

External sector resilience and domestic concerns

The government has taken several structural measures to counter external volatility, even as inflation poses a risk

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Recent developments in West Asia, while showing early signs of stabilisation, have already stress-tested India's macroeconomic resilience. The episode exposed the economy's continued sensitivity to external shocks, particularly through energy prices, capital flows, and currency pressures.

The rupee had been under pressure due to declining Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI), compounded by a surge in crude oil prices and severe supply chain disruptions affecting natural gas and fertilizers.

The resulting pressure on the current account deficit (CAD) and the balance of payments has forced the government and the Reserve Bank of India (RBI) to intervene actively to stem dollar outflows and attract fresh capital inflows.

While the immediate trigger may be easing, the policy response offers deeper insight: India is not merely reacting to episodic disruptions but actively strengthening its external-sector defences against recurring global volatility.

Initial tactical measures, including higher import duties on gold and export

taxes on petroleum products, provided little relief.

Recognising the need for deeper structural reforms, the government and the RBI launched a coordinated strategy to attract foreign capital directly.

KEY INITIATIVES

(i) Incentivising Foreign Currency Non-Resident (FCNR) deposits to attract stable diaspora capital. The RBI will provide a concessional hedge to commercial banks for mobilising fresh deposits, up to September 30, 2026, with a tenor of 3-5 years, effectively absorbing principal hedge cost for these deposits. RBI has also exempted FCNR(B) deposits from SLR and CRR. This will result in efficiency of up to 4 per cent, and most banks have passed on part of these benefits to depositors by increasing the rates on such deposits by up to 200 bps. RBI has also allowed leverage against these eligible deposits.

(ii) Providing a hedge to public sector undertakings (PSUs) and commercial banks for ECB (with maturity between 3-5 years) at a concessional rate of 1.5 per cent.

(iii) Eliminating withholding and capital gains taxes on Government Securities (G-Secs) to boost global investor participation.

These measures are likely to attract inflows of more than \$50 billion.



EXTERNAL STRESS. Robust response

THE INFLATIONARY PARADOX

The primary challenge of this strategy lies in a classic macroeconomic paradox: attracting large dollar inflows requires the central bank to release corresponding rupee liquidity, thereby risking the fuelling of domestic inflation.

This liquidity risk is compounded by severe supply-side vulnerabilities. An emerging El Niño threat looms over the monsoon season, heightening the risk of food inflation.

Furthermore, the retail economy has yet to absorb the impact of global energy prices fully. State-run oil marketing companies are currently holding back an estimated ₹15-20 per-litre pump price hike. As the government inevitably transitions towards gradual price corrections, broader inflationary pressures will intensify. Consequently,

the RBI is unlikely to ease policy interest rates anytime soon.

This domestic stance is linked to global realities, with the US 10-year Treasury yield remaining high at above 4.5 per cent, driven by fiscal expansion and sticky inflation in the world's largest economy.

RESILIENCE AMIDST UNCERTAINTY

Despite a flat immediate outlook, India's core economic indicators show remarkable resilience.

Corporate profitability is rebounding across key sectors. Bellwether industries like automotive and banking are reporting material improvements, defying tariff overhangs and global trade friction.

This corporate strength is anchored by a sturdy Q4 GDP growth rate of 7.8 per cent.

Ultimately, India is entering a transient phase with risks of wider fiscal deficits, elevated inflation, and restrained government spending. However, because this crisis is strictly event-driven rather than structural, a resolution to the West Asian conflict could brighten India's economic horizon just as quickly as it darkened.

The writer is Chief Rating Officer & Executive Director at CareEdge Ratings. Views expressed are personal