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Following days of sustained losses, the rupee has closed at nearly ₹97 to the dollar; while some advocate letting it find its own level, there is a risk in allowing depreciation to continue unchecked, especially as rising import costs of essential goods could fuel inflation

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[RAHUL MENON](#)



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Continuous days of sustained losses has seen the rupee close at almost ₹97 to the dollar, with no indication that the slide has been arrested. Rising oil prices and the threat of external inflation will put further pressure on the rupee in the days to come. This has prompted calls for intervention to prevent further falls.

Some writers, like Harvard professor Gita Gopinath, have resisted calls for intervention by the RBI, advocating for letting the rupee find its own level. A weaker rupee would automatically curtail imports and boost exports. Intervention would only obstruct the free flow of market forces.

While intervention does have its challenges, there is danger in letting the process of depreciation continue unabated, especially when much of it is being driven by speculative finance. With foreign interest rates bound to rise, capital will flow out faster, leading to stronger negative pressures on the rupee. In such a scenario, it might take inordinately long for the rupee to ‘find its level’, and the inflationary

dangers of a weak rupee will exert even more stresses on a populace already exposed to hardship as a result of worldwide spikes in energy prices.

## **Can intervention deepen volatility?**

A current account deficit implies more imports than exports, and hence a greater need for foreign currency. If this is adequately met by foreign capital inflow to purchase assets like stocks, the rupee's value relative to the dollar will not change.

If the economy experiences a deficit without sufficient inflow of foreign capital, it faces a problem, with demand for foreign exchange exceeding available supply. Mainstream models dictate that in such a situation, the rupee must depreciate. The weaker rupee makes exports more affordable and imports more expensive, leading to an automatic adjustment of the current account deficit relative to the available inflow of foreign capital.

In such a scenario, intervening to artificially prop up the value of the rupee only delays the inevitable. It inhibits adjustment by ensuring import demand does not fall, because the rupee has not depreciated enough to naturally shut off higher import demand, the cause of the widening deficit in the first place.

## **What is the difference between a weak rupee and a falling rupee?**

Arguments for non-intervention, however, conflate a falling rupee with a weak rupee. A fall in the rupee value would not automatically increase export demand if the market expects a further fall. Exports might be higher when the rupee is weak, but may not rise when the rupee is falling if foreign buyers expect the price to fall even further and for goods to become cheaper at a later date.

At the same time, if the economy imports essential goods like oil, demand may not automatically reduce sufficiently as the rupee falls. If people expect the rupee to fall further, and for the prices to rise even more tomorrow, they may front-load purchases today and increase import demand in the short run. This can be seen in the rush to buy petrol when prices were raised, as consumers expected further increases in the future.

A falling rupee would see higher import values, but no necessary increase in exports, ensuring that the deficit is not curtailed. The very problem that required a depreciation might just perpetuate itself. One might argue that exports would pick up and imports reduce when the process eventually works itself out. But the adjustment process is rarely painless. Rising import values of essential goods will lead to rising inflation in the domestic economy that has already experienced reverse migration and real wage squeezes.

## **What is the role of capital flows?**

For the sake of argument, one can posit an equilibrium value of the rupee driven by fundamental values, such as export and import demands that exhibits uniform and predictable behaviour as the rupee changes value. The process may be long, but the economy might eventually settle at this value, driven by fundamental changes in the current account. However, this assumption neglects the role of speculative foreign capital.

Much of the fall in the rupee has been driven by speculative outflows of foreign institutional investment that, for whatever reason, does not see Indian assets as being sufficiently remunerative. Perhaps investors think returns on Indian stocks will not be high in the future, that growth is not sustainable, or that interest rates will rise in developed country markets. Whatever the reason, these speculative expectations of foreign investors can lead to capital outflow and depreciation, necessitating current account adjustments based on the sentiments of foreign investors.

In such a situation, the ‘actual’ value of the rupee is determined not by consumption demand but by speculation. There are no fundamentals or technical values underpinning the pure speculation of financial markets. With indications that foreign Central Banks may soon raise interest rates, the rupee could come under further pressure.

Intervention is one amongst many policies that must be considered, and one that even developed economies have resorted to. As the yen slid against the dollar in April this year, Japanese Finance Minister Satsuki Katayama signalled that the government would take ‘decisive action’ in financial markets to maintain the yen. This announcement did lead to the yen recovering some losses initially after the announcement, though it continues to lose ground due to limited actual intervention.

Intervention to stem speculative capital flows is extremely hard to manage, and can lead to negative outcomes if the force of speculation is too great, or if governments do not - or cannot - show enough commitment in markets. However, we must not assume that the rupee can find an equilibrium value soon, for its fall is being driven by speculation rather than any fundamental economic behaviour. It is time to have a serious conversation regarding the role and place of foreign capital in India's growth story.

*(Rahul Menon is associate professor at O.P. Jindal Global University.)*