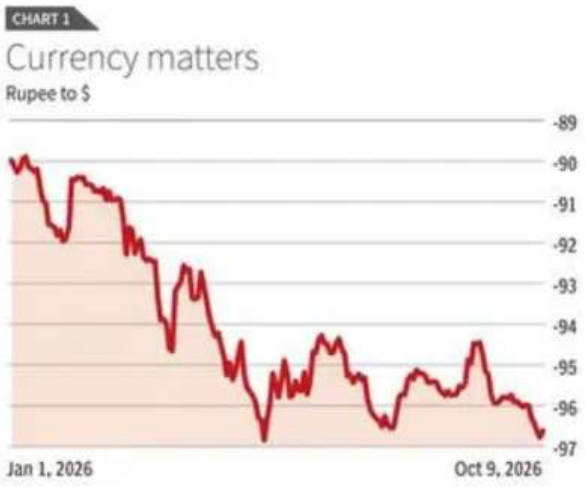
Desperate moves to shore up rupee

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The Modi government's cup of woes runneth over. Politically, the government is unable to respond to much less effectively address — the widespread protests (led by young people, now the dominant demographic) against the urgent problems of lack of employment, scams in education, and now the public anger over manipulation of voters' rolls and elections. Its ham-handed, large-fisted, stick-wielding approach to protests is making things much worse.

Its economic policy is similarly a combination of paralysis and doubling down on clearly failed strategies, which are now generating even worse outcomes for the people. All of this has spread to the external sector, which is showing great strain. It was always more fragile than the government sought to portray but now seems heading into quicksand.

One clear example of this is the continuous, occasionally precipitous and apparently unstoppable decline in the value of the rupee. The rupee to US dollar rate fell for several years from 2012 onwards, including 2020-22; it was largely stable at around ₹82 to the dollar in 2024, but thereafter it has slid substantially. In 2026, the rupee was one of the worst-performing currencies in the world. As chart 1 shows, it has even fallen significantly against the US dollar, which itself has been losing ground globally vis-a-vis other major currencies.



As in so many other areas, the Modi government's attempts to thwart, or even mitigate this process, have largely failed, or at best produced only temporary effects. Yet, these strategies themselves, which attempt to tide over the current problem of the falling rupee, are mostly not all that effective and can be very expensive in the future, entailing even more forex liabilities that the country may find it difficult to repay.

RBI Intervention

The most standard way central banks today try to control currency volatility is through open market operations, selling or buying (typically) US dollars or other reserve currencies to prop

up the value of the rupee in the currency markets. The RBI has certainly tried this multiple times even in the current year, losing tens of billions of US dollars through market interventions to support the rupee.

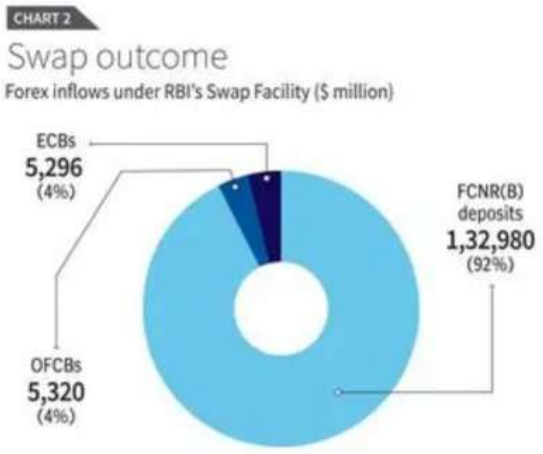
Ironically, the very loss of official foreign exchange reserve holding that this requires tends to create investor expectations of future depreciation, which can therefore add to more private financial outflows. This conundrum led to the extraordinary measures taken in early June, when the RBI sought to encourage private inflows through all means possible. This involved creating a set of three concessional swaps aimed at encouraging overseas fund-raising by state-owned firms and attracting foreign currency non-resident deposits Foreign Currency Non-Resident(B) scheme, the Overseas Foreign Currency Borrowing (OFCB) and External Commercial Borrowing (ECB) schemes

FCNR(B) does magic

All of these are questionable in that they enable and even actively encourage more foreign currency borrowing even when there is no reason to believe that the forex constraint on the Indian economy is likely to be eased much in the medium-term future. But the most extraordinary and most significant of such schemes is the FCNR(B) scheme.

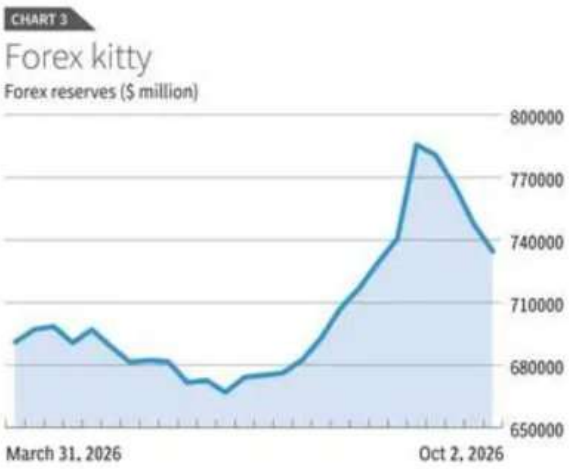
This provided such a bonanza to non-resident Indians that it could even be called the FCNR(B) scam, not a scheme. It offered 6-7 per cent interest (more than double of what US term deposit rates provide), with the principal guaranteed in US dollars at maturity. The exchange rate risk is borne by the RBI, so there is no fear of nominal depreciation of the rupee reducing returns to NRI investors. What is even worse is the option provided to leverage the initial investment into further investments within India such as in GIFT City.

Not surprisingly, this proved to be popular with NRIs to the point that the scheme, which was intended to continue until mid-October, was closed on August 31. Nearly $1.33 billion flowed into these accounts, adding to India's future forex debt. As chart 2 show, this scheme dominated over the other two in terms of inflows.



The massive amount of investor interest and the inflows this generated led the government to proclaim the FCNR(B) scheme/scam to be a huge success. And chart 3 indicates that this was associated with a recovery of foreign exchange reserves from late June to the end of August. But this recovery was short-lived, with reserves once again beginning to fall once the scheme

came to an end. So, it is difficult to claim success. And in any case, success for whom? While NRIs certainly benefit from this scheme, the people of India are set to lose because of the heavy costs of unnecessary forex borrowing which, in any case, is unlikely to be associated with any productive investment.



Another standard practice for dealing with currency volatility and depreciation fears is the exercise of various types of prudential regulation on cross-border financial flows. Indeed, these were the next to be resorted to after forex reserves fell by nearly $52 billion from $785.7 billion on September 4 to $734 billion on October 2. By October 10, the RBI announced a new set of measures. These include restrictions on rebooking of cancelled foreign exchange derivative contracts; reduction in the threshold for undertaking foreign exchange derivative transactions without establishing underlying exposure; requirement of additional documentation for verification of underlying exposures; and introduction of exchange risk reserve (FERR) for all foreign exchange derivative contracts involving rupee with notional values exceeding the equivalent of $2 million.

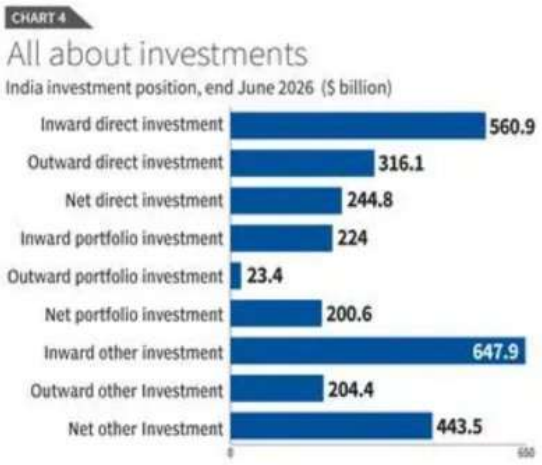
The Root Cause

Unfortunately, while these measures may reduce some of the bleeding, they are unlikely to address the root cause of the rupee's decline: the combination of unbalanced trade, lower remittances from workers abroad, and stagnant domestic mass consumer demand that makes even domestic businesses less interested in expanding productive capacity.

We can hardly expect foreign corporations to invest in India (without massive and expensive blandishments) if domestic companies and our own wealthy people refuse to do so. Indeed, one of the reasons why our balance of payments position remains so weak despite our claims of great strength, is the extent of outflows by various forms of capital, which have been enabled by financial deregulation.

Chart 4 shows the net investment position of India, indicating both direct and portfolio investments and other investments (these categories contain both equity and debt holdings and are stock numbers, not flow). For a lower middle-income country with most of its development projects incomplete and greatly in need to additional investments, the extent of capital outflows appears to be quite large. It significantly reduces the net inflows that economies in India's

position require for development.



Overall, the government appears to have run out of ideas on all fronts. The turmoil within the country can and will be sorted out, ideally with more democratic and inclusive outcomes. But the costs of continued economic mismanagement today will haunt the people of India for decades thereafter.

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