

Why the rupee has fallen steeply

CAPITAL WOES. Despite the economy doing well, there was sustained foreign capital outflow which put pressure on the rupee and affected the sentiment around it



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Between early December 2025 and the end of March 2026, the rupee moved from 84.68 to 94.65 against the dollar — a fall of nearly 11.8 per cent in under four months. By most historical standards, that is an unusually sharp descent for a major emerging-market currency. What makes this episode particularly intriguing is that it unfolded against a backdrop of strong macroeconomic fundamentals: India's GDP growth remained strong, inflation was benign, and the government's fiscal balances were sound, supported by fiscal consolidation.

In April 2026, the Reserve Bank of India stepped in with a clutch of corrective measures, and the rupee rebounded to around 93.3 to the dollar. But the question lingers — why did the rupee fall so hard, so fast, when the economy was, in most respects, doing rather well, especially compared to its peers?

The usual textbook explanations do not justify the sharp depreciation. The relative purchasing power parity theory, which holds that the currencies of high-inflation countries should weaken against those of low-inflation countries, offers little help here. Indian CPI inflation during this period was not running any higher than America's. The trade deficit, which had increased substantially in October 2025 to a merchandise gap of \$41.7 billion, had subsequently shrunk and stabilised. Once the services trade is included, the overall deficit in subsequent months looks manageable. Fiscal position, public debt, and monetary aggregates showed no major signs of distress either. Why did the rupee fall then?

The real reasons lie elsewhere — in the capital account. Since 1991, India has routinely run a current account deficit comfortably financed by strong inflows of foreign direct and portfolio investment. That regularity seems to have taken a setback. RBI data show that

net FDI flows have been negative every single month from September 2025 through January 2026, the last month for which figures are available. Data from National Securities Depository Ltd (NSDL) tells an interesting story on the portfolio side: seven of the nine months beginning July 2025 have seen net foreign institutional outflows, and March 2026 set a record for FII selling. Between late February and early April, foreign institutional investors were persistent net sellers in the cash equity market. This sustained outflow of foreign capital has not only put pressure on the rupee but also affected sentiment around it.

INTEREST RATE DIFFERENTIALS

An interesting trait of capital flows is that they often tend to chase the interest rate differential, adjusted for the perceived country risk parameter, reflecting sentiment about a particular currency. Thus, even with unchanged fundamentals across two countries, if a country is perceived to have become more (less) risky by the not-so-rational market players exhibiting herd behaviour, there may be sharp changes in capital flows and consequent exchange rate movements.

Once sentiment turns, the currency market begins to form expectations that can affect the behaviour of various economic agents. For example, if foreign investors expect, say, a 10 per cent depreciation ahead, then a 12 per cent rupee return on an Indian asset shrinks to a meagre 2 per cent in dollar terms — reason enough to diversify to other markets with higher expected returns. Exporters and remittance senders, anticipating a better exchange rate tomorrow, sit on their dollars today. Importers, fearing the opposite, rush to stock up. Speculators also try to take advantage. Each of these reactions, individually rational, collectively drags the currency down further. A strong

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expectation of depreciation, in other words, can become a self-fulfilling prophecy.

As regards the timing of the intervention by the Indian authorities, RBI Governor's Monetary Policy Statement of April 8, 2026, stated candidly:

“Despite stronger macroeconomic fundamentals, the Indian rupee in 2025-26 depreciated more than the average in the previous years. In this regard, let me reiterate that our exchange rate policy remains unchanged. Specifically, intervention in the foreign exchange market is aimed at smoothing excessive and disruptive volatility without targeting any specific level or band for the exchange rate. This is consistent with our long-standing policy of the exchange rates being market-determined. The RBI stands committed to this policy and would judiciously contain excessive or disruptive volatility to ensure that self-fulfilling expectations do not exacerbate currency movements beyond what is warranted by fundamentals.”

In practice, finding the fundamental value of the rupee can be quite difficult. Exchange rates are affected simultaneously by goods and asset markets, each adjusting at different speeds. In fact, one of the most celebrated theories of exchange rates (*à la* the American economist Rudiger Dornbusch) argues that currencies routinely overshoot their equilibrium values. In a quarter as turbulent as the Q1 of 2026, pinning down a single “correct” level for the rupee would have been an exercise in false precision.

DOESN'T STIMULATE EXPORTS

Depreciation cuts the economy in two ways. A cheaper rupee may help exporters price more attractively abroad, but because Indian exports are import-intensive — think oil, raw materials, intermediate goods, and capital goods — the cost of producing those very exports rises in tandem. Domestic inflation creeps up. The competitiveness gain turns out to be smaller and more fragile than it looks on paper, while the costs to households and firms are immediate and tangible. Moreover, if all EME currencies depreciate *vis-à-vis* the dollar, the

relative competitiveness of currencies remains largely unchanged; therefore, depreciation of the rupee does not help stimulate exports, particularly when it is fully offset by adverse terms of trade from rising production costs.

However, the gradual decline of the rupee may have affected market sentiment and contributed to the FII outflows. The deeper causes of the FII exodus go well beyond rupee jitters. While the overall macro indicators remained strong, slower corporate earnings at home due to lower nominal GDP growth, stretched equity valuations as reflected in higher P/E ratios, the lack of AI-related stocks in India, oil-price anxieties, and the ongoing conflict in West Asia could have pushed global capital towards other destinations. On the other hand, in the US, uncertainty over its tariffs, immigration, and high yield rates has kept dollar assets relatively appealing. Depreciation expectations have amplified an already bearish story — a classic Catch-22 in which outflows trigger depreciation, and depreciation in turn triggers more outflows.

Expectedly, the intervention will curb disorderly swings. With comfortable forex reserves behind it, the RBI has the firepower to do so. It also has the intellectual backing of the IMF's Integrated Policy Framework, which holds that forex intervention is part of the legitimate toolkit for EMEs to manage exchange rates. A spell of rupee stability lets trade and finance plan ahead, and restores a measure of calm to an economy. Hopefully, peace will endure in West Asia, risk perceptions of oil-importing developing countries will subside, and India's economy can look forward to a more stable external environment in the near future.

In some sense, the recent rupee swings in an otherwise strong economy with the highest growth among the G-20 economies, reminds one of Luigi Pirandello, the Italian playwright, who in his celebrated play, *Six Characters in Search of an Author*, said, “Life is full of strange absurdities, which, strangely enough, do not even need to appear plausible, since they are true.”

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