Falling of Indian Rupee

***Mains**: GS-III – Economy*

Why in News?

The rupee-to-dollar exchange rate, or the rupees needed to purchase a U.S. dollar, crossed 96 in May this year; the graph of the Indian rupee has been snaking sharply downward.

What is the Exchange Rate?

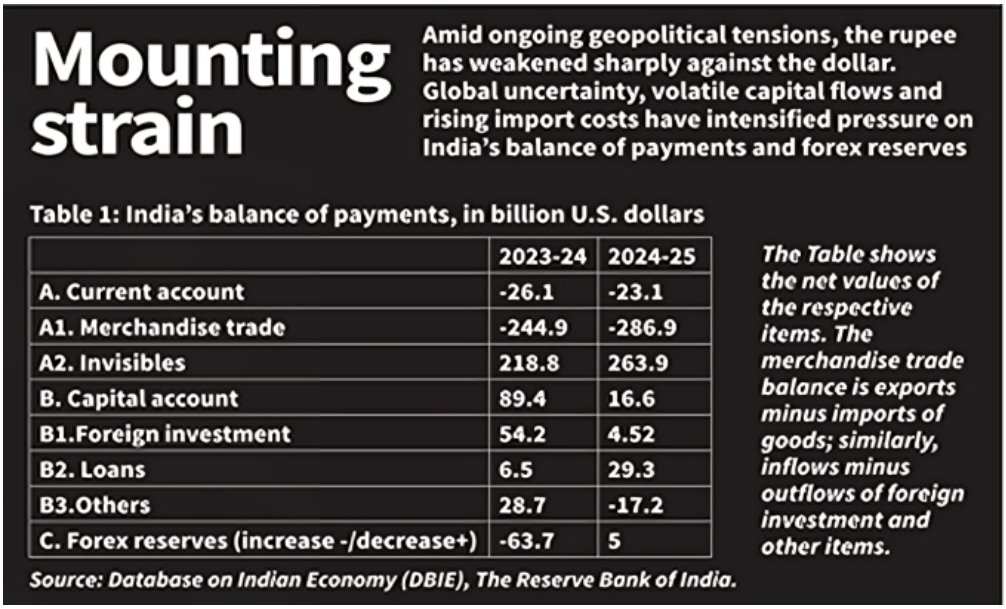
- **Exchange Rate –** It is the value of one nation's currency vs the currency of another nation or economic zone.
- Typically, exchange rates can be *free-floating or fixed*.
- **Free-Floating Exchange Rate** – It rises and falls due to changes in the foreign exchange market.
- **Fixed Exchange Rate** – It is pegged to the value of another currency.
- The rupee's exchange rate vis-à-vis a particular currency, say the US dollar, tells us how many rupees are required to buy a US dollar.

To know more about ***Exchange Rates***, click here

What is the impact of trade deficits on the rupee's value?

- **Demand –** The demand for the rupee rises with India's exports and falls with imports.
- **Impact of Increased Export** – When firms in Ludhiana export garments, the dollars or euros they receive from foreign buyers are exchanged for rupees to pay workers and suppliers, thereby *increasing demand for the rupee*.
- **Impact of Reduced Imports** – On the other hand, Indian companies import oil by exchanging rupees for dollars, thereby *reducing the demand for the rupee*.
- Even *individuals travelling abroad* exchange rupees for foreign currency (destination country), further reducing rupee demand.
- **Balance of Payments Link** – Overall, if India's *imports exceed exports*, the foreign currency payments it must make to the rest of the world exceed the foreign currency payments it receives.
- That implies more rupees are exchanged for dollars, leading to declines in the demand for, and the value of the rupee (requiring more rupees to purchase one dollar).
- Thus, a currency's exchange rate is closely tied to the country's balance of (foreign currency) payments (to and from the rest of the world).
- **India's Trade Deficit** – India has consistently run a *merchandise trade deficit*, with imports of goods (especially oil) exceeding exports.

    - Oil imports are a major contributor.
- This deficit is partly offset by a surplus in India's invisibles -
    - Service exports (especially IT/software).
    - Remittances from migrant workers in West Asia.
- **Current Account Deficit** – Overall, India's current account, which is the sum of merchandise trade and the invisibles accounts, has been in deficit.
- To bridge the current account gap, India relies on capital inflows, mainly
    - Foreign investment.
    - External loans.
- **Role of Forex Reserves** – If capital inflows exceed the current account deficit, the surplus adds to India's forex reserves.
- These reserves act as a buffer to stabilise the rupee during volatility.



How do capital outflows weaken the rupee?

- **Forex Reserves as a Safety Net** – A country's forex reserves are as valuable as a family's treasure trove.
- The reserves are tapped to pay for critical imports during periods of insufficient foreign currency inflows, and to defend the currency's value when capital outflows are too large.
- **FDI vs FPI**
- **Foreign Direct Investment (FDI)** – It is mostly in new or existing factories and businesses and, as a result, has some ties binding it to the host country.
- **Foreign Portfolio Investment (FPI)** – It involves purchases of stocks or bonds, is highly volatile and driven by speculation.
- Portfolio investors enter a country seeking quick financial returns and exit at the first sign of risk or when higher returns are offered elsewhere.
- **Impact of FPI Flows** – When FPI surges in, the stock markets are on a roll; when it flows out, it leaves a trail of destruction.
- This leads to
    - Falling demand for the rupee &
    - Depreciation of the exchange rate (more rupees needed per dollar).

- **Capital Outflows & Rupee Weakness** – Capital outflows imply that investors withdraw their investments in rupee assets and exchange them for dollar assets, leading to a tumble in demand for the rupee and in its exchange rate.
- **The Periods of Rupee Depreciation**

Period	Rupee/USD	Cause
Apr–Sep 2013	54.4 → 63.8	Trade deficit + FPI outflows
Jan–Oct 2018	63.6 → 73.6	Oil prices + capital flight
Feb–Apr 2020	71.5 → 76.2	Pandemic shock
Jan–Oct 2022	74.4 → 82.3	Global tightening
Sep 2024–Feb 2025	83.3 → 87.1	Oil + geopolitics
May 2025–May 2026	85.2 → 96	FPI retreat + U.S. rate hikes

- It has each been characterised by *worsening of the trade account, FPI outflows, or both*.
- **Investors Retreat** – The rupee's recent fall is mainly because foreign investors are pulling money out of India, choosing safer markets due to rising U.S. interest rates and global tensions.
- **Rising Import Costs** – The *depreciation of the rupee* imposes a high cost on the Indian economy.
- To purchase a barrel of oil at $100, Indian companies now must pay Rs. 9,600, compared to Rs. 8,500, had the exchange rate remained at Rs. 85 per dollar.
- **Export Advantage** – However, a depressed rupee can help boost exports: a shirt costing Rs. 1,200 can be sold in the U.S. market at $12.5 now; if the exchange rate were Rs. 80 per dollar, the price would have been $15.
- **Limitations** – But rupee depreciation alone may not help much, given the range of supply and demand constraints weighing on Indian manufacturing.
- Structural reforms are needed to fully leverage currency depreciation.

What is the role of the RBI?

- **RBI's Intervention** – The Reserve Bank of India (RBI) intervenes to prevent the exchange rate from falling to very low levels.
- When foreign investors rush out by selling their rupee assets for dollars, the RBI props up the rupee by selling some of the dollars (or treasury bonds) from its reserves.
- This raises the demand for rupee and slows its decline (as it did during October 2024-January 2025 and August-December 2025).
- **Strength of Forex Reserves** – India's forex reserves *remain sufficiently large*.
- They stood at *around USD 691.11 billion* at the end of March 2026, enough to *cover 10.8 months' worth of the country's imports* (as of the end of December 2025).
- These reserves are a powerful shield against speculative attacks on the rupee.

What lies ahead?

- The ongoing geopolitical tensions and the threat of further oil price increases pose severe challenges.
- India could be at risk of paying more dollars per barrel of oil and more rupees per dollar.
- The country must take steps to regulate speculative capital outflows and reduce its dependence on oil imports.

Reference

The Hindu | Why is the Indian Rupee falling?

