

# Rupee Under Stress: Understanding Forex Volatility in the Current Context

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Amid the ongoing West Asia crisis, India's foreign exchange markets have experienced heightened volatility, driven largely by rising energy prices and moderating capital flows. The RBI has responded proactively, taking measures to curb speculative activity and ensure orderly movements in the exchange rate. This report takes a deeper look at the present episode of volatility and the key reasons behind the rupee weakness. It looks further into past episodes of sharp rupee depreciation and the policy measures adopted to contain the currency weakening. The report also investigates the relatively better macro preparedness of the economy to manage the current episode of foreign exchange volatility than in previous instances.

## The current episode of volatility

Since the onset of the West Asia conflict, most currencies have depreciated against the US dollar, with a few exceptions such as the BRL, CNY, and GBP (Exhibit 1). Depreciation is particularly large for currencies like the Philippine Peso, Indian Rupee, South African Rand, Thai Baht, Korean Won, and Indonesian Rupiah, as these economies are highly dependent on West Asia for energy imports. Given exposure to the West Asia crisis, Asian currencies have taken a bigger hit compared to their global peers.

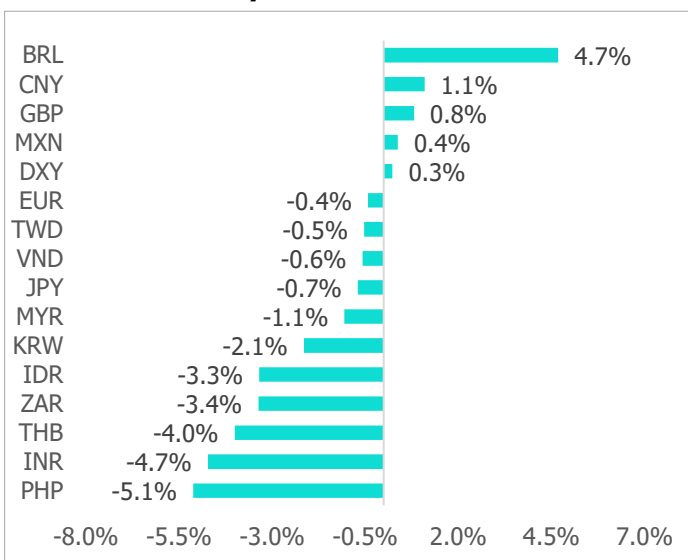
While such depreciation is largely expected amid rising energy prices and capital flows shifting toward safe-haven assets like the US dollar, the weakness in the Indian rupee has been a more persistent concern over the past year, even before the conflict. Weak

capital flows in the last year have been a major factor behind the weakening pressure on the rupee. The recent escalation in tensions in West Asia has only intensified these downward pressures. The persistent weakness in the rupee is evident from its ~11% depreciation over the past year, of which 4.7% occurred since the war started.

## RBI has been proactive in limiting volatility

The downside since the war has been limited by the RBI's forex intervention and other measures, such as capping net open positions of banks in rupee. The RBI has actively intervened in both the spot and forward markets. RBI's intervention is evident from the fact that India's forex reserves have declined by approximately USD 33 billion (as of 1st May) since the onset of the conflict. India still has large forex reserves of around USD 690 bn. However, adjusting for gold holdings and SDRs, it falls to about USD 560 billion; further adjusting for the RBI's forward position, it falls to USD 460 billion. This infact is not particularly concerning, as nearly USD 115 billion of the RBI's gold reserves is liquid and can be deployed to cushion against external shocks. While still at comfortable levels, the overall fall in forex reserves suggests that the RBI is likely to act prudently to preserve adequate reserve buffers, although it retains some capacity for spot market intervention going ahead. On the forward markets, the RBI's net short forward position had already expanded to USD 103 billion as of end-March, according to official data. It may

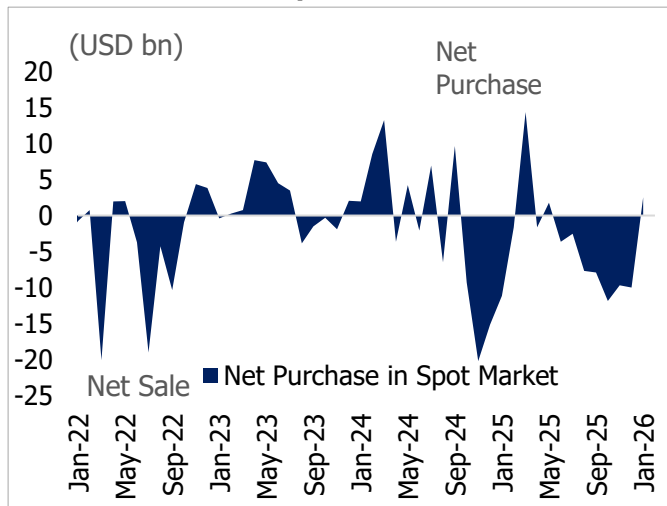
Exhibit 1: Currency Movements Since Feb End



Source: Havers, CareEdge. Changes compared to 26<sup>th</sup> February. Negative Value denotes depreciation in currency.

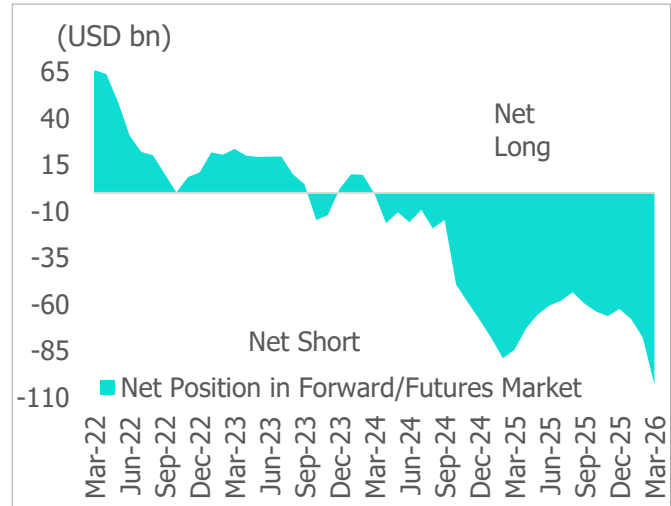
have increased further by end-April. Net short in the RBI’s forward book has earlier reached a peak of USD 89 billion in February 2025. The net short position in the forward book has now exceeded its previous peak. In recent months, the RBI has increasingly relied on longer-tenor contracts for intervention in the forward market. Reflecting this shift, the share of contracts with maturities exceeding one year rose sharply to around 50% of the RBI’s forward book as of end-March, compared with nil in January 2025.

**Exhibit 2: RBI’s Net Spot Intervention**



Source: CEIC, CareEdge.

**Exhibit 3: RBI’s Forward Book**



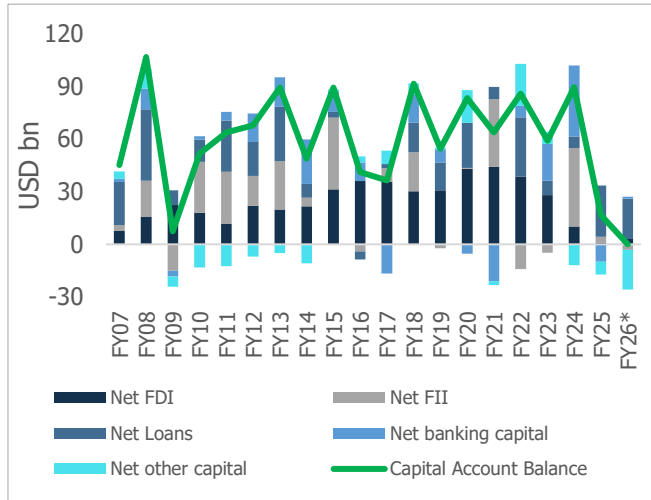
**Current Account Remains Manageable Despite Widening**

India is dependent on imports to meet about 88% of its total oil requirement and 51% of its gas requirement. Apart from the high crude oil's impact, there are two additional risks stemming from the exposure of exports and remittances to West Asian economies. West Asia accounts for 15% of India’s goods exports, and nearly 38% of India’s total inward remittances come from this region. We expect India’s CAD to widen to 2.1% of GDP (vs earlier projection of 1%) in FY27, assuming global crude oil prices average at USD 90/bbl. However, the CAD still remains comfortable compared to some of the previous stress periods. Robust growth in services exports has been a supporting factor for India’s current account balance in the last few years.

**Weak Capital Flows Remain Concerning**

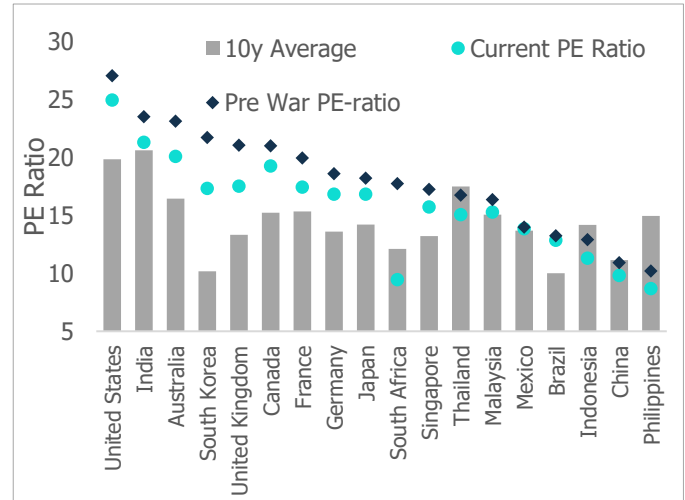
India’s capital flows have come under pressure amid volatile FPI flows and moderating net FDI (Exhibit 4). India’s FPI outflows intensified following the West Asia conflict, reaching USD 13.6 billion in March, the highest monthly outflow in the last six years. With this, FPI outflows for FY26 were recorded at USD 16.6 billion, as against inflows of USD 2.7 billion in FY25. Looking ahead, persistent global uncertainties, elevated crude oil prices, and rupee weakness are likely to keep investor sentiment cautious, weighing on the FPI flows. Furthermore, net FDI inflows (Gross inflows – Repatriation – FDI by India) have consistently been negative over the past six months. Higher repatriations and FDI outflows have been weighing on India’s net FDI inflows. During 11M FY26, India’s net FDI inflows were modest at USD 6.3 billion following a poor USD 1 billion in FY25. Even though there was an improvement compared to last year, it still remains below the long-term average of USD 31 billion (FY15-FY24). Global uncertainties have cast a shadow on capital flows into India. Moreover, India has also lagged in attracting a meaningful share of global AI investments, which has weighed on foreign capital inflows. High valuation in the Indian equity market prior to the West Asia conflict further dented FII sentiments (Exhibit 5). However, the fall in valuations amidst the recent correction in the equity market, along with easing trade uncertainties, could provide some support to FII inflows into the equity market in the future.

**Exhibit 4: India’s Capital Account Balance**



Source: CEIC, CareEdge. Note – Data for FY26 is for 9M FY26

**Exhibit 5: Equity Market Valuations**

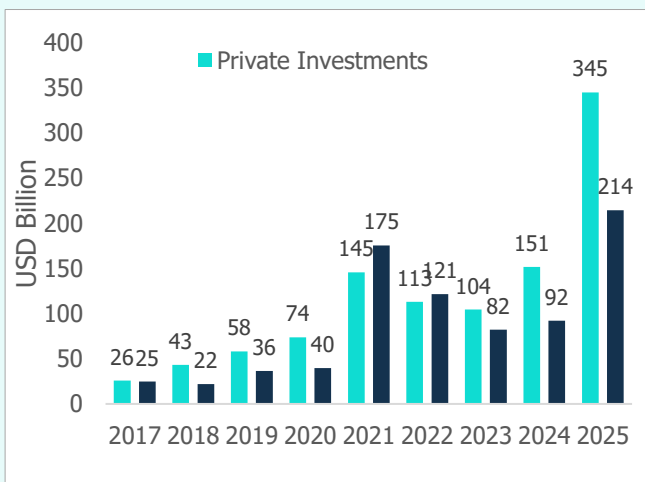


Source: WorldPERatio, CareEdge. \*Based on Broad stock market ETF valuations. The pre-war period is Feb 2026.

**Box 1: Lack of an AI story is likely a Factor Behind Weak FPI Flows**

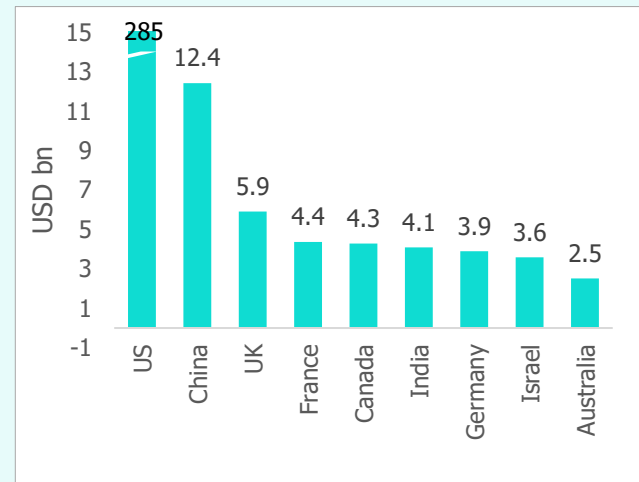
Globally, Private investment in AI surged to USD 345 billion in 2025 (up from USD 152 billion in 2024), while M&A activity rose to USD 214 billion (from USD 92 billion) (Exhibit 6). A significant portion of these investments has been concentrated in the US (USD 285 billion) and China (USD 12.4 billion), whereas India attracted only about USD 4.1 billion in 2025. India’s private AI investment has largely been skewed toward data centres, while it lags in frontier model development and semiconductor innovation. At a time when global funding for AI is accelerating, the absence of “pure-play” AI stocks—particularly listed firms focused on model development and chip manufacturing—has limited foreign investors’ interest. Additionally, concerns that traditional IT services companies, which form a substantial part of India’s equity market, could face disruption from AI are further weighing on market sentiment and foreign investment flows.

**Exhibit 6: Global Corporate Investment in AI**



Source: Stanford AI Index Report 2026

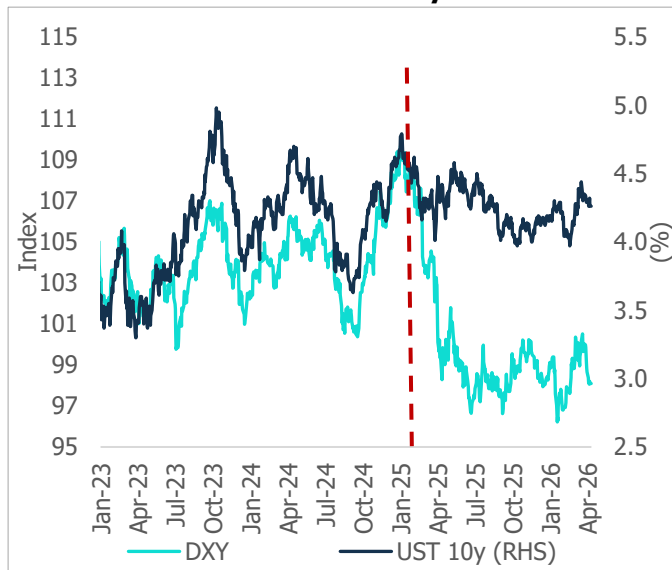
**Exhibit 7: Private Investments in AI – By Countries**



### Rupee Has Depreciated despite Dollar Weakness

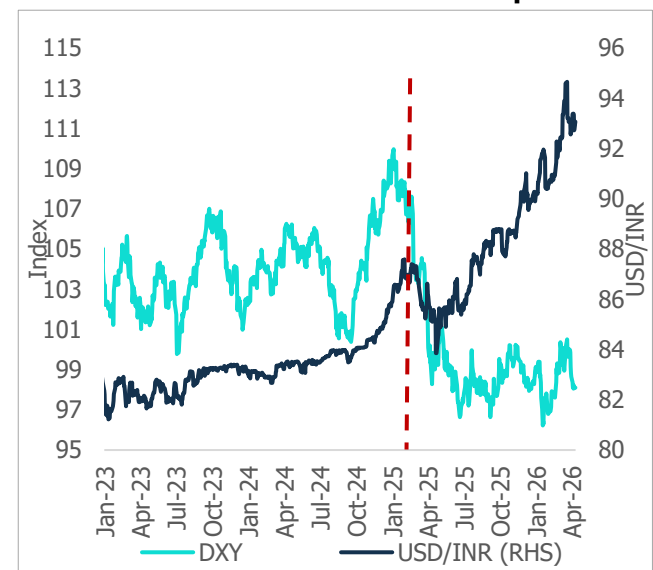
The dollar has strengthened by 0.3% since the West Asia crisis. However, the longer-term trend shows weakness. The US dollar has weakened by 10% since the beginning of 2025 due to fiscal worries and concerns over de-dollarisation (Exhibit 8). Since early 2025, we have seen a breakdown in the relationship between the dollar index and the US bond yields. Despite 10-year US bond yields remaining higher, the USD has continued to weaken. However, a weaker dollar has not translated into gains for the Indian rupee. Despite the weakness in the US dollar, the Indian rupee continued to depreciate over the past year (Exhibit 9). Rupee depreciation against the dollar during dollar weakness suggests that the rupee has depreciated far more against currencies such as the Japanese Yen, the British Pound, and the Euro.

**Exhibit 8: Dollar Index and US yields**



Source: CEIC, CareEdge.

**Exhibit 9: Dollar Index and Indian Rupee**



Source: CEIC, CareEdge.

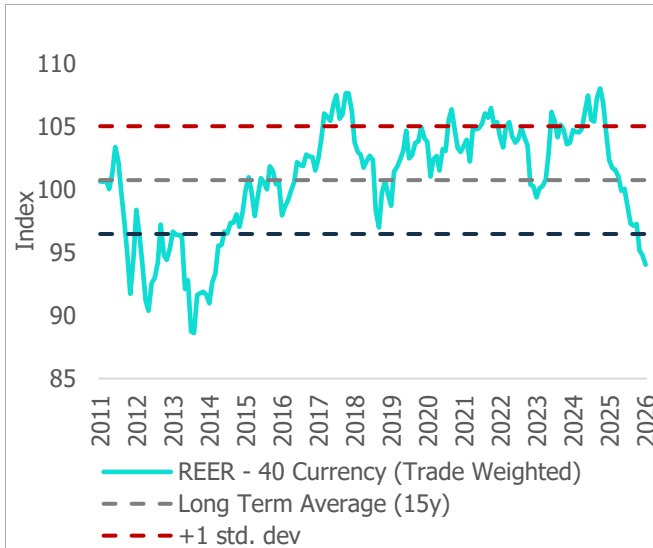
### Despite Weakness, Some Fundamentals Remain Supportive

In the wake of the West Asia crisis, interbank USD forward premia have risen sharply, reflecting market expectations of further weakness in the rupee. However, the rupee appears undervalued when assessed against interest rate differentials and REER metrics. The Real Effective Exchange Rate (REER) is a trade-weighted index that measures a currency’s value against its trading partners. A REER level of 100 indicates fair value or parity; a reading below 100 suggests the currency is undervalued and may have scope to appreciate, while a level above 100 indicates overvaluation.

Notably, this is only the second instance in the past 15 years where the REER has fallen more than one standard deviation below its fair value (Exhibit 10). The previous occurrence was during the “Taper Tantrum and the Fragile Five” episode. Historically, such deviations have been followed by a meaningful appreciation of the rupee in REER terms once it breaches the one-standard-deviation threshold. However, a bottoming out of domestic inflation could contribute to a gradual correction in REER levels, limiting the scope of potential appreciation. After averaging 3.1% in Q4 FY26, CPI inflation is expected to rise above 4% in H1 FY27, peaking at around 5.1% in Q3, with the full-year average projected at approximately 4.6% (assuming Brent crude at USD 90/bbl). However, some medium-term appreciation in the rupee cannot be ruled out, even though short-term pressure remains.

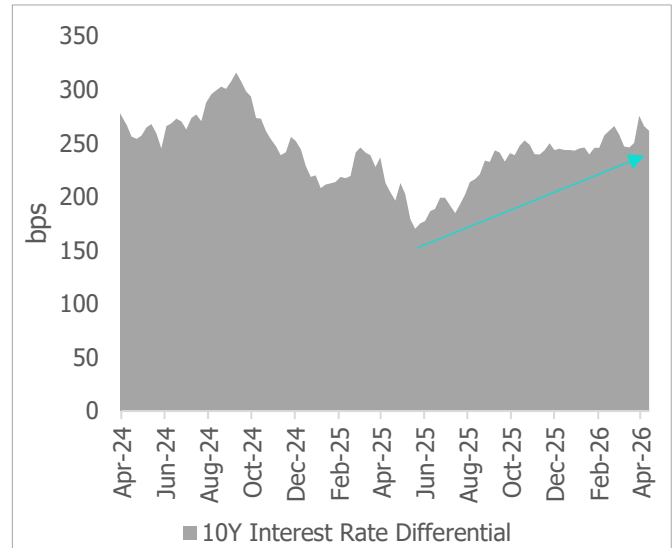
Apart from REER valuations, the interest rate differential has also remained supportive. The average 10-year interest rate differential between India and the US has increased from around 190 bps in May 2025 to approximately 260 bps by mid-April 2026 (Exhibit 11). The rising trend in interest rate differential should have supported the USD/INR. However, despite this, the rupee has depreciated from about 85 to 93 against the dollar during the same period.

**Exhibit 10: REER Valuation of INR**



Source: CEIC, CareEdge.

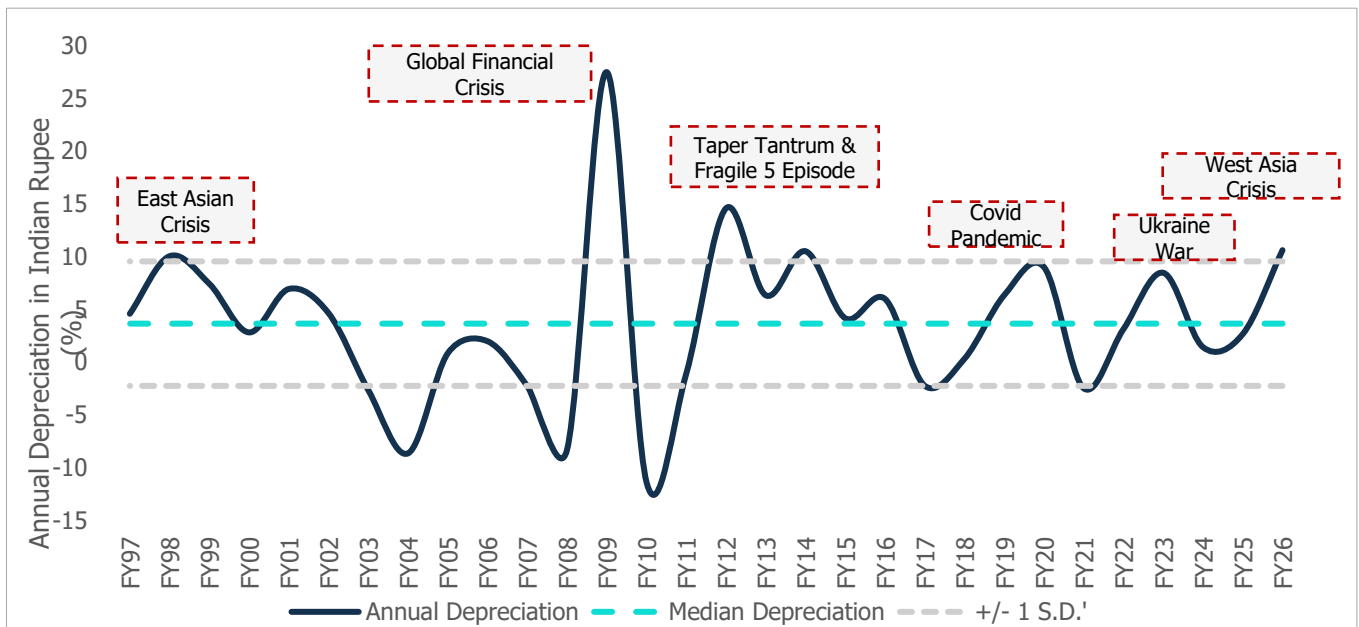
**Exhibit 11: Interest Rate Differential**



Source: CEIC, CareEdge

**Past Episodes of Volatility**

**Exhibit 12: Major Episodes of Depreciation In Indian Rupee in the Past Three Decades**



Source: RBI, CEIC, CareEdge

Over the past three decades, on an annual basis, the rupee has depreciated at a median rate of 3.5% against the US dollar (Exhibit 12). This gradual and persistent depreciation is consistent with the structural features of the

Indian economy, including a sustained current account deficit and its status as a net importer of capital. Within this period, we focus on episodes where the annual rupee depreciation approached or exceeded one standard deviation from the mean. Six such episodes stand out: the East Asian Crisis (1997–98), the Global Financial Crisis (2008–09), the Taper Tantrum and 'Fragile Five' episode (2012–13), the COVID-19 pandemic (2020), the war in Ukraine (2022), and the West Asia crisis (2026). These periods were marked by sharp capital outflows, coupled with a widening of the CAD in some episodes. The RBI adopted various measures during these stress periods to contain the depreciation of the rupee. Some of the key measures of the past include interest rate hikes, currency swap arrangements for oil-importing firms, and steps to attract foreign capital—such as liberalising capital flow norms and incentivising FCNR deposits. Additionally, there are instances in the past when the government has imposed import curbs on precious metals to reduce the import bill. In the Appendix, we have covered in detail various measures undertaken by RBI and the government in past episodes to manage volatility in the foreign exchange market.

### **India's macroeconomic fundamentals are stronger than in previous episodes**

India's macroeconomic fundamentals are significantly stronger than during earlier episodes of sharp rupee depreciation (Table 1). Prior to the West Asia crisis, India experienced relatively stable macro fundamentals in terms of high growth (estimated at 7.6% for FY26), low inflation (average CPI of 2% in FY26) and manageable CAD (estimated around 1% of GDP in FY26). Moreover, the Centre was on a fiscal consolidation path, having reduced fiscal deficit to 4.4% (RE) in FY26 from the pandemic peak of 9.2% in FY21. This has created valuable policy space to manage external headwinds. The previous stress periods were marked by a sharp deterioration in macro parameters. For instance, during the taper tantrum and the "Fragile Five" period (FY12–14), average CPI inflation exceeded 8%, the fiscal deficit stood at around 5.1% of GDP, and the current account deficit averaged 3.6% of GDP.

In the current crisis period, the dent in economic growth is unlikely to be grave. Assuming an early resolution of the conflict and an average global crude oil price of US\$ 90/bbl in FY27, we expect GDP growth to moderate to 6.7%, lower than the pre-conflict projection of 7.2%. The growth during the current crisis is likely to be robust relative to the East Asian crisis, taper tantrum episodes, and the contraction witnessed during the pandemic. However, growth is likely to remain below the levels seen during the GFC (FY2009) and the Russia–Ukraine conflict period, when it was supported by favourable base effects and substantial crisis-related stimulus. Inflationary impact of West Asia crisis is likely to be muted as the burden of higher crude oil prices will be shared between the government, households and OMCs. We expect inflation to average 4.6% in FY27. However, if the war prolongs for longer, the growth and inflation dynamics could worsen.

On the external front, the projected current account deficit (CAD) in FY27 at 2.1% of GDP is lower than the levels recorded during the Global Financial Crisis (2.3%) and the taper tantrum period (average of 3.6%). However, it remains higher than the deficit observed during the pandemic. The relatively favourable CAD during the pandemic is not directly comparable with current conditions, as lockdowns and subdued global oil prices significantly compressed import demand. However, India recorded a much lower CAD during the East Asian crisis compared to the projected CAD for FY27.

Foreign investments have remained weaker compared to previous crisis episodes. For instance, during the Taper Tantrum and the Fragile Five-episode, foreign investments were supported by healthy FDI inflows despite periods of weakness in FPI inflows. In the current context, we expect foreign inflows to remain subdued in FY27, as net FDI inflows have remained weak—largely due to profit repatriation and overseas investments by Indian firms—

while pressure on FII inflows continues. In fact, projected foreign investments for FY27 are likely to be the weakest across all previous episodes.

However, forex reserves remain comfortable, with an import cover of around 11 months. This is significantly more favourable compared to all previous crisis episodes, though marginally lower than the levels seen during the pandemic period. Overall, the substantial FX buffer should provide the necessary cushion for the Indian economy to withstand shocks arising from the West Asia crisis. However, despite the comfortable reserve position, the RBI is likely to act prudently to preserve adequate reserve buffers rather than intervening aggressively in the forex market.

**Table 1: India's Macroeconomic Fundamentals in Previous Episodes of Depreciation**

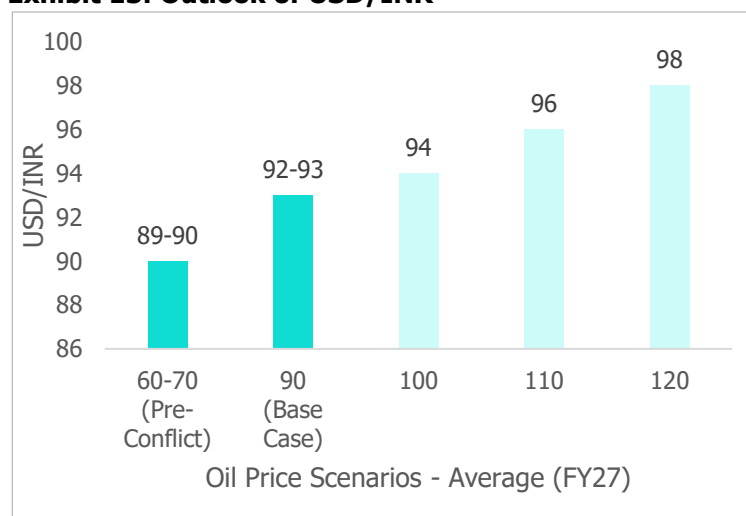
	East Asian Crisis (FY1997)	GFC (FY2009)	Taper Tantrum & Fragile 5 Episode* (FY2012-14)	Pandemic (FY2020)	Ukraine-Russia War (FY2023)	2027 Projection
Growth (% YoY)	4.0	7.9	6.4	-5.8	9.2	6.7
Inflation (% YoY)	6.8	10.6	8.4	6.2	5.4	4.6
Fiscal Deficit (% of GDP)	4.8	6.1	5.1	4.6	6.5	4.3**
Current Account Balance (% of GDP)	-1.2	-2.3	-3.6	-0.9	-2.0	-2.1
Foreign Investment (% of GDP)	1.5	0.7	2.0	1.6	0.7	0.5-0.6
Forex Reserves (Months of Merchandise Import)	6.5	9.8	7.3	11.8	9.6	11.4#

Source: IMF, CEIC, CareEdge, \*values are the average of FY2012-12. \*\* Budget Estimate and could be higher. # As of Feb 2026 (pre-conflict period).

### The Future: Outlook of the Indian Rupee

The situation on the currency front remains fluid, given external developments. Even if the conflict de-escalates in the near term, we expect crude oil to average around USD 90 per barrel in FY27. Under this baseline scenario, the rupee is likely to average in the 92–93 range. The fall in valuations amidst the recent correction in the equity market, along with easing trade uncertainties, should support FII inflows into the equity market. Rupee has already weakened sharply, and hence, from these levels, we feel the scope of further sharp weakening is less if a resolution is reached soon. In case of an early resolution of the crisis, we could see some support for the Indian rupee.

**Exhibit 13: Outlook of USD/INR**



Source: CareEdge Estimates.

As per our scenario analysis, if crude oil continues to linger at the 100 level, we expect INR to continue hovering around the 94 level. In the worst-case scenario where the conflict intensifies and oil prices rise further, we could see further sharp weakening of the rupee from the current levels. If additional pressure on the rupee emerges, the RBI could consider a range of measures, including reopening a currency swap window for OMCs, offering incentives for FCNR(B) deposits, and further liberalising capital inflows. Additionally, the possibility of interest rate hikes as a measure of stabilising the rupee is unlikely given the rising growth concerns amidst the crisis, while inflationary pressures are likely to remain within the tolerance band of the RBI. We expect the RBI to maintain a prolonged pause on policy rates.

## Appendix: Management of Past Episodes of Currency Volatility

### East Asian Crisis (FY1997)

The contagion from South-East Asian economies created severe downward pressure on the rupee, exacerbated by domestic political uncertainty. During this period, USD/INR witnessed an annual depreciation of 10%.

Measures taken to reduce volatility in the forex market:

- **Aggressive Monetary Tightening:** The RBI raised the Bank Rate significantly (to 11%) and increased the Cash Reserve Ratio (CRR).
- **Import/Export Controls:** To prevent leads and lags in payments, the RBI introduced a 15% surcharge on import finance and shortened the period for which exporters could keep foreign earnings abroad.
- **Capital Inflow Innovation:** To bypass the dry international market, India launched Resurgent India Bonds (RIBs), successfully raising over USD4 billion from non-resident Indians (NRIs) to shore up reserves.

### The Global Financial Crisis (FY2009)

The Lehman Brothers collapse led to a "flight to safety," where investors pulled capital out of emerging markets like India. In FY2009, following the GFC, the USD/INR depreciated sharply by 27%.

Measures taken to reduce volatility in the forex market:

- **Forex Liquidity Windows:** The RBI opened special facilities to provide foreign exchange liquidity to Indian banks and authorised dealers.
- **Interest Rate Management:** In a delicate balancing act, the RBI lowered domestic interest rates to support growth while simultaneously intervening in the forex market to prevent a free-fall of the rupee.
- **Export Support:** Credit facilities were extended to exporters in foreign currency to ensure that the trade engine of the economy did not stall.

### Taper Tantrum & Fragile 5 Episode (FY2012-14)

This was perhaps the most volatile period in recent history, triggered by the US Federal Reserve's hint at reducing its bond-purchase program. USD/INR depreciated by 15% in FY2012, followed by another 10% depreciation in FY2014. This episode also saw India in the fragile five grouping. The "Fragile Five" economies - India, Brazil, Indonesia, South Africa, and Turkey were deemed most vulnerable due to high CAD and heavy reliance on foreign investments to fund it.

Measures taken to reduce volatility in the forex market:

- **Liquidity Squeeze:** The RBI capped the amount banks could borrow under the Liquidity Adjustment Facility (LAF) and raised the Marginal Standing Facility (MSF) rate to 10.25%.

- **The OMC Swap Window:** RBI allowed Oil Marketing Companies (OMCs) to buy dollars directly from it via a "swap window" rather than the open market.
- **FCNR(B) Incentives:** RBI had offered to swap dollars raised by banks from foreign currency non-resident (FCNR) deposits of maturity 3-year and above into rupee, at a concessional rate of 3.5% p.a., which is about 3.0% cheaper than the market rate. Second, it allowed banks to raise foreign currency funding and swap it into rupees at a concessional rate of 1% below the market.
- **Curbing gold import:** Import duty raised to 10%; the 80:20 rule required traders to export 20% of imported gold.

### Covid Pandemic (FY2020)

The rupee came under sharp depreciation pressure during the initial phase of the pandemic, as global economies entered widespread lockdowns, with the USD/INR depreciating by 9% in FY20. However, this pressure proved short-lived. As central banks in advanced economies implemented aggressive rate cuts alongside large-scale asset purchase programs, global liquidity conditions eased significantly. Amid this backdrop, the rupee began to appreciate, reducing the need for aggressive market intervention by the RBI. The RBI largely allowed the exchange rate to adjust, having effectively navigated the immediate supply-side shock of the pandemic. Instead, it relied on forward guidance and communication aimed at discouraging speculative activity and stabilising market sentiment. In contrast to conventional responses to forex pressure, the RBI prioritised growth given the severity of the supply shock. It reduced policy rates and conducted open market operations to ensure comfortable liquidity conditions, anchor bond yields, and facilitate economic recovery following the disruption caused by mobility restrictions.

### Russia-Ukraine War (FY2023)

The USD/INR has depreciated by 9% in FY2023. The Russia-Ukraine war has significantly impacted the Indian Rupee, causing volatility against the dollar due to surging oil prices. The war caused a major energy crisis, with Brent crude oil prices surging by over 56% to peak around USD 130/bbl in March 2022. The oil price remained above \$100/bbl from March to August 2022, with a full-year FY23 average at \$95/bbl. Unlike the past episodes, the measures undertaken during the period were multi-pronged.

Measures taken to reduce volatility in the forex market:

- **Dollar Selling:** RBI sold US dollars from its reserves to smooth excessive volatility in USD/INR. India's reserves declined from peak levels of ~USD 635 bn in January 2022 to ~USD 530 bn in November 2022 as the RBI actively intervened.
- **FCNR(B) Incentives:** In 2022, FCNR deposits saw significant changes, including RBI's temporary removal of interest rate ceilings from July to October, allowing banks to offer higher rates. Unlike 2013, no large-scale swap window was introduced, but conditions were made more attractive.
- **Liberalisation of Capital Inflows:** For a temporary period, investments by FPIs in bonds were exempted from the prevailing 30% limit on short-term investments. Additionally, the RBI announced temporary relaxations to the External Commercial Borrowings to enhance foreign exchange inflows. The limit for automatic route ECBs was doubled from USD 750 million to USD 1.5 billion per financial year.
- **Policy Tightening and Liquidity Absorption:** RBI started to raise policy rates starting mid-2022, which supported currency by improving interest rate differentials.
- **Trade Settlement in INR:** In July 2022, the RBI introduced a mechanism allowing international trade settlement in Indian Rupees, which enables invoicing and payments in rupees via Special Rupee Vostro Accounts (SRVAs) maintained by domestic banks, aiming to simplify cross-border transactions.

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