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EDITORIAL ANALYSIS

Defending the Rupee: The RBI Between Reserves and Room

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THE LIFT LINE

A central bank defending its currency is spending its own ammunition, and every dollar it sells to hold the exchange rate is a dollar and a degree of policy freedom it no longer has for the next shock.

WHY THIS EDITORIAL MATTERS FOR YOUR EXAM

The rupee has slipped to about a one-month low, near 95 to the dollar, pressed by steady importer demand for dollars, capital outflows and a firm dollar globally. The Reserve Bank of India has responded in its familiar way, selling dollars through state-run banks to slow the slide and taking steps to attract inflows. Every such intervention, however, is a trade-off: defending the currency draws down foreign-exchange reserves and can tighten domestic liquidity, narrowing the room the central bank has for monetary policy (https://ujiyari.com/terms/monetary-policy/). For your exam this is a compact lesson in exchange-rate management, the managed float, and external-sector vulnerability.

GS Paper 3: issues relating to the external sector, the balance of payments and exchange-rate management; the role of the Reserve Bank of India and monetary policy.

For **Prelims**, hold the specifics: India follows a managed float, in which the exchange rate is market-determined but the RBI intervenes to curb excessive volatility (https://ujiyari.com/vocab/volatility/) rather than target a level; foreign-exchange reserves are the buffer used for such intervention; RBI intervention through dollar sales withdraws rupee liquidity from the system, while a weaker rupee raises the cost of imports and can add to imported inflation. For **Mains**, argue that the choice between defending the currency and preserving reserves and policy space is a genuine trade-off with no cost-free option.

BACKGROUND AND CONTEXT

The rupee has come under pressure from a combination of forces. On the demand side, importers, including oil-marketing companies, buy dollars to pay for imports, and when that demand is steady it pushes the rupee down. On the capital side, outflows and a strong dollar globally, reinforced by expectations about interest rates abroad, draw funds away from emerging markets like India. Together these have carried the rupee to about a one-month low, near the 95 mark against the dollar.

The RBI's response follows the logic of the managed float. Rather than let the currency fall in a disorderly rush, it sells dollars from its reserves, often through state-run banks, to smooth the depreciation and steady sentiment, while also acting to encourage dollar inflows. This is standard central-bank practice, but it is not free. Selling dollars depletes the reserve buffer that exists precisely to absorb external shocks, and it simultaneously withdraws rupee liquidity from the banking system, which can tighten domestic monetary conditions at a time the central bank might prefer them loose. The rupee's level, in other words, cannot be defended without cost to the reserves and to the freedom of monetary policy.

THE CORE ARGUMENT / ISSUE

The managed float is a balance, not a peg

India does not fix its exchange rate, nor does it let it float entirely free. The RBI intervenes to curb excessive volatility, not to defend a particular number. The recent action is therefore about smoothing a sharp move and steadying expectations, not about drawing a line in the sand. Understanding this distinction is essential: the goal is orderly adjustment, not a fixed rupee.

Every defence has a cost

Intervention is a transaction with consequences. Selling dollars runs down the reserves that cushion the economy against future shocks, and it drains rupee liquidity, which can work against the domestic monetary stance. Conversely, allowing the rupee to fall unchecked raises import costs, feeds imported inflation and can unsettle sentiment. There is no option that avoids all costs; the central bank is choosing which costs to bear.

POLICY CHOICE	IMMEDIATE BENEFIT	THE COST INCURRED
Sell dollars to defend the rupee	Slows depreciation, steadies sentiment	Depletes reserves; drains rupee liquidity
Let the rupee depreciate	Preserves reserves and policy space	Costlier imports, imported inflation
Attract dollar inflows	Supports the currency structurally	Depends on external conditions, not instant
Raise domestic rates	Defends currency, curbs outflows	Tightens credit, can slow growth

External-sector vulnerability is the deeper issue

The episode is a reminder that India remains exposed to external swings, in global dollar strength, oil prices and capital flows. A comfortable reserve buffer and a stable external balance are what give the central bank room to manage volatility without exhausting its options. The long-run answer lies less in intervention and more in strengthening the external sector, exports, stable inflows and a manageable current-account position, so that pressure on the rupee is less frequent and less severe.

HOW TO THINK ABOUT THIS (ANALYTICAL FRAME)

Frame currency management as a trade-off between competing goods, not a technical fix with a single right answer. The transferable rule: a central bank defending an exchange rate is spending finite resources, reserves and policy space, so the relevant question is never simply whether to intervene but how much cost to absorb and for how long. Exchange-rate stability, reserve adequacy and monetary-policy freedom cannot all be maximised at once. Judge the RBI not by whether the rupee holds a particular level but by whether it manages volatility while conserving the buffers that matter in a crisis.

THE DIAGRAM IN WORDS

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Importer dollar demand + capital outflows + strong global dollar -> rupee falls to ~1-month low near 95 -> RBI sells dollars via state banks + seeks inflows -> depreciation slowed BUT reserves drawn down + rupee liquidity tightened -> trade-off: currency defence vs reserves and policy space -> deeper fix: strengthen external sector (exports, stable inflows) -> less pressure, more room
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WAY FORWARD

1. **Intervene to smooth, not to fix.** Use dollar sales to curb disorderly volatility rather than to defend a specific level, conserving reserves for genuine shocks.
2. **Guard reserve adequacy.** Weigh each intervention against the buffer it consumes, keeping reserves strong enough to reassure markets and absorb future external stress.
3. **Attract durable inflows.** Prefer measures that draw stable, longer-term capital and export earnings over repeated spot intervention, addressing the pressure at its source.
4. **Strengthen the external sector.** Build export competitiveness and a manageable current-account position so that the rupee faces less frequent and less severe pressure, reducing the need to choose between defence and policy room.

PYQ LINKAGE AND PRACTICE

UPSC has asked about exchange-rate management, the role of foreign-exchange reserves, and the challenges of the external sector. This editorial connects those themes to the rupee's slide and the RBI's response in 2026.

Practice question: "Defending the rupee and preserving reserves and monetary-policy space are competing objectives." Examine the trade-offs in the Reserve Bank of India's exchange-rate management. (250 words, 15 marks)

Sources: Mint (https://www.livemint.com/), Business Standard (https://www.business-standard.com/markets/news/rupee-hits-three-week-low-as-omc-dollar-demand-ndf-maturities-weigh-126070601172_1.html)

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