

Battling to hold the Rupee

C.P. Chandrasekhar and Jayati Ghosh

In early June, the Ministry of Finance and Reserve Bank of India (RBI) announced a set of unusual measures to stabilise the rupee. Instead of resorting to ‘open market intervention’ through dollar sales to prop up the rupee’s value, the Ministry and the central bank went along two routes: (i) they enlarged access to the government securities (G-Secs) markets for foreign portfolio investors (FPIs), by expanding the list of government securities open to them under the Fully Accessible Route (which has no investment limits); and (ii) they did away with a bunch of taxes on returns and capital gains deriving from G-Secs, and sought to attract foreign investors to this segment by making it a mini tax haven.

The income tax rate on interest income earned from G-Secs by FPIs has been reduced from 20 per cent to nil, and taxes on short-term (less than 12 months) and long-term capital gains of 30 and 12.5 per cent respectively have been abolished.

By rendering the G-Sec market much more attractive for FPIs, the government aims to attract large volumes of foreign financial investment. The resulting abundance of foreign exchange is in turn expected to stabilise the rupee.

Debt Market Focus

The focus on the government debt market is not without basis. In recent times FPI investments in India’s equity market have been more volatile and less buoyant than its debt markets, excepting for after the recent policy change (Chart1). And within the debt market, it is the market for government securities that dominates (Chart 2), with central government G-Secs having an overwhelming share in government bonds (Chart 3). Leveraging that evidence, the government is making a push to use FPI investments in G-Secs to stabilise the rupee.

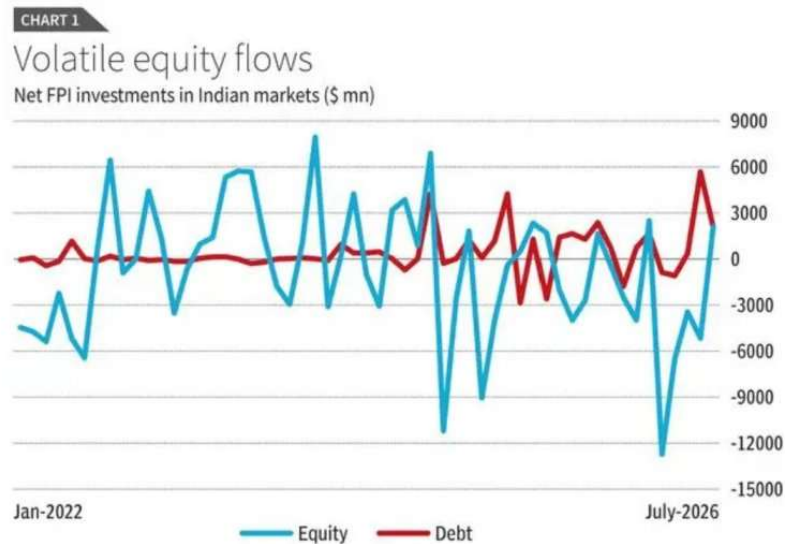


CHART 2

G-Secs dominate

Government and corporate bonds outstanding end-March 2026 (₹ crore)

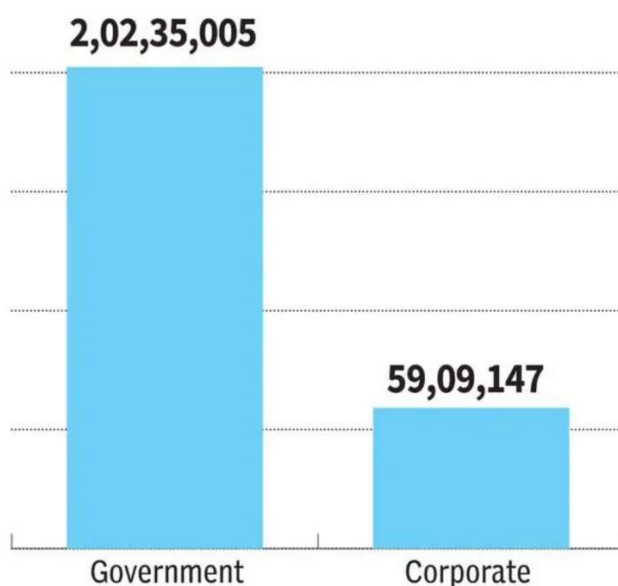
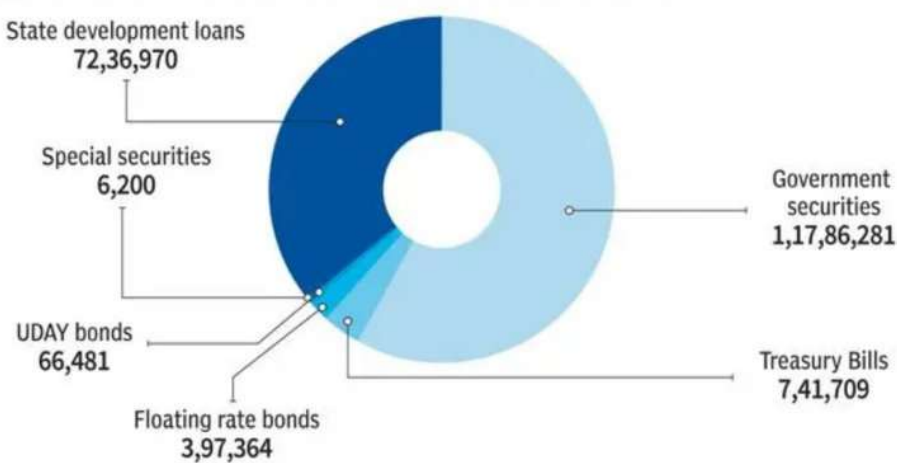


CHART 3

Bonds profile

Total outstanding government bonds end-March 2026 by type (₹ crore)



The exchange value of the rupee, as captured by its nominal rate vis-à-vis the US dollar has been in long-term decline since end of the Covid pandemic. It stood at around ₹75 to the

dollar at the beginning of 2022, fell to just above ₹81 by the end of that year, then depreciated slowly to cross ₹83 at the end of the next year and approached ₹85 by the end of 2024. This trend has however gained momentum since January 2025 and brought the currency down to around ₹96 to the dollar more recently.

Multiple factors have played roles here. The appreciation of the dollar, the counterpart currency; current account strains induced by volatile movements in energy prices; and, most importantly, episodes of capital outflows both because of the withdrawal of portfolio investors and net outflows of foreign direct investment.

RBI Ambivalence

Mandated to manage the country's exchange rate, the RBI's response to this trend has been ambivalent. With foreign reserves in excess of \$650 billion, or around seven months' worth of imports, the central bank should have been sitting pretty. Especially since, for many years preceding the pandemic, India had emerged as a favoured destination for foreign financial investors targeting both equity and debt assets worldwide.

Inflows exceeded current account financing needs, facilitating reserve accumulation. Moreover, since the currencies of India's proximate trade competitors in Asia and elsewhere were also depreciating, some fall in the rupee's value was needed to support export competitiveness. Not surprisingly, over significant spans of this long depreciation episode, the RBI has chosen not to exploit its foreign reserve war chest to intervene in currency markets to shore up the rupee.

That stance is being reversed in recent months. First, for reasons varying from the adverse impact on exports of the trade aggression of the US and its allies and the rise in the import bill because of geopolitically driven, periodic, speculative increases in energy prices, there is reason to believe the India's current account deficit is likely to widen.

Losing Lustre

Simultaneously, the market mood and the available evidence suggest that India is losing its position in the pecking order of favoured markets for foreign financial investors looking for returns from equity and debt markets. With equity investors increasingly focused on AI and AI-related firms, Indian equities showing signs of having crossed sustainable valuation levels, and with less abundant cheap capital in global markets, the trend underlying fluctuations in equity market investments point to decline and investor exit.

Even if the net flow is absolute positive, the volume is no longer such as to consistently raise the size of the central bank's foreign reserves. Once we recognise that the foreign reserve pool is not a reflection of a robust current account surplus, but of accumulated liabilities owed to foreign investors, an increase in reserves becomes imperative to match the cumulative volume of legacy portfolio investment in the country and convince foreign investors that the host has the wherewithal to guarantee their free exit if and when the need arises. If that confidence is undermined, any small reversal of capital flow into the country can soon turn into an avalanche.

An 'excess' depreciation of the currency can be the signal that triggers such exit, warranting intervention to stabilise the currency. But if that intervention swallows much of the reserve, confidence can only erode further, accelerating capital exit and the currency's slide.

The RBI's ambivalence is therefore understandable.

However, under pressure to shore up market confidence and keep the money flowing, the RBI has adopted the measures mentioned earlier, including the decision to convert the G-sec market into a mini-enclave that serves as a tax haven. Unfortunately for the government, that effort has not been as successful as expected. It is true that June 2026 saw a record inflow of ₹54,150 crore of investment into the debt market, which was the highest single month figure ever achieved.

Volatile Flows

But the contribution of this record inflow into the debt market was almost completely neutralised by an FPI outflow of around ₹49,340 crore from equity markets. That is, the enhanced access and huge tax benefits provided to investors in debt markets largely triggered a shift out of equity into debt, rather than an increase in aggregate inflows. And in July, while net equity inflows recovered to ₹20,200 crore, net debt inflows shrank significantly to just ₹18,883 crore. The government's actions are not having the intended effect as yet.

However, the long-term effect of this move to open up the government equity markets as a means of currency stabilisation can be counterproductive. Domestic institutional investors and banks who are currently the principal holders of government debt are more predictable and within the reach of the government's regulatory arms.

On the other hand, FPI flows are driven by global factors. Even when the government manages to ensure a degree of macroeconomic and monetary stability domestically, changes in global conditions such as interest rate hikes, geopolitical factors that affect risk appetites, and the like, can affect FPI sentiment, leading to an exit of capital, balance of payments vulnerability and an unexpected degree of currency instability.

Moreover, once markets are open to foreign financial investors leading to the accumulation of a legacy stock of investment, reversing the policy is much more difficult than instituting it. And as the share of foreign holding of government debt stock increases, any retreat by foreign capital can lower prices and raise yields, hiking government borrowing costs, with extremely adverse implications for fiscal autonomy and management.

International experience, especially in countries in Latin America, illustrates the dangers of going down this road. Since the early signs are that the policy is not working, the government may be well advised to retract before it is too late.

Over significant spans of this long depreciation episode, the RBI has chosen not to exploit its foreign reserve war chest to intervene in currency markets to shore up the rupee. That stance is being reversed in recent months

** This article was originally published in The Business line on August 4, 2026.*