons for the depreciation of the Indian rupee? What measures can be taken to stabilise it? (GS Paper III — Classic Question Type)

MODEL ANSWER (approx. 250 words)

Currency depreciation — the organic weakening of a currency in a market-determined exchange rate system — is a multi-causal phenomenon. For India, the rupee's decline reflects both structural realities and technical-cyclical triggers that must be understood separately to prescribe appropriate solutions. Structural Causes: India runs a persistent current account deficit because its import basket — crude oil, electronics, gold, and capital goods — consistently exceeds export earnings. This structural dollar demand creates a permanent downward bias on the rupee. In addition, India-US yield spread compression — from a historical average of 3.5–4% to around 2.5% today — reduces the premium India offers to foreign fixed-income investors, making dollar-denominated assets comparatively more attractive. Technical-Cyclical Cause — The Liquidity Put Paradox: India's domestic mutual fund ecosystem (SIPs, EPFO, NPS) has created a structural floor under equity valuations. When Foreign Portfolio Investors (FPIs) sell Indian equities, domestic institutional buyers absorb the selling without allowing proportionate price falls. FPIs, seeing valuations remain elevated, continue exiting. The capital account bleeds. The rupee falls. The normal price-correction mechanism is short-circuited. Stabilisation Measures: Moderate interest rate adjustment to widen the India-US yield spread Sovereign dollar bond issuance (following the FCNR-B precedent of 2013) as confidence capital Capital gains tax rationalisation to benchmark India's FPI attractiveness against peer markets Fuel price pass-through to reduce fiscal strain and moderate structural oil demand Export promotion leveraging the REER undervaluation that has now emerged What must be explicitly avoided is austerity. Consumption constitutes 60% of India's GDP — suppressing it would damage the very growth story that makes India attractive to foreign capital. India's macro fundamentals — 6.5% growth, 3.5% inflation, $690 billion in reserves — are sound. The response must be proportionate to a technical problem, not a structural crisis.

MODEL QUESTION

Discuss the implications of FPI outflows on India's equity markets and currency. How has the domestic savings ecosystem moderated the impact? (GS Paper III — Contemporary Type)

MODEL ANSWER (approx. 250 words)

Foreign Portfolio Investors (FPIs) are major participants in Indian equity and government bond markets. When global risk aversion rises — typically during episodes of US Federal Reserve rate hikes or geopolitical stress — FPIs liquidate Indian holdings and repatriate capital in dollars. This dual pressure — equity selling and simultaneous dollar buying — historically caused both equity market crashes and currency depreciation simultaneously. The Changed Dynamic: India's capital market architecture has undergone a structural transformation over the past decade. Monthly SIP inflows have crossed Rs.26,000 crore, EPFO's equity exposure has grown steadily, and NPS assets have expanded substantially. Together, these domestic institutional flows create a permanent, systematic demand for equities — what is termed the 'liquidity put.' The Paradox: This is largely virtuous — it democratises wealth creation, deepens markets, and prevents panic-driven crashes.

However, it creates a structural paradox in the currency-equity nexus. When FPIs sell massively, domestic flows absorb the selling, keeping the Nifty 50 within 10% of all-time highs despite outflows of over Rs.1.7 lakh crore. Valuations remain elevated. FPIs, seeing valuations still high, continue exiting. The capital account continues to drain, and the rupee depreciates without the equity market offering a compensating price signal of undervaluation. Implications and Way Forward: The solution requires technically targeted policy: widening yield spreads through modest monetary tightening, issuing sovereign dollar bonds to rebuild confidence capital, and rationalising capital gains taxation to improve the FPI cost environment. Austerity — cutting government spending to reassure currency markets — would damage the growth engine and is counterproductive. India's macro stability is the bedrock. The currency problem is technical and correctable, not existential.

UPSC RELEVANCE & NOTE-MAKING TIPS

Currency dynamics sit at the intersection of almost everything UPSC tests. It is not merely a current affairs topic — it is a recurring macroeconomic phenomenon across 1966, 1991, 2013, 2022, and 2024–25. Understanding it requires integrating monetary policy, fiscal management, external sector analysis, international finance, political economy, and philosophical reasoning about markets.

Note-Making Tips:

- Maintain a running table of India's macro indicators across years (CAD, fiscal deficit, inflation, reserves, growth rate) — this allows instant comparison with crisis periods in answers.
- Master the four policy tools: interest rate adjustment, sovereign dollar bonds, capital gains tax reform, fuel price pass-through — and know the specific trade-off each involves.
- The South Korea–Pakistan comparison is a model for evidence-based, comparative analytical writing — practise constructing similar arguments across other economic topics.
- The 'liquidity put' paradox is a high-value concept for distinguishing excellent answers from average ones — use it precisely, not casually.
- For APSC: Always connect to Assam's specific vulnerabilities — high fuel dependence (landlocked transportation costs), fertiliser price sensitivity (agriculture-dominated economy), and remittance dependence. The 3Fs hit Northeast India with disproportionate force.

— Sourobh | UPSC/APSC 2026