Indian Economy · GS - III

Examine how foreign capital flows and investor sentiment influence exchange rate movements in India. Discuss the implications of rupee appreciation for the domestic economy.

EXAM YEAR	PAPER	SUBJECT
DAILY PRACTICE 17/11/2026	GS - III	Indian Economy

MARKS	WORD LIMIT
15	~250 words

Answer Hint

Foreign portfolio investment, capital account, currency demand and supply, rupee appreciation, import costs, export competitiveness, inflation, external sector stability, RBI intervention, capital-flow volatility.

Model Answer

Introduction

The exchange rate of the rupee is influenced by demand and supply of foreign currencies, capital flows and market expectations. Foreign investment inflows can strengthen the rupee by increasing demand for domestic currency.

Role of Capital Flows and Sentiment

1. **Foreign investment:** FPI inflows into equities and bonds increase demand for rupees when foreign funds are converted into domestic currency.
2. **Short-covering:** Investors closing bearish positions against the rupee may generate additional buying demand.
3. **Market confidence:** Positive economic expectations and global risk appetite can attract foreign capital.

Economic Implications of Rupee Appreciation

- **Imports:** Reduces the domestic cost of imported crude oil, machinery and other commodities.
- **Inflation:** Lower import costs can moderate imported inflation.
- **Exports:** Makes Indian goods relatively more expensive for foreign buyers, potentially affecting export competitiveness.
- **External debt:** Reduces the rupee burden of servicing foreign currency-denominated debt.
- **Capital markets:** Strong inflows can support financial markets but may also create vulnerability to sudden reversals.

Policy Considerations

The RBI should maintain orderly foreign exchange market conditions while allowing market forces to determine the exchange rate. Export diversification, productivity improvements and stable macroeconomic fundamentals can strengthen long-term currency resilience.

Conclusion

Rupee appreciation reflects favourable capital-flow conditions but has mixed effects across sectors. Sustainable currency stability requires strong fundamentals, diversified exports and prudent management of external vulnerabilities.

BECOME IAS
AI POWERED UPSC PREP