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Why the Government Is Worried About Dollars Flowing Out

THE HINDU

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Why the Government Is Worried About Dollars Flowing Out

 **The Hindu** 31 May 2026 **GS3**

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INTERVIEW ANGLE

"When portfolio capital exits and the rupee weakens, the RBI must choose between defending the currency, protecting reserves, and keeping rates supportive of growth. How should a central bank prioritise among these in a shock?"

Latest RBI figures reveal capital outflows that pressure forex reserves and the rupee. The piece argues this constrains policy space and explains the government's heightened concern over external-sector stability.

THE ARGUMENT IN ONE LINE

Capital outflows are not just a market event — they **shrink the RBI's and the government's room to manoeuvre**, forcing hard choices between defending the rupee, protecting reserves, and supporting growth.

THE MECHANISM — HOW OUTFLOWS BITE

STEP	EFFECT
FPI / portfolio exit	Foreign investors sell Indian assets, demanding dollars
Rupee weakens	More rupees needed per dollar; the currency depreciates
Reserves drawn down	If the RBI sells dollars to defend the rupee, forex reserves fall
Imported inflation	A weaker rupee raises the cost of crude oil, electronics, and inputs
Policy space shrinks	Higher inflation limits the RBI's ability to cut rates for growth

THE UNDERLYING BIND — THE IMPOSSIBLE TRINITY

A central bank **cannot simultaneously** have all three of:

- ① A **fixed/stable exchange rate**,
- ② **Free capital movement**, and
- ③ An **independent monetary policy**.

When capital flows out, defending the rupee (goal 1) and keeping rates low for growth (goal 3) pull in opposite directions.

INDIA'S CUSHIONS — AND THEIR LIMITS

- India holds a **large stock of foreign-exchange reserves** (among the world's biggest), providing import cover.
- External debt is relatively **prudent** in composition.
- **But** reserves are finite, and global **risk-off** shocks (oil spikes, US monetary tightening) can drive rapid reversals.

WHY IT MATTERS

- **Energy import bill** — India imports ~85% of its crude; a weak rupee directly worsens the import bill and inflation.
- **Growth-inflation balance** — the RBI's flexible inflation target (4% ±2%) is harder to hold when the rupee imports price pressure.
- **Confidence** — orderly management preserves investor confidence; disorderly depreciation erodes it.

THE WAY FORWARD

- Let the rupee **find its level within limits**; use reserves only to **smooth volatility**, not to fix a rate.
- **Deepen domestic capital markets** to reduce reliance on volatile foreign flows.
- Prefer **stable FDI** over hot portfolio money.
- Keep **macro fundamentals** (fiscal deficit, inflation) sound to retain buffers.

UPSC RELEVANCE

PAPER	RELEVANCE
GS3	External sector, forex reserves, rupee management, monetary policy, impossible trinity
Prelims	FPI vs FDI; forex reserves components; flexible inflation targeting (4% ±2%); impossible trinity

Sources: *The Hindu*, Reserve Bank of India

Source: Why the Government Is Worried About Dollars Flowing Out — Ujyari.com | Free UPSC & State PCS Editorial Analysis

● **KEY ARGUMENTS AT A GLANCE**

Latest RBI data showing worrying capital outflows — pressuring forex reserves and the rupee — explain the government’s heightened concern over external-sector stability, because such outflows constrain monetary and fiscal policy space precisely when the economy needs support.

✓ **SUPPORTING**

- Portfolio (FPI) outflows and a widening current-account pressure draw down reserves and weaken the rupee, raising the cost of imported energy and inputs.
- A weaker rupee imports inflation, complicating the RBI’s flexible inflation-targeting mandate and limiting room to cut rates for growth.
- Defending the currency by selling dollars depletes reserves; not defending it risks disorderly depreciation and loss of confidence — a classic trilemma bind.

⚠ **COUNTER**

Some argue moderate, orderly depreciation is healthy — it boosts export competitiveness and that India’s large reserve buffer can absorb temporary outflows without alarm.

→ **WAY FORWARD**

A calibrated mix — letting the rupee find its level within limits, using reserves only to smooth volatility, deepening domestic capital markets, and encouraging stable FDI over volatile portfolio flows — best preserves stability and policy space.

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MAINS ANSWER FRAMEWORK
QUESTION

"Capital outflows expose the structural vulnerabilities of an emerging economy's external sector." Examine the policy trade-offs the RBI faces in managing the rupee, reserves, and growth simultaneously. (250 words)

INTRODUCTION

For an open emerging economy, capital flows are a double-edged sword: they finance growth in good times but amplify shocks in bad. Recent RBI data on outflows, and the government's evident concern, spotlight the external-sector vulnerabilities that constrain India's policy choices.

BODY

When foreign portfolio investors exit and the current account comes under strain, forex reserves are drawn down and the rupee weakens. A weaker rupee raises the cost of crude oil and other imports, importing inflation and complicating the RBI's flexible inflation-targeting framework (4% +/- 2%). This narrows the room to cut interest rates to support growth — the heart of the impossible trinity, where a country cannot simultaneously fix the exchange rate, allow free capital movement, and run an independent monetary policy. The RBI's options are uncomfortable: selling dollars defends the rupee but depletes reserves; standing aside conserves reserves but risks disorderly depreciation and dented confidence.

India's relatively large reserve buffer and prudent external-debt profile provide cushion, but they are not infinite, and global risk-off episodes (oil shocks, US rate shifts) can trigger rapid reversals.

CONCLUSION

The durable answer lies less in firefighting and more in structure: deepening domestic capital markets, prioritising stable FDI over volatile portfolio flows, and keeping macro fundamentals sound. Managing outflows well is about preserving policy space — so that the RBI and government retain room to support growth when it is most needed.


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