



Macroeconomic Theme: USD/INR & Currency Markets

The Curious Case of the Falling Rupee

Highlights:

- ✓ *The Indian Rupee (INR) has breached record lows against the US Dollar (USD) touching a low of ₹91 to a dollar despite strong macroeconomic fundamentals and RBI interventions*
- ✓ *Real effective exchange rate (REER) index has fallen below the fair value for the first time since April 2019, indicating the INR's weakness against trading partners.*
- ✓ *Depreciation of the domestic currency is not good or bad in itself; the puzzle is that the weakness contrasts with India's economic situation.*
- ✓ *Considering that rupee has depreciated this far, there is scope for the INR's appreciation against the USD considering the outcome of the US-India trade deal.*

The INR has depreciated ~ 5 per cent against the USD since the beginning of FY2025-26, while the USD itself has weakened by ~ 6 per cent during the same period against its peers as is evident from the movement of the dollar index (DXY). While dollar weakening and simultaneous rupee and other emerging market (EM) currency depreciation is not uncommon, it does raise questions given RBI's active interventions in the foreign exchange markets. The puzzle deepens further as the Indian economy has grown at a rate of 8 per cent in H1 FY2025-26, and retail inflation has moderated to 2.2 per cent. Despite robust macroeconomic trends, and RBI interventions, the INR has been the worst performing EM currency amongst its peers. While INR has seen depreciating pressure so far, we expect the trends to stabilize and pivot to a reversal in the near term.

The Story So Far: The domestic currency breached the ₹91 level against the USD in December 2025, prompting significant central bank intervention to address volatility. This has brought the USD/INR rate back to around ₹89 levels. Overall, INR depreciation has led the central bank to net sell USD 33.6 Bn since April 2025. To sterilize or neutralize the liquidity effects of its dollar sales the RBI has bought ₹4.2 lakh crore worth domestic G-sec in open market operations (OMOs). The RBI has announced a total of ₹ 2.0 lakh crore worth of OMO purchases in 4 tranches of ₹50,000 crore each up to 22nd January, 2026. Apart from this RBI has also announced USD/INR buy/sell swaps worth USD 15 Bn during the period.

Against the Grain: In theory, the INR should have appreciated against the USD considering the inflation levels in both countries and the interest rate differentials between US and India. Meanwhile, the USD has weakened against its six major peers i.e. the Canadian Dollar, Swedish Krona, Japanese Yen, British Pound, Euro and the Swiss Franc. It has strengthened against most EM currencies and has strengthened by ~ 4.9 per cent against the INR in this financial year.

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Chart 1: USDINR & DXY

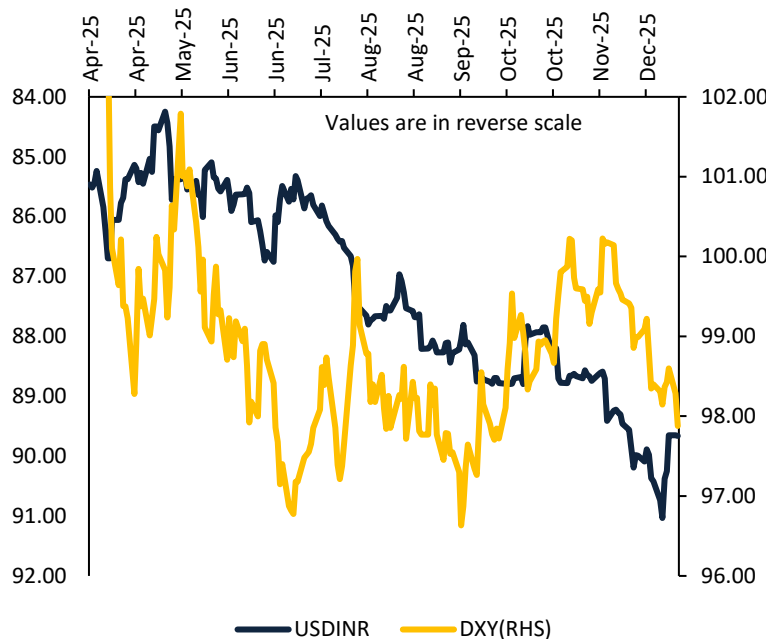
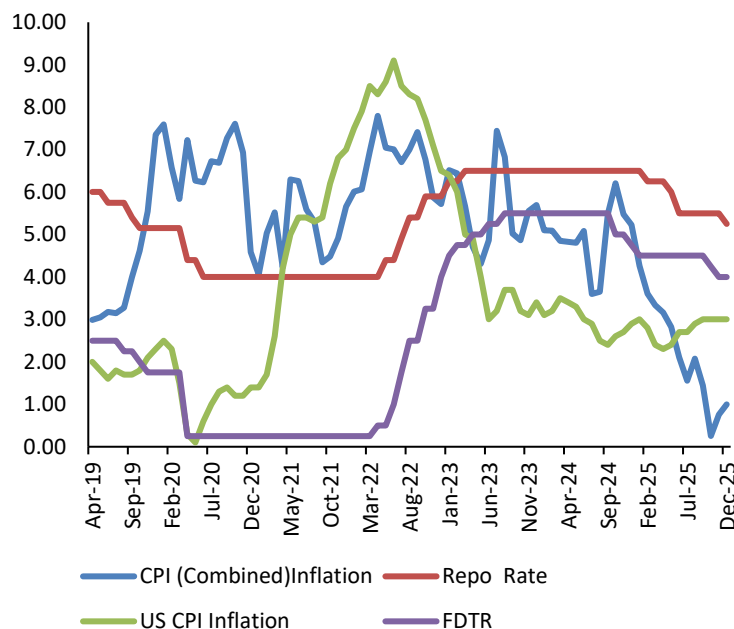


Chart 2: Inflation & Repo rates (Per Cent)



Source: Bloomberg, STCI PD Research

In a two-country framework, the country with higher inflation will witness currency depreciation against the other country due to a decline in purchasing power relative to the other country. Observing data during the period, India's inflation has been below 2 per cent for FYTD2025-26, while US inflation has hovered around the 2.7 per cent level during the same period. This is an uncommon occurrence of an emerging market economy (EME) having lower inflation rates than an advanced economy (AE).

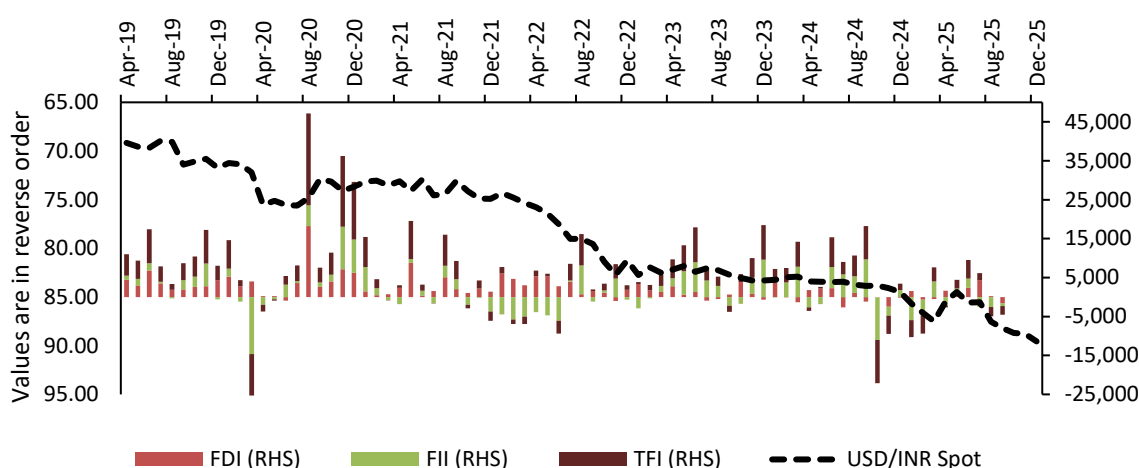
Capital Outflows and Sentiment: This brings the focus on the real drivers of currency movements for the EMEs like India. Since the announcement of the so-called Liberation Day tariffs, the INR has faced sharp depreciation like many EMEs around the world. India has been amongst the worst hit by tariffs and the INR has faced significant depreciation pressures unlike China where the Chinese Yuan has seen controlled depreciation owing to the Chinese currency regime and the huge trade surplus of USD 1.1 Tn dollars with the rest of the world as per October 2025 data.

India has a significantly smaller size and scale on the global trade map, with a trade deficit with the rest of the world. Although the trade deficit widened to record levels of USD 41 Bn during October 2025, owing to a fall in Indian exports to the US, along with a decline in overall imports, the trend has corrected in November 2025 with the trade deficit moderating to USD 28 Bn. Overall, the current account deficit (CAD) is expected to remain



moderate at around 1-1.2 per cent of GDP in FY2025-26, assuming that the US India trade deal outcome is not very unfavorable. Despite these favorable macro-trends, the uncertainty surrounding the US-India trade deal has spoiled investment trends for India and the sentiment of foreign investors has remained weak as is indicated in the data of net sales of Indian assets by foreign institutional investors (FIIs) and foreign direct investors (FDIs) since April 2025.

Chart 3: Capital Flows & USDINR (USD Mn, ₹ crore)



Source: RBI (TFI = total foreign investment)

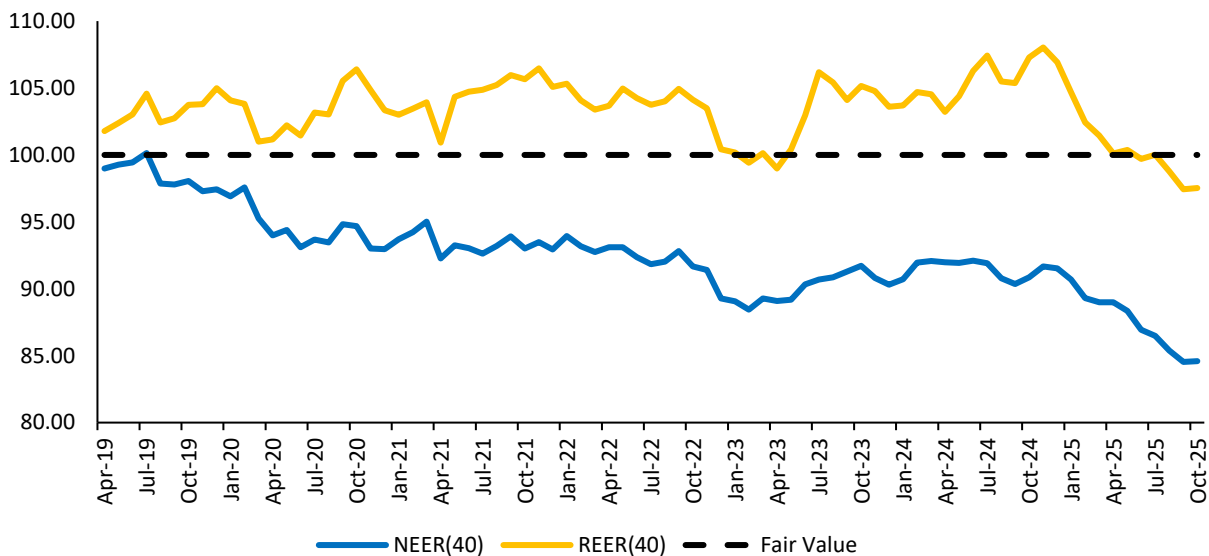
REER & NEER- How is the Rupee Valued? Effective exchange rates (EER) i.e. real effective exchange rate (REER) and nominal effective exchange rate (NEER) are used as gauges of the fair value of a currency. Effective exchange rates are indices based on trade and export weights with partner countries, and the fair value of a currency is when the effective exchange rates are at 100. This indicates parity with the foreign currencies and any value trading below 100 indicates that the home currency is undervalued giving rise to the possibility of appreciation in the near term, while any value above 100 signifies that the home currency is overvalued indicating a likelihood of depreciation for the home currency. The recent movements in the real effective and the nominal effective exchange rates are observed from the data published by RBI, which are available up to October 2025. The most recent series has a base year as 2015-16, and a broader 40-country trade weighted and export weighted basket.

According to RBI data, over the past decade (FY2015-16 to FY2024-25), while the INR has always been overvalued in real terms due to its relative inflation levels compared to its peers, it has generally been undervalued in nominal terms. However, the INR has been



depreciating in real terms since December 2024 and has remained at or below the fair value level since April 2025.

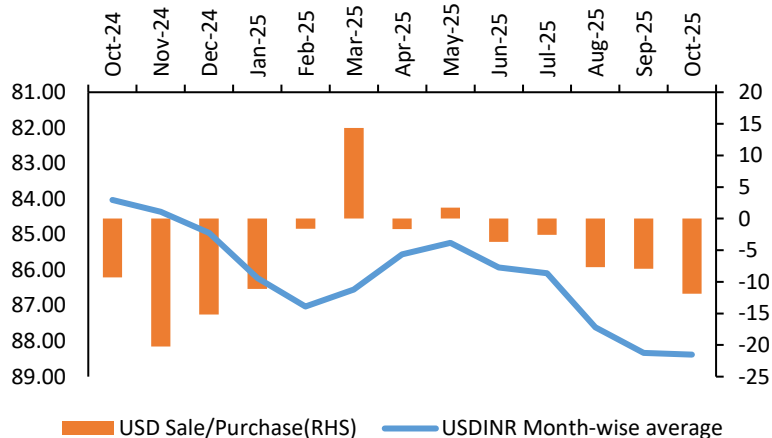
Chart 4: REER & NEER (Trade Weighted)



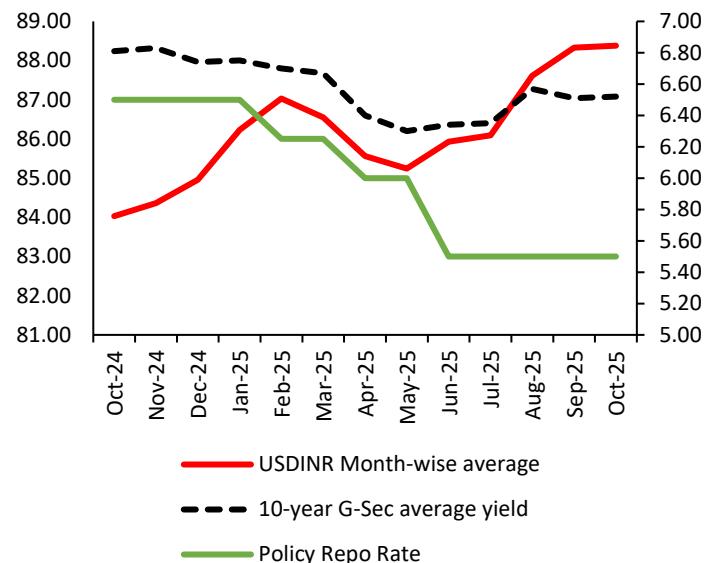
Source: RBI

RBI Intervention in the FX & Rates Markets: Over the past year, RBI has largely intervened to smoothen out the volatility in the foreign exchange markets. This has led to a steady depreciation of the INR that has been worsened by the relocation of foreign capital from EMEs due to the global risk-off environment. The depreciation of the INR was acknowledged by the International Monetary Fund (IMF), that changed its description of India's currency regime from "stabilized" to a "crawl-like" management. Overall, RBI has sold about USD 33.6 Bn (as of October 2025) and has approximately done OMO purchases of domestic assets i.e. G-Sec to the tune of ₹4.2 lakh crore in FY2025-26 so far to inject durable liquidity and sterilize the liquidity effects of its dollar sales.

RBI has cut CRR by 1 per cent to address system liquidity tightness during the festive season. In anticipation of further strain on liquidity at the beginning of the last quarter of FY2025-26, in addition to the pressures of currency depreciation, RBI announced other liquidity measures. To inject durable liquidity into the system with a total of USD 15 Bn worth of USD Buy/Sell swap for a tenor of 3 years. The first swap announced was USD 5 Bn and conducted on December 16, 2025 and a USD 10-year swap to be conducted on January 13, 2026. RBI also announced OMO purchases of ₹3.0 lakh crore, with ₹1.0 lakh crore conducted in December 2025, while the remaining ₹2.0 lakh crore to be bought in four tranches of ₹50,000 crore in January 2026.


Chart 5: RBI's Dollar Interventions (USD Bn) & USDINR


Source: RBI, Bloomberg, STCI PD Research

Chart 6: USD/INR & G-sec Yield


Unexpected Outcomes: For the Indian FX as well as interest rates market, the recent months have shown divergence of policy outcomes from what they were expected to be. Despite a significant 125 basis points easing of monetary policy rates and inflation declining to record lows, G-sec yields have remained sticky and in fact displayed a sort of reverse transmission by inching higher to 6.55-6.65 range from a 6.15-6.30 range earlier at the beginning of the interest rate easing cycle. In the foreign exchange market, the rupee has depreciated on the back of selling by the FII/FPI segment to breach a record low of ₹91 against the dollar, more due to currents of a risk-off rather than specifically due to domestic macroeconomic parameters. Both the interest rate and currency markets are behaving contrary to the extant economic arithmetic. Market forces play a dominant role in determining the levels of these assets beyond the formulaic assessment of the effective exchange rates and the relationship between monetary transmission and interest rates.

USD/INR Appreciation on the Cards? It is observed that the REER usually trades above the fair value for the Indian rupee while the NEER stays below the fair value, indicating a higher inflation level in India as compared to the US and other major trade partners. Since April 2025 both NEER as well as REER are trending below the fair value. Declining EERs, coupled with currency depreciation and moderation in retail inflation is an unsustainable trend as inflation is expected to inch up, and the trend is not expected to last long as Indian exports will be cheaper relative to most of its peers while domestic imports may moderate owing to higher prices faced by domestic consumers. This indicates a reversal in trend and the INR might see an appreciation trend in the medium term.



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