Indian Economy · GS - III

A strengthening US dollar amid rising geopolitical uncertainties has significant implications for emerging market economies such as India. Examine its impact on the Indian economy and capital markets. Suggest measures to mitigate the associated risks.

EXAM YEAR	PAPER	SUBJECT
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MARKS	WORD LIMIT
15	~250 words

Answer Hint

Dollar as a safe-haven asset; geopolitical uncertainty; rupee depreciation; crude oil imports; imported inflation; foreign portfolio investment outflows; Sensex and Nifty volatility; external debt burden; RBI intervention; export competitiveness; diversification of trade and reserves; macroeconomic stability.

Model Answer

Introduction

The US dollar plays a dominant role in global trade, finance and foreign exchange reserves. During periods of geopolitical uncertainty, investors often shift towards dollar-denominated assets, strengthening the dollar and creating financial pressures for emerging economies such as India.

Impact on the Indian Economy and Capital Markets

1. Currency and External Sector: A stronger dollar can put downward pressure on the Indian rupee. This raises the rupee cost of dollar-denominated imports, particularly crude oil, natural gas and certain industrial inputs, potentially widening the trade deficit.

2. Inflationary Pressures: Higher import costs can transmit into domestic fuel, transportation and production costs. This may complicate monetary policy decisions and constrain household purchasing power.

3. Stock Market Volatility: Foreign portfolio investors may reallocate funds towards safer assets, leading to capital outflows from Indian equities. Consequently, the Sensex and Nifty 50 may face selling pressure, particularly in sectors dependent on foreign investment or imported inputs.

4. Corporate and External Debt: Companies with unhedged dollar-denominated borrowings face higher repayment costs when the rupee depreciates. The government and the Reserve Bank of India may also face challenges in managing external stability and inflation expectations.

5. Potential Benefits: Exporters and businesses earning dollar revenues may benefit from higher rupee realisations. However, the gains depend on imported input costs, global demand and currency hedging.

Measures to Mitigate Risks

India should maintain prudent fiscal and monetary policies, build adequate foreign exchange reserves, and allow the exchange rate to adjust in an orderly manner. The RBI can address excessive volatility through appropriate liquidity management and foreign exchange interventions.

Greater diversification of energy imports, expansion of renewable energy, promotion of domestic manufacturing and wider use of currency hedging can reduce external vulnerability. Strengthening export competitiveness and attracting stable long-term investment would further improve resilience.

Conclusion

A stronger dollar presents both risks and opportunities for India. Rather than targeting a particular exchange rate, India should prioritise macroeconomic stability, diversified trade, resilient capital markets and reduced dependence on imported energy.

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