THEIR VIEW

The rupee has stabilized but key vulnerabilities remain

SAUMITRA BHADURI

is professor, Madras School of Economics

The rupee's recent stability has brought relief, having earlier hit a record low. The Reserve Bank of India (RBI) deserves credit for taking decisive action. It reportedly sold about $7 billion in one of its largest foreign-exchange interventions in recent months to prevent disorderly depreciation. It supplemented this intervention with a special foreign currency non-resident (FCNR-B) deposit scheme that included a concessional dollar-rupee swap facility announced on 8 June.

As of 21 August, banks had mobilized more than $65 billion through this window. Total foreign-currency inflows via the new facility, including external commercial borrowings and the overseas foreign-currency class of loans, reached nearly $73 billion. At a time when the rupee was under pressure, this has been read as a vote of confidence. Meanwhile, India's foreign exchange reserves have risen sharply to $717 billion, providing RBI with a substantially larger buffer to intervene in the currency market and contain excessive volatility. Nonetheless, exchange rate stability should not be mistaken for exchange rate strength.

The FCNR-B scheme is an effective crisis-management tool, but it is not a permanent solution. Its large inflows led RBI to announce the scheme's premature closure by end-August, even as competition among banks to attract these deposits intensified, pushing up the scheme's funding costs. Letting the scheme continue would have become progressively more expensive and may have distorted bank funding structures.

The underlying vulnerabilities remain. The *first* is geopolitical. Any prolonged disruption around the Strait of Hormuz would push up crude oil prices, widening India's import bill and sharply increasing demand for dollars. Given India's dependence on imported energy, the rupee continues to carry a significant oil risk.

The *second* vulnerability is the nature of capital inflows. Foreign portfolio investment has recovered in recent weeks, but such capital is inherently volatile. Unlike foreign direct investment (FDI), it responds quickly to changes in global risk appetite rather than domestic fundamentals. Foreign portfolio investors had pulled roughly $28 billion out of Indian equities despite bringing in a net $2.1 billion in July. But that still represents a modest reversal relative to the vast exodus seen through March-June. So, it is too early to view this as a return of foreign investors.

Ironically, the improvement in portfolio flows may owe less to developments in India than to those abroad. For almost two years, global investors poured enormous sums into artificial intelligence (AI)-related stocks, particularly in the US. Investors are now assessing whether that extraordinary AI investment will generate equally extraordinary earnings. As enthusiasm moderates, global capital is searching for markets where valuations are more closely aligned with economic fundamentals. India, with one of the fastest-growing large economies and relatively resilient corporate earnings, has therefore become attractive again.

> **The Reserve Bank of India's special steps offer relief but don't address risks at the structural level**

But this window may prove temporary. A much larger force is quietly emerging in Washington. Federal Reserve chair Kevin Warsh has constituted a Balance Sheet Policy Task Force co-led by former RBI governor Raghuram Rajan to re-assess the future of quantitative easing (QE) as a policy. The implications extend beyond the US. For nearly 15 years, QE flooded global markets with dollar liquidity, much of which flowed into emerging market debt and equity. India was among the beneficiaries of this exceptionally cheap capital.

If the Fed goes for an aggressive balance sheet reduction, global liquidity will tighten. Higher US Treasury yields would raise the opportunity cost of investing in emerging markets while increasing the cost of external borrowing for Indian firms. The US Treasury's decision to double its buybacks of longer-dated securities could ease global credit costs to an extent. However, if the bond market resists yield-curve management and US yields stay elevated, dollar assets could stay attractive enough to keep pressure on capital flows to emerging markets like India while keeping their external debt costs high as well.

A recent International Monetary Fund (IMF) Working Paper, 'The Changing Landscape of Financial Integration in Asia-Pacific,' offers an insight: despite accounting for roughly one-third of global trade and output, Asia holds only about one-fifth of global external financial assets, with an even smaller share of global portfolio investment. Emerging Asia is under-integrated financially. The IMF also draws a crucial distinction between trade and financial integration. Greater trade supports FDI, but has little effect on portfolio flows or cross-border bank lending. That matters because portfolio flows are volatile, driven by interest rates, liquidity and investor sentiment. FDI is more stable as it reflects the confidence in an economy's productive capacity.

For India, deeper financial integration should mean more than luring short-term capital. We need more FDI, deeper domestic financial markets, stronger institutions and greater resilience to external shocks. Done well, integration can lower the cost of capital, bring technology and improve risk sharing. But openness also exposes India to global financial cycles, making sound macro management essential. A currency is ultimately sustained not by the central bank's dollar sales but by confidence in the economy.