Indian Economy · GS - III

Examine how currency appreciation and short-term capital flows influence India's external sector stability.

EXAM YEAR	PAPER	SUBJECT
DAILY PRACTICE 24/11/2026	GS - III	Indian Economy

MARKS	WORD LIMIT
15	~250 words

Answer Hint

Exchange rate, carry trade, foreign portfolio investment, RBI intervention, export competitiveness, import bill, capital flow volatility

Model Answer

Introduction

Currency carry trades involve borrowing in a low-interest-rate currency and investing in another currency to earn returns. The rupee's reported attractiveness to such investors highlights the influence of exchange-rate expectations and global capital movements on India's external sector.

Impact on External Sector Stability

1. **Exchange Rate Appreciation:** Foreign inflows can increase demand for the rupee, leading to appreciation. This may improve investor confidence but can also make Indian exports relatively expensive.

2. **Import Cost Reduction:** A stronger rupee reduces the domestic cost of dollar-denominated imports, including crude oil, thereby potentially easing imported inflation and the current account deficit.

3. **Export Competitiveness:** Sustained appreciation may reduce the price competitiveness of Indian goods and services in international markets, affecting export-oriented sectors.

4. **Volatile Capital Flows:** Carry trades are sensitive to global interest rates, risk perceptions and exchange-rate expectations. Sudden reversals can create pressure on the rupee and financial markets.

5. **Monetary Policy Challenges:** RBI intervention can moderate excessive volatility and maintain orderly market conditions, but prolonged reliance on temporary measures may create market distortions.

Way Forward

1. **Maintain Exchange Rate Flexibility:** Allow market forces to determine the rupee's broad direction while addressing excessive volatility.

2. **Strengthen External Fundamentals:** Improve export competitiveness, diversify energy sources and maintain adequate foreign exchange reserves.

3. **Monitor Capital Flows:** Strengthen surveillance of short-term external borrowing and potentially volatile portfolio investments.

4. **Enhance Economic Resilience:** Develop deeper domestic financial markets and reduce vulnerability to sudden changes in global liquidity.

Conclusion

A stronger rupee can offer short-term benefits, but exchange-rate stability must rest on robust economic fundamentals rather than temporary capital-flow incentives. A resilient external sector requires a balance between capital mobility, competitiveness and macroeconomic stability.

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