Indian Economy · GS - III

Examine how fluctuations in the US dollar and global currency markets influence India's external sector stability. Suggest measures to reduce the vulnerability of the Indian economy to exchange-rate volatility.

EXAM YEAR	PAPER	SUBJECT
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MARKS	WORD LIMIT
15	~250 words

Answer Hint

Exchange-rate volatility, dollar appreciation, import bill, current account deficit, external debt, capital flows, RBI intervention, foreign exchange reserves, export competitiveness

Model Answer

Introduction

Exchange-rate fluctuations influence international trade, investment and financial stability. A strengthening US dollar can create pressures for emerging economies such as India through higher import costs, external debt servicing and volatile capital flows.

Impact on India

1. **Import inflation:** Dollar appreciation raises the rupee cost of crude oil, fertilisers and other imported commodities, potentially increasing domestic inflation.

2. **Current account pressure:** Higher import expenditure can widen the current account deficit if export earnings do not compensate.

3. **External debt burden:** Dollar-denominated borrowing becomes costlier in rupee terms, affecting companies and institutions with unhedged liabilities.

4. **Capital flow volatility:** Global risk aversion can trigger foreign portfolio investment outflows, increasing pressure on the rupee and domestic financial markets.

5. **Export competitiveness:** Rupee depreciation may improve price competitiveness of certain exports, although imported inputs become more expensive.

Measures to Reduce Vulnerability

1. Diversify export markets and import sources, particularly for energy.
2. Maintain adequate foreign exchange reserves and calibrated RBI intervention.
3. Encourage currency-risk hedging by businesses.
4. Strengthen domestic manufacturing and reduce excessive import dependence.
5. Promote stable macroeconomic fundamentals and prudent external borrowing.

Conclusion

Exchange-rate volatility cannot be eliminated in an integrated global economy. However, diversified trade, resilient macroeconomic fundamentals and effective financial risk management can strengthen India's external sector stability.