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EDITORIAL ANALYSIS

Building Buffers: Forex Inflows Should Be Used to Build Up Reserves

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Building Buffers: Forex Inflows Should Be Used to Build Up Reserves

Business Standard 25 June 2026 **GS3**

Source: ujyari.com — researched, fact-checked & UPSC-mapped



INTERVIEW ANGLE

"RBI incentives for FCNR(B) deposits, by bearing hedging costs and lifting rate caps, can pull in foreign currency but move the exchange-rate risk onto the central bank. Should such inflows be used to build reserves rather than to paper over external vulnerabilities?"

Source: [Original editorial](#) [Business Standard](#)

✓ Every fact web-verified against primary sources (<https://ujyari.com/how-we-verify/>)

WHY THIS MATTERS NOW

The RBI's incentives for FCNR(B) deposits, by bearing hedging costs and lifting interest-rate caps, can attract foreign-currency inflows during external stress. For an aspirant, this is a precise **GS3 (economy, external sector) lead** that rewards a key insight: such inflows are useful, but they **shift exchange-rate risk to the central bank** and can **mask vulnerability** (<https://ujyari.com/vocab/vulnerability/>). The right policy choice is to use any forex inflows to **build up reserves**, not to defend a rupee level.

THE CRUX IN 60 WORDS

FCNR(B) incentives (RBI bearing hedging costs, relaxing rate caps) draw in **dollar deposits**, but because the liability is in **foreign currency**, the **exchange-rate risk migrates to the RBI**. These flows are **debt-creating and reversible**. Policymakers should debate their **scale**, account for the **contingent** (<https://ujyari.com/vocab/contingent/>) **cost**, and use inflows to **build reserves**, not to **mask external weakness**. Durable **FDI** is the deeper fix.

THE ISSUE, DECODED

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CONCEPT	WHAT IT MEANS	WHY IT MATTERS
FCNR(B) deposit	NRI foreign-currency deposit with Indian banks	A fast source of dollar inflows
Hedging cost borne by RBI	Central bank absorbs currency-cover cost	Makes deposits attractive but costly
Currency risk transfer	Exchange-rate risk moves to the RBI/system	A contingent liability if rupee falls
Reserve building	Adding inflows to forex reserves	Buffers absorb shocks durably
FDI vs debt flows	Non-debt, durable vs debt-creating	Quality of inflows shapes resilience (https://ujjiyari.com/vocab/resilience/)

THE ANALYSIS: THE USE MATTERS AS MUCH AS THE TOOL

- ❶ **The incentive works fast.** Bearing hedging cost and lifting rate caps pulls in dollars during stress.
- ❷ **The risk does not vanish.** A foreign-currency liability shifts exchange-rate risk to the central bank.
- ❸ **The flows are debt-creating.** Unlike FDI, FCNR(B) deposits are reversible and add to external debt.
- ❹ **Masking is the trap.** Using inflows to defend a rupee level hides weakness instead of fixing it.
- ❺ **Reserves are the prudent** (<https://ujjiyari.com/vocab/prudent/>) **use.** Channelling inflows into buffers builds resilience that survives the shock.

DATA AND INSTITUTIONS VAULT

FCNR(B) (*Foreign Currency Non-Resident Bank deposit*), **NRE** and **NRO** accounts; earlier **FCNR(B) swap windows** were used in past external squeezes. **Concepts:** debt-creating vs non-debt-creating flows; **FDI vs FPI**; **original sin** (*borrowing in foreign currency*); **hedging** and the **forward premium**. **External account:** **forex reserves** (*import-cover metric*), **current-account deficit (CAD)**, **balance of payments (BoP)**; the rupee as a **managed float**. **Risk:** currency mismatch and **contingent liabilities** on the central-bank balance sheet. **Principle:** use inflows to **build buffers**, not to peg the exchange rate.

THE DEBATE

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Argument for the measure: In a genuine external-financing squeeze, FCNR(B) incentives are a fast, proven tool to restore confidence and stabilise the rupee, as earlier swap windows demonstrated.

Argument on the risk: The inflows are debt-creating, reversible and shift currency risk to the central bank, so leaning on them to defend the rupee can mask underlying vulnerability rather than cure it.

The balanced verdict: Both are right. The tool has a place in a crisis, but its use must be disciplined: debate the scale openly, account for the contingent cost, and direct inflows to reserves rather than to a defended exchange rate.

HOW TO THINK ABOUT THIS (TRANSFERABLE SKILL)

*A weak answer celebrates an inflow as an unambiguous good. The strong answer traces the **incidence of risk**: a foreign-currency liability does not remove exchange-rate risk, it relocates it, often onto the public balance sheet. The move is from “did money come in?” to “who carries the downside, and what is the money used for?” The same risk-incidence lens applies to guarantees, subsidies and any contingent public commitment.*

DIAGRAM-IN-WORDS

External stress -> RBI bears hedging cost + lifts rate caps -> FCNR(B) deposits attractive -> dollar inflows. But foreign-currency liability -> exchange-rate risk migrates to RBI -> contingent cost if rupee falls. The wrong use: inflows -> defend rupee level -> masks weakness. The right use: inflows -> build forex reserves -> durable buffer. The structural fix: reforms -> more FDI (non-debt) -> resilient external account.

THE WAY FORWARD

- ① **Debate the scale and timing transparently**, so the measure is sized to need, not to optics.
- ② **Account honestly for the contingent hedging cost** on the central-bank balance sheet.
- ③ **Use inflows to build reserves** rather than to defend a particular rupee level.
- ④ **Prefer durable, non-debt inflows** by improving the investment climate for FDI.
- ⑤ **Monitor reversibility and external debt** so debt-creating flows do not build hidden fragility.

THE TAKEAWAY BOX

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“Foreign-currency deposit incentives can attract inflows but transfer risk to the central bank.” Critically examine the use of such measures for external-sector management. (250 words)

“A foreign-currency inflow does not erase exchange-rate risk; it relocates it. Used to build buffers it adds resilience, used to mask vulnerability it merely defers the reckoning.”

FCNR(B), NRE, NRO accounts · FCNR(B) swap window · debt vs non-debt-creating flows · FDI vs FPI · forex reserves and import cover · current-account deficit · balance of payments · managed float · contingent liability.

Should a central bank absorb private currency risk to stabilise the rupee, and how transparent must it be about the contingent cost to the public?

Connects to GS3 PYQs on the external sector, capital flows and the rupee; a probable question is the build-reserves-versus-mask-vulnerability framing above.

the daily edition’s external-sector and rupee articles; static GS3 on balance of payments, forex reserves and capital-account management.

Sources: *Business Standard* (<https://www.business-standard.com>), *Reserve Bank of India* (<https://www.rbi.org.in>), *PIB* (<https://pib.gov.in>)

Source: **Building Buffers: Forex Inflows Should Be Used to Build Up Reserves** — [Ujyari.com](https://ujyari.com) | Free UPSC & State PCS Editorial Analysis

KEY ARGUMENTS AT A GLANCE

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The RBI's incentives for FCNR(B) deposits, bearing hedging costs and lifting interest-rate caps, may attract foreign-currency inflows but shift exchange-rate risk to the central bank; policymakers should debate their scale carefully and use any forex inflows to build up reserves rather than to mask underlying external vulnerabilities.

 **SUPPORTING**

- Bearing hedging costs and relaxing rate caps makes FCNR(B) deposits attractive, drawing in dollar inflows during external stress.
- Because the liability is in foreign currency, the exchange-rate risk migrates to the RBI or the system, a contingent cost if the rupee weakens.
- Such inflows can be debt-creating and reversible, so relying on them to defend the rupee can mask rather than fix external weakness.

 **COUNTER**

Proponents argue that in a genuine external-financing squeeze, FCNR(B) incentives are a fast, proven tool to shore up confidence and the rupee, as earlier swap windows demonstrated.

 **WAY FORWARD**

Debate the scale and timing transparently, prefer using inflows to build reserves rather than to defend a rupee level, account honestly for the contingent hedging cost, and pair the measure with structural steps to lift durable non-debt inflows like FDI.


MAINS ANSWER FRAMEWORK

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QUESTION

"Foreign-currency deposit incentives can attract inflows but transfer risk to the central bank." Critically examine the use of such measures for external-sector management. (250 words)

INTRODUCTION

When the external account tightens, the temptation is to reach for inflows that arrive quickly. The RBI's incentives for FCNR(B) deposits do exactly that, but the speed comes with a question: who carries the currency risk, and what are the inflows for?

BODY

FCNR(B), the foreign-currency non-resident bank deposit, lets non-resident Indians park dollars and other hard currencies with Indian banks without converting to rupees. By bearing the hedging cost and lifting interest-rate caps, the RBI makes these deposits more attractive, pulling in foreign currency at a moment of external stress.

The catch is where the risk lands. Because the liability is denominated in foreign currency, the exchange-rate risk does not vanish; it migrates to the central bank or the system.

If the rupee depreciates, the cost of servicing and repaying these deposits rises, turning a near-term inflow into a contingent future liability. These flows are also debt-creating and potentially reversible, unlike durable non-debt inflows such as foreign direct investment.

The danger, then, is using such measures to defend a particular rupee level, which can mask underlying weakness rather than address it. The proponents have a fair point: in a genuine financing squeeze, FCNR(B) incentives are a fast, tested way to restore confidence, as earlier swap windows showed.

But the use matters as much as the tool. The prudent course is to debate the scale and timing openly, account honestly for the contingent hedging cost, and channel any inflows into building up reserves rather than smoothing the exchange rate.

Buffers absorb shocks; a managed rate only postpones them. The deeper fix lies in structural reforms that lift durable, non-debt inflows.

CONCLUSION

FCNR(B) incentives can buy time, but time is not a strategy. Used to build reserves and viewed with clear eyes about who bears the currency risk, they strengthen resilience; used to mask vulnerability, they merely defer it.


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