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EDITORIAL ANALYSIS

Defending the Rupee: Why the RBI Should Choose Reform Over Repeated Intervention

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Defending the Rupee: Why the RBI Should Choose Reform Over Repeated Intervention

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INTERVIEW ANGLE

"Should the RBI defend a rupee level at all, or let a managed float do the work while it focuses purely on inflation and financial stability?"

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WHY THIS EDITORIAL MATTERS

The rupee has been under steady depreciation pressure, and the instinct of any central bank is to lean against the wind. Ananth Narayan's Business Standard column, "Alternatives to intervention," makes a sharper argument: the problem is not that the rupee is falling, but that policymakers are trying to do four mutually inconsistent things at the same time. They want a supported rupee, low interest rates, contained inflation, and comfortable financing of a large government borrowing programme. Pursued together, these goals quietly fight one another, and the tool currently in fashion, a subsidised swap window for FCNR(B) deposits and foreign-currency borrowing, eases the visible symptom while seeding longer-term costs.

For a UPSC aspirant, this is a model GS3 case study. It connects the textbook impossible trinity (<https://ujyari.com/terms/impossible-trinity/>) to a live policy choice, and it tests whether you can argue both sides rather than parrot "intervention bad."

THE CORE ARGUMENT

Narayan's thesis is that repeated market intervention and clever balance-sheet workarounds are second-best. The first-best is structural reform of India's external sector so that the rupee does not need constant defending. A swap window that subsidises the cost of bringing in foreign-currency deposits can relieve immediate pressure, but it transfers exchange-rate risk to the RBI and creates distortions and contingent (<https://ujyari.com/vocab/contingent/>) liabilities that resurface precisely when conditions turn hostile again.

The deeper claim is about the quality of capital. Defending a level tends to attract the wrong kind of inflows, short-term, yield-seeking debt that leaves at the first sign of trouble, rather than stable foreign direct investment. A policy framework that keeps reaching for intervention can therefore make the external account more fragile even as it looks calmer on any given day.

HOW TO THINK ABOUT IT: THE IMPOSSIBLE TRINITY

The intellectual spine of this editorial is the impossible trinity, or **trilemma** (<https://ujjayanti.com/vocab/trilemma/>), associated with the Mundell-Fleming framework.

The three corners

A central bank can choose at most two of the following three at once:

- ❶ A fixed or tightly managed exchange rate.
- ❷ Free movement of capital across the border.
- ❸ An independent **monetary policy** (<https://ujjayanti.com/terms/monetary-policy/>) set to domestic conditions, such as inflation.

You cannot have all three. If capital is mobile and you also fix the exchange rate, then interest rates must follow whatever keeps the peg, and monetary independence is lost. If you insist on independent rates with open capital flows, the exchange rate must float. If you want both a fixed rate and independent rates, you must control capital flows.

Where India sits

India runs a managed float, a **deliberate** (<https://ujjayanti.com/vocab/deliberate/>) middle position. The rupee is largely market-determined, but the RBI intervenes to smooth volatility rather than to defend a fixed number. Capital flows are open but not fully, since some capital-flow management measures remain. Monetary policy targets inflation through a flexible inflation-targeting mandate. This “corner-avoiding” stance gives flexibility, but it also means the trilemma tension never fully disappears; it is managed, not abolished.

Diagram in words

Picture a triangle. Label the corners “fixed exchange rate,” “open capital account,” and “independent monetary policy.” India does not sit at any single corner. It hovers near the middle of one edge, leaning toward open capital and independent policy, while accepting a managed rather than fixed rate. Every time policymakers tug the rupee toward stability, they pull the dot back toward the “fixed rate” corner, and the cost is paid in lost monetary room or in capital controls. The swap window is an attempt to widen the triangle itself by importing dollars, but it does so by stretching the central bank’s balance sheet.

THE MECHANICS: INTERVENTION, RESERVES AND THE SWAP WINDOW

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When the rupee weakens, the conventional defence is to sell dollars from forex reserves and buy rupees. This supports the currency but drains liquidity from the banking system and pushes domestic interest rates up, which clashes with the desire to keep borrowing cheap. To offset that, the RBI can sterilise the intervention by injecting rupee liquidity through open-market operations, but sterilisation has fiscal and quasi-fiscal costs and cannot run indefinitely.

The FCNR(B) route is an alternative. FCNR(B) accounts are foreign-currency deposits held by non-resident Indians, denominated in foreign currency, so the depositor, not the bank, would normally bear no rupee risk. A subsidised swap window lets banks convert those dollars into rupees while the RBI absorbs the hedging cost. The attraction is obvious: dollars flow in without the headline reserves falling. The catch, Narayan stresses, is that the exchange-rate risk and cost migrate to the central bank, building contingent liabilities that mature when the rupee is weakest and dollars are dearest. The recent tightening that caps banks' net open positions in foreign exchange is part of the same story, an attempt to keep the system's currency risk contained while these flows are encouraged.

THE COUNTER-VIEW: WHEN INTERVENTION IS THE RIGHT CALL

A balanced answer must concede the other side. Markets are not always rational, and a sudden stop, a rapid reversal of capital, can produce a disorderly slide that has nothing to do with fundamentals. In such moments, **calibrated** (<https://ujjiyari.com/vocab/calibrated/>) intervention and a temporary swap window are legitimate circuit-breakers. They buy time, prevent overshooting, and stop a self-fulfilling panic from feeding into imported inflation and corporate balance-sheet distress, especially for firms with unhedged foreign-currency debt.

A deep stock of forex reserves is itself a confidence buffer; the willingness to deploy it can deter speculators rather than invite them. The honest position is therefore not “never intervene,” but “intervene rarely, transparently, and only against disorder, not against the market's verdict on fundamentals.”

WAY FORWARD

- Deepen onshore currency and hedging markets so firms can manage rupee risk without the RBI underwriting it.
- Improve the quality of inflows, favouring stable FDI and equity over short-term debt, including through credible bond-index inclusion.
- Let the managed float do its job, allowing gradual depreciation to vent pressure rather than bottling it up.
- Reserve sterilised intervention for genuinely disorderly markets, with clear communication.
- Keep monetary policy anchored to the inflation target, not to a rupee level, so credibility is not spent defending a number.

- Treat the swap window as a bridge, not a destination, with a stated exit path and full disclosure of contingent liabilities.

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PYQ LINKAGE

- **GS3 (2018):** “Examine the impact of liberalisation on companies owned by Indians. Are they competing with the MNCs satisfactorily?” links to capital-account openness and external-sector exposure.
- **GS3 (2014):** “Capital Account Convertibility may bring with it severe instabilities. Do you agree?” maps directly onto the trilemma and the risks of open capital flows.
- **Prelims angle:** questions on the impossible trinity, FCNR(B) deposits, sterilisation, open-market operations and the difference between a fixed peg and a managed float are all fair game.
- **Mains framing tip:** structure any answer on the rupee around the trilemma, then weigh intervention against structural reform, and close with a calibrated, not absolutist, position.

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KEY ARGUMENTS AT A GLANCE

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Repeated forex intervention and subsidised swap windows treat the symptom of rupee weakness while deepening underlying distortions; durable stability needs structural reform of the external sector, not more market support.

 **SUPPORTING**

- The impossible trinity means India cannot at once anchor the rupee, keep monetary policy independent and allow free capital flows, so something must give whenever all four goals are pursued together.
- Subsidised FCNR(B) swap windows and concessional foreign-currency borrowing shift exchange-rate risk onto the central bank's balance sheet and build up contingent liabilities that surface exactly when stress returns.
- Drawing down forex reserves to defend a level signals a soft peg, invites one-way speculative bets and can drain the very buffer that reassures investors during a genuine shock.

 **COUNTER**

In a sudden-stop or panic, calibrated intervention and a swap window are legitimate circuit-breakers; refusing to act on ideological grounds can let a disorderly slide feed into imported inflation and corporate balance-sheet distress.

 **WAY FORWARD**

Deepen onshore currency and bond markets, widen genuine capital inflows through stable FDI and index inclusion, let the managed float absorb gradual adjustment, reserve sterilised intervention for disorderly moves, and keep monetary policy anchored to inflation rather than to a rupee number.


MAINS ANSWER FRAMEWORK

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QUESTION

The Reserve Bank of India is simultaneously trying to support the rupee, keep interest rates low, cushion inflation and finance higher government borrowing. In light of the impossible trinity, examine why these goals pull against one another. Critically evaluate the use of subsidised swap windows for FCNR(B) deposits and foreign-currency borrowing as a tool to ease exchange-rate pressure, and discuss the structural alternatives India should prefer over repeated forex-market intervention. (250 words, GS3)

INTRODUCTION

A currency is a price, not a target. When the RBI tries to fix that price while also keeping rates low, taming inflation and funding heavy borrowing, it runs straight into the impossible trinity, and Ananth Narayan's column asks whether the swap window is the cure or merely a costlier disease.

BODY

The trilemma is unforgiving: with reasonably open capital flows, the RBI can own monetary policy or the exchange rate, not both. Defending the rupee by selling dollars tightens domestic liquidity and pushes rates up, which collides with the wish to keep borrowing cheap; sterilising that intervention only postpones the strain.

The subsidised swap route for FCNR(B) deposits and foreign-currency borrowing looks clever because it pulls in dollars without spending reserves, but it parks exchange-rate risk on the central bank and creates contingent liabilities that mature when stress is highest. It also distorts incentives, rewarding short-term debt flows over durable equity and FDI. The structural answer is to make the rupee easier to hold and the external account stronger: deeper onshore hedging markets, broader investor access through bond-index inclusion, stable FDI, and a credibly managed float that lets gradual depreciation vent pressure. Intervention then becomes a rare circuit-breaker for disorderly days, not a standing policy.

CONCLUSION

The cheapest way to defend the rupee is to need to defend it less. Reform of market depth and capital quality buys lasting resilience; the swap window buys only time, and time on the central bank's balance sheet is never free.


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