

GENERAL STUDIES II

Rupee Depreciation 2026: Complete UPSC Economy Notes

Faculty/Author: Faculty Editorial Board

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Should India allow the rupee to depreciate freely, or should the Reserve Bank of India intervene to prevent a sharp fall? This question has become increasingly important in 2026 amid geopolitical tensions, elevated crude oil prices, foreign portfolio outflows and volatility in global currency markets. While depreciation can improve export competitiveness and help the economy adjust to external shocks, an uncontrolled decline can increase imported inflation, foreign debt servicing costs and financial instability. This article examines both sides of the debate, the RBI's managed floating exchange rate system, foreign exchange interventions, the impossible trinity and a balanced policy framework for India. The debate gained renewed attention on 22 October 2026 when former RBI Deputy Governor Michael Debabrata Patra cautioned that relying on the exchange rate alone to absorb external shocks could expose the economy to overshooting and financial instability.

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UPSC CURRENT AFFAIRS | 23 OCTOBER 2026 | INDIAN ECONOMY

A comprehensive examination of the rupee's decline, its benefits and risks, the RBI's exchange rate management strategy and the policy choices facing India.

Civil Service Gurukul Editorial Team | 23 October 2026

GS Paper III

Indian Economy

External Sector

RBI

UPSC Prelims 2027

Should the Indian rupee be allowed to find its market-determined value, even when it depreciates against the US dollar? The answer requires a balance between exchange rate flexibility and macroeconomic stability. A weaker rupee can support some exporters and help absorb external shocks, but it can also raise the cost of essential imports, worsen inflation and increase foreign currency liabilities. India therefore faces a policy choice between excessive defence of a particular exchange rate and completely unmanaged currency

volatility.

1. Why Is Rupee Depreciation in the News?

The Indian rupee faced substantial depreciation pressure during 2026 amid geopolitical tensions in West Asia, higher energy import costs, foreign portfolio outflows and global financial uncertainty.

In May 2026, the rupee briefly approached ₹87 per US dollar. Subsequent intervention and regulatory measures contributed to periods of recovery.

In October 2026, the policy debate intensified over whether the rupee should operate primarily as an automatic shock absorber or whether the RBI should intervene more actively to prevent destabilising currency movements.

Core UPSC Question: Should India prioritise a flexible exchange rate that adjusts to global shocks, or should it intervene to protect domestic prices, financial stability and market confidence?

2. What Is Currency Depreciation?

Currency depreciation means a decline in the external value of a currency under a market-determined exchange rate system.

For example, suppose the exchange rate changes from ₹85 per US dollar to ₹95 per US dollar. More rupees are now required to purchase one dollar, meaning the rupee has weakened.

Illustrative Exchange Rate Calculation

Initial rate: ₹85 per US dollar

New rate: ₹95 per US dollar

Increase in rupee cost of one dollar: $(95 - 85) \div 85 \times 100 = \text{approximately } 11.76\%$.

This is the percentage increase in the rupee price of a dollar. Measured in dollar terms, the rupee's value falls by approximately 10.53%.

3. Depreciation vs Devaluation vs Appreciation

Concept	Meaning	Example
Depreciation	Market-driven fall in currency value.	₹85/\$ becomes ₹95/\$.
Appreciation	Market-driven rise in currency value.	₹95/\$ becomes ₹85/\$.
Devaluation	Official downward adjustment of a fixed or pegged currency value.	Government or monetary authority changes the official parity.

Concept	Meaning	Example
Revaluation	Official upward adjustment of a fixed or pegged currency value.	Official parity is increased.

4. Why Does the Indian Rupee Depreciate?

A. Rising Crude Oil Prices

India imports substantial quantities of crude oil. Higher international oil prices increase the demand for foreign currency to pay for imports. This can place downward pressure on the rupee.

B. Foreign Portfolio Outflows

When foreign investors sell Indian financial assets and repatriate proceeds, demand for foreign currency can increase.

C. Strong US Dollar

Higher US interest rates, global uncertainty and demand for dollar assets can strengthen the dollar against emerging market currencies.

D. Current Account Deficit

A current account deficit indicates that payments to the rest of the world exceed current receipts. Its financing conditions can affect exchange rate pressure.

E. Geopolitical Uncertainty

War, sanctions, shipping disruptions and energy supply shocks can increase global risk aversion and volatility.

F. Inflation and Productivity Differences

Over longer periods, relative inflation, productivity, trade competitiveness and capital flows influence exchange rates.

5. How Does Rupee Depreciation Affect the Economy?

Potential Benefits

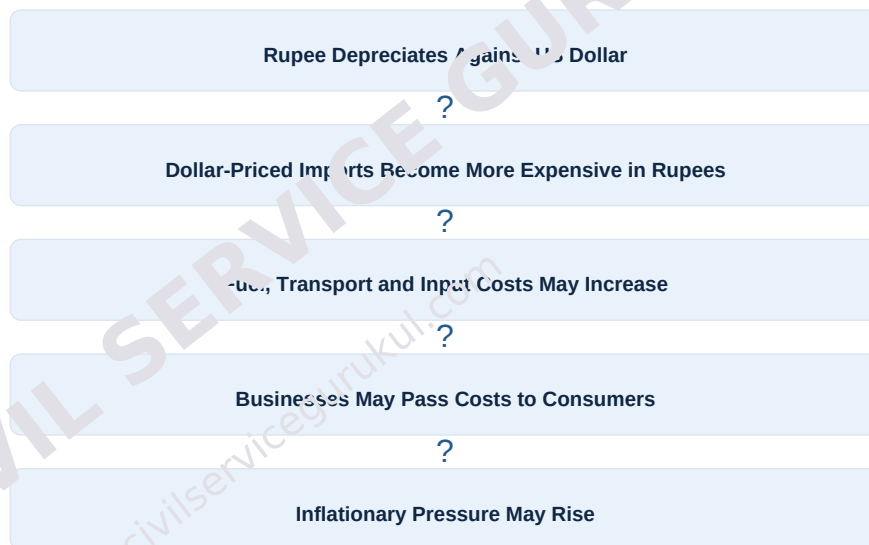
- Improved price competitiveness for some exporters.
- Higher rupee value of foreign currency remittances.
- Support for certain tourism and tradable sectors.
- Adjustment to external economic imbalances.

Potential Costs

- More expensive crude oil and other imports.
- Imported inflation.
- Higher servicing costs on unhedged foreign currency debt.
- Potential loss of market confidence during sharp declines.

6. Why Can a Weak Rupee Increase Inflation?

Many essential commodities are priced internationally in US dollars. A weaker rupee raises their cost in domestic currency.



The extent of inflation depends on global commodity prices, tax policy, subsidies, pricing decisions and how much of the exchange rate change businesses pass through to consumers.

7. Does Depreciation Always Help Exporters?

Not necessarily. A weaker rupee can make Indian goods cheaper in foreign currency terms if exporters maintain their rupee prices.

However, export competitiveness also depends on:

- Demand in destination markets.
- Imported raw materials and components.
- Labour productivity and logistics costs.
- Currency movements of competing exporters.
- Contract currency and hedging arrangements.

UPSC Insight: Nominal depreciation does not guarantee improved export performance. The real effective exchange rate, production structure and external demand matter.

8. India's Exchange Rate System

India follows a market-determined exchange rate regime with RBI intervention to address excessive or disruptive volatility.

The RBI does not formally commit to defending a fixed rupee-dollar exchange rate or a specific band.

This arrangement is commonly described as a managed float.

9. How Does RBI Intervene in Forex Markets?

Instrument	How It Works	Purpose
Spot Dollar Sales	RBI sells foreign currency and receives rupees.	Can ease excessive dollar shortages.
Spot Dollar Purchases	RBI buys foreign currency and supplies rupees.	Can moderate excessive appreciation pressure.
Forward Transactions	RBI enters contracts for future foreign currency settlement.	Helps manage forward-market conditions.
Currency Swaps	Foreign currencies are exchanged with an agreement to reverse the transaction.	Can manage foreign currency and rupee liquidity.
Regulatory Measures	Rules affecting market positions, risk management or transaction practices.	Can address market dysfunction, subject to costs and trade-offs.

10. Why Not Defend a Fixed Exchange Rate?

Defending a particular rupee-dollar level can require substantial foreign exchange intervention.

If the underlying pressure is persistent, the RBI may face rising costs, reserve depletion and reduced flexibility.

A rigid exchange rate may also delay necessary adjustment to changes in trade and financial conditions.

11. Why Not Allow Completely Unmanaged Depreciation?

Financial markets do not always adjust smoothly to shocks. Exchange rates can overshoot levels justified by economic fundamentals.

Sharp movements can generate:

- Self-reinforcing expectations of further depreciation.
- Sudden increases in hedging costs.
- Stress for importers and foreign currency borrowers.
- Volatility in financial markets.

- Imported inflation and uncertainty for businesses.

The policy challenge is therefore not simply choosing between a fixed exchange rate and a completely unmanaged float.

12. RBI Intervention: Benefits and Trade-Offs

Possible Benefit	Associated Trade-Off
Reduces disorderly exchange rate movements.	Can consume foreign exchange reserves.
Improves short-term market confidence.	May encourage expectations of continued support.
Protects vulnerable importers from sudden volatility.	May delay necessary exchange rate adjustment.
Limits immediate financial stability risks.	May affect capital liquidity and require offsetting operations.

13. What Is the Impossible Trinity?

The impossible trinity, also called the monetary policy trilemma, states that a country cannot simultaneously achieve all three of the following:

1. A fixed exchange rate.
2. Completely free capital mobility
3. Independent monetary policy

A country must sacrifice at least one of these objectives in its fully unrestricted form.

India's exchange rate flexibility and its regulatory framework for cross-border capital flows help preserve room for domestic monetary policy.

14. NEER and REER: Important UPSC Concepts

Nominal Effective Exchange Rate (NEER)

NEER is a weighted index of a currency's exchange rates against a basket of trading-partner currencies.

Real Effective Exchange Rate (REER)

REER adjusts the nominal effective exchange rate for relative price or cost movements.

REER is useful for assessing changes in international price competitiveness, although it is not a complete measure of export performance.

Prelims Reminder: A rupee-dollar movement and a movement in the rupee's effective exchange rate are not necessarily identical.

15. Foreign Exchange Reserves: Why Do They Matter?

Foreign exchange reserves provide an important buffer against external financial shocks.

India's reserve assets include foreign currency assets, gold, Special Drawing Rights and its reserve position in the IMF.

Major Functions

- Support external payment confidence.
- Provide foreign currency liquidity during stress.
- Help manage disorderly currency movements.
- Strengthen resilience against sudden capital outflows.

Reserves are valuable shock absorbers, but using them indefinitely to maintain an unsustainable exchange rate would involve substantial costs.

16. Impact on Different Sections of the Economy

Stakeholder	Possible Impact of Depreciation
Exporters	Potential gains in competitiveness and rupee receipts, depending on imported inputs and contracts.
Importers	Higher rupee costs for foreign currency purchases.
Students Studying Abroad	Higher rupee cost of foreign tuition and living expenses.
NRI's Sending Remittances	Potentially more rupees received per unit of foreign currency.
Foreign Currency Borrowers	Higher domestic currency burden on unhedged liabilities.
Consumers	Possible increases in prices of imported and import-intensive products.

17. India's Policy Options

1. Allow Orderly Market Adjustment

Exchange rates should reflect underlying demand, supply and macroeconomic fundamentals.

2. Intervene Against Excessive Volatility

RBI intervention should focus on disorderly market conditions rather than permanently defending an arbitrary exchange rate.

3. Preserve Reserve Adequacy

Foreign exchange reserves should remain available to respond to future external shocks.

4. Encourage Prudent Currency Hedging

Businesses with foreign currency exposures should manage risk through appropriate hedging, while considering the costs involved.

5. Reduce Structural Import Vulnerabilities

Energy diversification, greater efficiency and competitive domestic production can reduce exposure to external price shocks.

6. Strengthen Export Competitiveness

Infrastructure, logistics, innovation and productivity improvements provide more durable export advantages than currency depreciation alone.

7. Maintain Credible Communication

Clear central bank communication can reduce uncertainty and destabilising speculation.

18. Should the Rupee Be Left to Depreciate? A Balanced Assessment

A completely rigid exchange rate is generally undesirable because it can prevent necessary adjustment to external shocks.

However, an entirely passive approach may be risky when financial markets become disorderly and currency movements threaten inflation or financial stability.

The appropriate approach for India is a flexible, market-determined exchange rate supported by proportionate RBI intervention against excessive volatility.

This balances market signals, foreign exchange reserve management and the central bank's responsibility for financial stability.

19. UPSC Prelims Quick Revision

- Depreciation occurs under a market-determined exchange rate.
- Devaluation is an official reduction in a fixed or pegged currency value.
- India follows a market-determined exchange rate regime with RBI intervention.
- RBI intervention aims to contain excessive volatility, not formally target a fixed rate.

- A weaker rupee generally increases the rupee cost of dollar-priced imports.
- Depreciation may help exporters but does not guarantee export growth.
- Spot, forward and swap operations can be used in foreign exchange management.
- NEER is a trade-weighted nominal exchange rate index.
- REER adjusts for relative price or cost movements.
- The impossible trinity concerns exchange rate stability, capital mobility and monetary independence.
- Foreign exchange reserves act as buffers against external shocks.

20. Original UPSC Prelims Practice MCQs

Question 1. With reference to currency depreciation, consider the following statements:

1. It can increase the domestic currency cost of imports.
2. It always improves the trade balance immediately.
3. It may increase the servicing burden of unhedged foreign currency debt.

Which statements are correct?

- (a) 1 only
- (b) 1 and 3 only
- (c) 2 and 3 only
- (d) 1, 2 and 3

Answer: (b) 1 and 3 only.

Depreciation raises the domestic currency cost of imports and unhedged foreign debt. It does not necessarily improve the trade balance immediately because import demand, export supply and contractual factors matter.

Question 2. The impossible trinity states that a country cannot simultaneously maintain:

- (a) Low inflation, high growth and full employment
- (b) Fixed exchange rates, unrestricted capital mobility and independent monetary policy
- (c) High exports, low imports and foreign investment
- (d) Fiscal stability, tax revenue and public investment

Answer: (b).

The monetary policy trilemma identifies a fundamental constraint on open-economy macroeconomic policy.

Question 3. With reference to India's foreign exchange management, consider the following statements:

1. The rupee's exchange rate is primarily market-determined.
2. RBI may intervene in spot and forward markets.
3. RBI formally guarantees a fixed rupee-dollar exchange rate.

Which statements are correct?

- (a) 1 and 2 only
- (b) 2 and 3 only
- (c) 1 and 3 only
- (d) 1, 2 and 3

Answer: (a) 1 and 2 only.

India has a market-determined exchange rate system. RBI intervention addresses excessive volatility and does not constitute a formal fixed-dollar peg.

Question 4. Which of the following best describes REER?

- (a) A measure of the government's fiscal deficit
- (b) A bilateral exchange rate against the US dollar
- (c) A weighted exchange rate index, adjusted for relative price or cost changes
- (d) The total value of India's foreign exchange reserves

Answer: (c).

REER measures a currency's effective exchange rate after adjusting for relative prices or costs.

21. UPSC Mains Practice Question

GS Paper III | 15 Marks | 250 Words

"Exchange rate flexibility can absorb external shocks, but excessive depreciation can threaten macroeconomic stability."

Critically examine whether India should allow the rupee to depreciate freely.

Model Answer Framework

Introduction

India follows a market-determined exchange rate system with RBI intervention to contain excessive volatility. Depreciation can facilitate external adjustment, but abrupt movements may destabilise prices and financial markets.

Arguments for Greater Flexibility

- Allows exchange rates to reflect economic fundamentals.
- Can improve price competitiveness of some exports.
- Reduces the need for continuous reserve use.
- Provides a mechanism for absorbing external shocks.

Arguments for Intervention

- India is vulnerable to imported energy inflation.
- Sharp depreciation raises foreign currency debt costs.
- Currency markets may overshoot in periods of panic.
- Sudden movements can disrupt business planning and financial stability.

Way Forward

India should permit orderly exchange rate adjustment while using calibrated intervention to contain disorderly movements. This should be complemented by adequate reserves, credible monetary policy, prudent hedging, energy diversification and stronger export competitiveness.

Conclusion

The goal should not be to defend a particular rupee-dollar number, but to preserve an orderly currency market and macroeconomic stability while allowing fundamental adjustment.

22. Frequently Asked Questions

Should RBI allow the rupee to depreciate?

RBI can allow orderly depreciation driven by fundamentals while intervening against excessive volatility and market dysfunction.

Does a weak rupee benefit India?

It can benefit some exporters and remittance recipients, but it can also raise import costs, inflation and foreign debt obligations.

Why does RBI sell dollars?

Dollar sales can increase foreign currency supply and ease disorderly depreciation pressure.

What is the difference between depreciation and devaluation?

Depreciation is a market-driven currency decline, while devaluation is an official adjustment under a fixed or pegged exchange rate.

What is the impossible trinity?

It is the constraint that prevents a country from simultaneously having a fixed exchange rate, completely free capital movement and independent monetary policy.

Why is this topic important for UPSC?

It connects exchange rate systems, RBI functions, imported inflation, trade competitiveness, balance of payments and macroeconomic policy.

23. Conclusion

The debate over rupee depreciation is fundamentally about balancing economic adjustment and financial stability.

A flexible exchange rate can absorb global shocks, but severe and disorderly depreciation can increase inflation, financial risk and uncertainty.

India's policy should therefore combine market-based exchange rate determination with prudent, transparent and proportionate RBI intervention.

For UPSC aspirants, the issue offers an important example of how monetary policy, international trade, financial markets and economic governance interact.

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Editorial Note: This original educational article is prepared for UPSC examination purposes using publicly available economic information as of 23 October 2026. Exchange rates, reserve levels, policy measures and market conditions may change. Illustrative calculations are not live exchange rate quotations.

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