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RBI Bans Rupee NDD Contracts — Forex Policy and Currency Stability

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WHY IN NEWS

The Reserve Bank of India (RBI) issued a directive barring banks from participating in **Non-Deliverable Derivative (NDD) contracts** on the Indian rupee in offshore markets. Following the directive, the rupee appreciated sharply — from below ₹95/USD to ₹93.10/USD — signalling the extent to which offshore speculation had been driving currency weakness.

WHAT ARE NON-DELIVERABLE DERIVATIVES (NDDS)?

A Non-Deliverable Derivative (NDD) is a **cash-settled foreign exchange forward contract** traded primarily in offshore markets (Singapore, Hong Kong, London) for currencies that are not fully convertible — like the Indian rupee.

How they work

1. A buyer and seller agree on a notional exchange rate (the NDF rate) for a future date

2. On settlement day, the difference between the NDF rate and the prevailing spot rate is paid in **US dollars** — no actual rupees are exchanged
3. This allows global investors, hedge funds, and banks to bet on rupee movements **without holding or delivering rupees**

Why does this matter?

DIMENSION	IMPACT
Price discovery	Offshore NDF rates can diverge from onshore spot rates, creating arbitrage and volatility
RBI oversight	NDF transactions happen outside India's regulatory perimeter — RBI cannot directly supervise them
Speculation	Hedge funds can take large short positions on the rupee without using India's onshore forex markets
Currency pressure	Large NDF short positions create sustained depreciation pressure on the rupee

RBI'S CONCERN AND ACTION

The RBI's primary concerns were:

1. **Distorted price discovery:** Offshore NDF rates were increasingly setting the tone for onshore spot rates rather than the reverse
2. **Rupee at ₹95/USD:** The rupee had depreciated to an unusual low, partly driven by speculative NDD activity
3. **Monetary sovereignty:** Allowing banks to participate made Indian institutions complicit in offshore rupee speculation

By directing banks to **stop participating**, the RBI effectively reduced the liquidity available to offshore NDD traders, causing short-covering (speculators buying back rupees to close positions) and the subsequent rupee appreciation.

INDIA'S CAPITAL ACCOUNT AND FOREX POLICY

India maintains **partial capital account convertibility** — meaning not all cross-border capital flows are freely allowed:

TYPE	STATUS
Trade transactions (current account)	Fully convertible
FDI	Largely liberalised
FPI (equity)	Allowed with limits
External borrowings	Regulated
Full capital account convertibility	**Not yet implemented**

NDDs emerged precisely because of this partial convertibility — offshore players created an alternative market to express rupee views that they could not easily implement onshore.

UPSC RELEVANCE

GS Paper 3 — Economy:

- RBI's role as regulator of forex markets under FEMA (Foreign Exchange Management Act), 1999
- Capital account convertibility — Tarapore Committee recommendations (1997, 2006)
- Exchange rate management: managed float vs fixed vs fully flexible
- Monetary policy transmission — how exchange rate volatility complicates inflation targeting

UPSC RELEVANCE

"India's managed float exchange rate regime must balance openness to global capital with the monetary sovereignty needed to pursue independent macroeconomic policy."

FACTS CORNER

- **FEMA:** Foreign Exchange Management Act, 1999 — governs cross-border transactions; administered by RBI and Enforcement Directorate
- **Managed float:** India's exchange rate regime — the rupee floats but RBI intervenes to smoothen excessive volatility
- **NDF hubs:** Singapore is the largest offshore NDF market for the rupee; followed by Hong Kong and London
- **Tarapore Committee:** Recommended preconditions for full capital account convertibility — fiscal consolidation, low inflation, strong banking sector

- **Rupee convertibility:** India's rupee is convertible on current account (trade) but not fully on capital account (investment flows)
- **RBI forex reserves (2026):** ~$640–650 billion; one of the world's largest; used to defend the rupee during extreme volatility
- **FCNR(B) deposits:** Foreign Currency Non-Resident (Bank) accounts — another tool RBI uses to attract forex inflows during currency stress

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