

## **Rupee Pressure: Is It Time to Tap the Diaspora Bonds Yet?**

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The recent depreciation of the Indian rupee toward ₹95 per USD has renewed focus on currency stability and external sector resilience. However, unlike earlier episodes of stress such as the 1998 sanctions, the early 2000s slowdown, or the 2013 taper episode, the current phase is unfolding against a backdrop of significantly stronger macroeconomic fundamentals.

Historically, external stress in India has coincided with underlying vulnerabilities, including wide current account deficits, limited foreign exchange reserves, or constrained access to global capital. The 1998 sanctions restricted external financing and led to currency pressure, while the 2013-episode exposed reliance on volatile portfolio flows, necessitating measures such as the FCNR(B) swap window to stabilise the rupee.

In the current episode, pressures are being driven more by external factors than domestic imbalances. Oil prices have firmed above ~\$100 amid geopolitical tensions, raising India's import bill given its dependence on crude imports. This has increased demand for dollars and contributed to currency pressures. At the same time, global financial conditions have tightened, with elevated yields and more cautious investor behaviour affecting capital flows. These dynamics are being reflected in domestic markets, with the rupee weakening and bond yields firming, as the 10-year G-sec moves above the ~7.10% level. Additional risks, including potential supply disruptions and weather-related uncertainties, could further complicate the outlook.

Despite these pressures, India's external position remains relatively strong. The current account deficit is contained at around 1% of GDP, foreign exchange reserves are estimated at about ~\$630–650 billion; even after accounting for net forward short positions, and policy credibility has strengthened over time. This marks a clear shift from past episodes, where external stress was amplified by underlying macroeconomic weaknesses. The question, therefore, is not whether India needs extraordinary measures like diaspora bonds to stabilize the Rupee, but how the country can demonstrate its strength in managing external pressures without resorting to crisis-era tools.

By analysing the current depreciation within this framework, we can assess whether India's improved fundamentals are sufficient to weather global volatility; or if further steps are needed to reinforce confidence in the Rupee's stability.

Source: Bloomberg

## **Real Issue: Not Trade, But flight of Capital**

Global markets appear to be entering a deleveraging phase, marked by broad-based asset sell-offs and a flight to the dollar. Against this backdrop, India's external dynamics are increasingly being shaped by capital flow behaviour. For over two decades, India's external position has been supported by steady and rising capital inflows, averaging \$30–40 billion annually in the 2000s, increasing to around \$60 billion in the following decade, and exceeding \$75 billion per year

between 2020 and 2024. That trend now appears to have reversed. Net capital inflows fell sharply to around \$17 billion in FY25 and have weakened further in FY26, marking a structural break rather than a cyclical slowdown.

Crucially, this shift is not driven by a deterioration in macro fundamentals. The current account deficit remains contained at around 1% of GDP, while forex reserves; at close to \$630 to 650 billion US dollars; even after accounting for net forward short positions, continue to provide a substantial buffer and adequate import cover.

Source: Bloomberg, KMAMC Internal, CNBC TV18

## **RBI Carefully Playing Its Cards**

### **1. RBI's First Signal: Controlling the Build-Up of Risk**

The RBI, while mandated to maintain price stability, also remains acutely sensitive to developments in the forex market. In periods of rising external stress, it has tended to act pre-emptively to prevent the build-up of speculative pressures on the currency.

In this context, RBI has recently introduced measures to tighten limits on banks' Net Open Positions (NOP) in the rupee. NOP represents the net exposure that banks carry to currency movements across their onshore foreign exchange books. Previously, these limits were largely determined internally by banks, with large institutions often maintaining exposures in the range of \$500 million to \$1 billion. RBI has now imposed a more binding constraint, capping positions at \$100 million. This marks a significant tightening of risk limits and directly curtails the ability of banks to build large directional positions against the rupee. The move is aimed at reducing the scope for speculative activity and limiting the amplification of volatility arising from one-sided market positioning.

Source: RBI

### **2. Reopening Capital Door: Press Note 3 Shift**

The recent easing of Press Note 3 also marks an important policy signal. Introduced in 2020 to prevent opportunistic acquisitions during the pandemic, it mandated government approval for investments from countries sharing a land border with India, effectively restricting a meaningful source of capital. Recent recalibration does not indicate a shift in strategic stance. Rather, it reflects a response to evolving economic conditions, while continuing to balance caution with the need to support stable sources of capital over the longer term.

### **3. Restricted Banks' Participation in Offshore NDF Markets**

RBI has tightened forex regulations to curb speculation and stabilize the rupee after it weakened to around ~₹95/USD. Banks are now barred from offering INR non-deliverable forwards (NDFs) to clients, with derivatives restricted to genuine hedging and no overlap with offshore positions. Additional steps such as a \$100 million net open position cap, bans on rebooking cancelled contracts, and limits on related-party trades aim to close arbitrage loopholes, especially amid \$25–50 billion in offshore-onshore positions. These steps have already led to a degree of position

unwinding and provided near-term support to the rupee. At the same time, they may result in some reduction in market liquidity and have implications for banks' trading revenues over the medium term.

Source: Bloomberg, KMAMC Internal

### Lessons from the Past:

India has encountered similar phases before and, in such periods, has turned to its global investor base; particularly Non-Resident Indians, to mobilise foreign currency through instruments such as diaspora bonds. While each episode has been shaped by different triggers, the underlying challenge has remained consistent: disruptions in capital flows requiring timely and targeted intervention to restore stability.

Diaspora bonds are instruments through which a country raises foreign currency from its overseas citizens, typically during periods of external stress. In India's case, these funds are mobilised primarily from Non-Resident Indians through the banking system, often with the support of RBI and are typically denominated in foreign currencies such as the US dollar. The objective is to augment foreign exchange reserves, stabilise the currency, and ease pressure on the external account.

### India's NRI Funding Strategy Through Crises

Year	Scheme	Details
1998	Resurgent India Bond (RIB)	This measure was taken after sanctions were put on India following the second India ended up raising \$4.8 billion through this activity.
2000-01	India Millennium Deposit (IMD)	In 2001, \$5.5 billion was raised as a result of these bonds. They were of a five-year maturity.
2013	Foreign currency non-resident deposits (FCNR-B)	Special deposits worth \$34 billion were floated in September 2013 against the backdrop of the markets due to US Fed's announcement to taper off its bond repurchase program. The RBI had mopped up \$30 billion with a three-year maturity.

Source: RBI, Morgan Stanley

### Event 1 - 1998: Sanctions and Sudden Financial Isolation

Following the nuclear tests at Pokhran in 1998, India faced international sanctions that sharply restricted access to global capital markets, leading to an abrupt tightening of external financing conditions. Investor sentiment weakened, capital inflows slowed, and the rupee came under pressure, depreciating from around ₹36–37 per dollar to nearly ₹41–42 over the following months.

While the adjustment was significant, it remained contained, supported by policy measures and a partially managed exchange rate framework.

In response, **India launched the Resurgent India Bonds (RIBs)**, targeted at Non-Resident Indians, to mobilise foreign currency outside conventional channels. **The response was swift, with around \$4.8 billion raised within a short span.** These inflows led to a meaningful improvement in foreign exchange reserves, eased liquidity pressures, and helped stabilise market sentiment. Although the rupee did not reverse its earlier depreciation, it stabilised in the ₹41–43 range, with reduced volatility and more anchored expectations.

### **Event 2 - 2000: Slowdown Without Crisis**

The early 2000s saw a global slowdown following the dotcom bust, weakening capital flows and domestic growth. At the same time, rising oil prices and broader emerging market stress put pressure on the rupee. Policy response was swift and coordinated. Under Governor Bimal Jalan, RBI tightened monetary conditions decisively raising the Bank Rate by 100 bps to 8%, increasing the CRR by 50 bps, and sharply curtailing refinance limits, all in a single move. Primary dealer support was retained to ensure orderly gilt market functioning, marking one of the last decisive uses of the pre-LAF framework. Alongside this, **India mobilised around \$5.5 billion through India Millennium Deposits (IMDs)**, strengthening foreign exchange reserves and easing pressure on the currency. Together, these measures stabilised the rupee without disorderly adjustment, highlighting the effectiveness of early and coordinated policy action.

### **Event 3 - 2013: Taper Tantrum and Currency Stress**

Taper Tantrum triggered a broad EM selloff, with the rupee coming under sustained pressure. INR moved from ~₹54–55/USD in May 2013 to a low near ₹68.8/USD by late August, reflecting external imbalances and a sharp reversal in capital flows, albeit alongside broader EM weakness. India's vulnerability stemmed from a wide current account deficit and reliance on portfolio inflows. As pressures intensified, domestic financial conditions tightened. The RBI avoided a repo hike and instead imposed a liquidity shock: MSF +300 bps to 10.25%, LAF capped at ₹75,000 crore, and ₹12,000 crore OMO sales. The objective was to tighten short-end liquidity and anchor currency expectations without signalling a structural shift in policy. Yields adjusted immediately; the 10Y G-sec rose ~50 bps intraday, reflecting compressed liquidity and higher term premia. Policy pivoted under Raghuram Rajan. As FX pressures eased, liquidity measures were unwound and focus shifted to strengthening the external balance sheet. **Foreign Currency Non-Resident (Bank) deposit FCNR(B) swap window mobilised ~\$30 billion, supporting the rupee and augmenting reserves.** The rupee subsequently stabilised, retracing toward ~₹60–62/USD as inflows improved and volatility subsided.

Source: Bloomberg, KMAMC Internal

### **Importance of Capital Quality**

One key lesson from past episodes is that the composition of capital matters. Foreign institutional flows tend to be fast-moving and sensitive to global conditions, often reversing quickly during

periods of stress. In contrast, diaspora-linked capital has historically been more stable, anchored in longer-term confidence and a deeper economic connection. As one of the world's largest recipients of remittances, with a well-established global diaspora, India retains the ability to tap this pool of relatively stable capital.

Source: RBI, As per latest available data

### **What Makes This Time Different**

The current episode differs materially from earlier stress periods, reflecting a sustained strengthening in India's macroeconomic fundamentals. The external position is more resilient, with a contained current account deficit, elevated foreign exchange reserves, and improved policy credibility. Even after accounting for net forward short positions, reserves at roughly \$630 to 650 billion US dollars, provide an import cover of about 11 months on a balance of payments basis, and somewhat lower on a merchandise basis.

External balances have improved structurally. Since FY20, the current account deficit has averaged close to 1% of GDP, including a surplus in FY21. In the post pandemic period, the current account deficit has generally remained within a range of 0 to 1.5% of GDP. This represents a clear improvement compared to the 2009 to 2013 period, when the deficit widened sharply, peaking above 4% of GDP.

That said, the outlook is subject to evolving external risks. A sustained increase in crude oil prices or a prolonged weakening in global demand could widen the trade deficit and exert pressure on the current account. At the same time, the global financial environment has become less supportive. Elevated US yields and tighter financial conditions have increased the relative attractiveness of advanced economy assets, while risk episodes have made capital flows more volatile and shorter in duration.

Source: Bloomberg, Investing.com, KMAMC Internal

### **Understanding the Mechanics and Costs of Raising Dollars**

These instruments, while effective, are not simple capital-raising tools. Indian banks mobilise foreign currency deposits from NRIs, with RBI converting them into rupees through swap arrangements that shield banks from exchange rate risk and support domestic liquidity. At the core is a currency swap: banks exchange dollars with RBI for rupees, ensuring liquidity flows into the system while transferring FX risk onto the RBI's balance sheet as forward liabilities. The costs, however, are less visible. To attract inflows, deposit rates are typically set above global benchmarks, and concessional swap terms can embed implicit subsidies; costs that are ultimately borne over time through the central bank's balance sheet.

### **Concluding Remarks: A Test of Strength, not a Crisis**

**The rupee's depreciation in 2025–26 is not a crisis but a test of resilience.** Unlike past episodes marked by structural vulnerabilities, India now faces global volatility from a position of strength, with a contained current account deficit, robust forex reserves, and stronger policy frameworks.

This analysis has demonstrated that India's fundamentals are far more resilient than in past crises, reducing the need for extraordinary measures like diaspora bonds.

#### **Key Takeaways:**

- **Stronger External Fundamentals:** Current account deficit is contained around ~1% of GDP, with forex reserves providing ~11 months of import cover. Even if crude sustains near ~\$100/bbl, CAD is likely to remain around ~2% of GDP, well below past stress episodes.
- **Improved Policy Framework:** Recent RBI actions reflect a more calibrated approach to managing volatility, avoiding the need for disruptive or emergency-style interventions.
- **Shift in Capital Composition:** India's external financing is supported by more stable flows such as FDI and remittances, reducing reliance on volatile portfolio capital.
- **Externally Driven Pressures:** Currency weakness is largely driven by global factors, including elevated US yields and risk aversion, rather than domestic macroeconomic stress.

#### **Path Forward:**

- **Maintain Policy Consistency:** Continue a measured approach to forex management and monetary policy to anchor expectations.
- **Reinforce Structural Strengths:** Emphasise improved fundamentals and reduced external vulnerabilities in investor communication.
- **Strengthen Policy Signalling:** Ensure clear and consistent communication to avoid misinterpretation of policy actions.
- **Remain Vigilant to External Risks:** Monitor oil prices and global financial conditions, which remain key sources of potential pressure.

Ultimately, the Rupee's current depreciation is an opportunity for India to demonstrate its economic maturity. By navigating this episode without resorting to extraordinary measures, India can reinforce its reputation as a stable and resilient economy; one that no longer faces external crises from a position of weakness, but from one of strength.

**Mr. Siddharth Kothari, Economist at Sunidhi Securities & Finance Ltd adds:** The note provides a clear and well-articulated assessment of the recent depreciation in the rupee, appropriately reframing the narrative away from domestic macroeconomic weakness towards the evolving dynamics of global capital flows. The emphasis on the sharp moderation in net capital inflows as a potential structural shift, rather than a purely cyclical slowdown, is particularly noteworthy and relevant in the current context of tighter global financial conditions. The analysis effectively highlights the strength of India's external fundamentals, including a contained current account deficit, comfortable foreign exchange reserves, and improved policy credibility, distinguishing the present episode from earlier periods of external stress. In this regard, the argument that the

current phase represents a test of resilience rather than a balance of payments crisis is well-founded. The discussion on the policy response is balanced and insightful, particularly in outlining the RBI's calibrated approach towards managing currency volatility through targeted measures aimed at containing speculative positioning, rather than resorting to broad-based or disruptive interventions. Overall, the note presents a coherent view that the current episode reflects a cyclical, externally driven adjustment and a test of resilience, rather than a balance of payments concern.

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