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India's External Balances: Robust Performance, Lingering Risks

16 June 2026

India's external sector today exhibits considerable resilience yet remains structurally vulnerable because it is deeply embedded in a world economy marked by geopolitical contestation, technological bifurcation and shifting capital flows. India's policy challenge is to leverage the opportunities created by this fluid environment, especially supply-chain reconfiguration, while prudently managing the macro-financial and commodity-price risks that have intensified in the last decade.



The End of the Era of Hyper-Globalisation

India's external position can no longer be analysed against the backdrop of the benign, rules-based globalisation that followed the end of the Cold War. The earlier regime of steadily falling trade barriers, increasing trade openness and near-unfettered capital mobility is gradually giving way to a more fragmented order marked by strategic trade restrictions, industrial policy and regional blocs (Ahrend, et al 2012). This transition is evident in the rising use of tariffs, non-tariff barriers, industrial subsidies, export controls, and "*friend-shoring*" strategies.

In this new setting, trade and capital flows are increasingly shaped not only by cost and efficiency considerations, but also by national-security, technology-control and resilience objectives (Yoshino, 2012; Sethi, 2008). India's external sector is thus being re-priced through the lens of geopolitical alignment, participation in minilateral groupings, and the ability to position itself as a trusted, reliable partner in critical supply chains (Rangarajan, et al, 2013).

Geopolitical Shocks and Trade Disruptions

The wars in Ukraine and West Asia, along with disruptions in key maritime chokepoints such as the Red Sea and the Black Sea corridors, have underscored the vulnerability of global trade routes to geopolitical shocks. These events have raised shipping costs, lengthened delivery times and forced trade rerouting, with disproportionate effects on energy-importing economies and time-sensitive value chains. For India, which conducts the bulk of its merchandise trade via sea routes and relies heavily on energy imports, these disruptions carry direct terms-of-trade and inflation implications.

Sanctions regimes, secondary sanctions risk, and technology-related export controls are further complicating India's external environment. Restrictions on advanced semiconductors, telecom equipment, dual-use technologies and critical minerals are redrawing supply chains in sectors central to India's growth ambitions in electronics, EVs, renewables and defence manufacturing. Navigating these constraints requires deft diplomacy, diversification of suppliers, and strategic use of trade and technology partnerships.

Goeconomic Fragmentation and Multilateral Concerns

Multilateral institutions such as the IMF, World Bank and WTO have repeatedly cautioned that goeconomic fragmentation could lower global growth, weaken trade efficiency and reduce the gains from specialisation. Fragmentation operates through multiple channels—splitting of technology regimes, parallel payment systems, the potential erosion of the dollar-centric order, and the rise of overlapping regional trade arrangements.

For India, slower global growth dampens export demand, particularly for labour-intensive manufactures and modern services. At the same time, fragmentation of payment and financial systems can affect capital flows, remittances and the cost of cross-border financing. Yet it also opens space for India to play a bridging role in South–South trade, regional value chains and digital-economy standards, especially if it can anchor credible, rules-based frameworks in its neighbourhood and in groupings such as the Indo-Pacific Economic Framework for Prosperity (IPEF) (comprising USA, Australia, India, Japan, South Korea, Brunei, Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam, Fiji and New Zealand), Bay of Bengal Initiative for Multi-Sectoral Technical and

Economic Cooperation (BIMSTEC, comprising Bangladesh, India, Myanmar, Sri Lanka, Thailand, Bhutan, and Nepal) or expanded BRICS (Brazil, Russia, India, China, South Africa, Egypt, Ethiopia, Iran, Saudi Arabia, and the United Arab Emirates)-like arrangements.

Risks and Opportunities from Supply-Chain Reconfiguration

The strategic re-assessment of dependence on China, particularly by advanced economies, hedge against geopolitical exposure, rising labour costs, and operational disruptions, has triggered a wave of “*China+I*” and “*China+N*” strategies in manufacturing and sourcing. This creates a once-in-a-generation opportunity for India to attract investment and relocate segments of global value chains in electronics, semiconductors, renewable-energy equipment, pharmaceuticals, automotive components and other advanced manufacturing sectors.

Realising this opportunity, however, is not automatic and necessitates, *inter alia*, competition with agile Southeast Asian economies and near-shoring destinations that offer attractive logistics, stable policy regimes and investor-friendly ecosystems. Success will depend on India’s ability to provide:

- Competitive and predictable policy frameworks, including tariff rationalisation and trade facilitation.
- High-quality infrastructure and logistics that reduce delivered cost and uncertainty.
- Adequate skills and deep supplier ecosystems to support large-scale, export-oriented manufacturing.

Supply-chain diversification can strengthen India’s export base, deepen technological capabilities, and make the external sector more resilient to shocks in any single geography, subject to the fulfilment of the three basic conditions mentioned above.

When Oil Prices Spike, India Pays the Price

Heightened geopolitical tensions have made global commodity markets, especially crude oil and natural gas, more volatile, amplifying risks for a net energy-importing country like India. Energy price spikes immediately widen trade and current account deficits, pressure the exchange rate, and complicate the central bank's inflation management. In such episodes, import-dependent sectors and fiscally sensitive items like fertilisers are also exposed, transmitting external shocks to domestic growth and public finances (Virmani, 2003).

Over the medium term, diversification of energy sources, expansion of strategic petroleum reserves, and accelerated adoption of renewables and electrification can mitigate some of

this vulnerability. However, given India's scale and growth trajectory, external-sector risks linked to hydrocarbons and critical raw materials (such as lithium, cobalt and copper for the green transition) remain a key structural concern.

External Resilience: Buffers and Strengths

India's external sector has, however, displayed notable resilience in recent years because of:

- A large and increasingly diversified services-export base—IT, business process management, consulting, R&D, and digitally delivered services—has helped offset merchandise trade deficits.
- Robust and stable remittance inflows from a wide diaspora provide a steady, counter-cyclical cushion to the current account.
- Accumulation of foreign-exchange reserves and prudent external-debt management have strengthened India's ability to absorb shocks, smooth volatility, and maintain confidence in the rupee.

These buffers give policymakers some room for manoeuvre when commodity prices spike or when global financial conditions tighten abruptly. However, resilience built on services and remittances alone is inadequate; deeper, broad-based export competitiveness in goods and greater sophistication in services are crucial to structurally reducing external vulnerability.

The Capital Conundrum: Hot Money, Cold Reality

In a world of frequent “*risk-on, risk-off*” episodes driven by global interest-rate cycles and geopolitical events, portfolio and debt flow to emerging markets can be highly volatile. India's relatively strong macro fundamentals and market depth have helped attract stable long-term capital, including Foreign Direct Investment (FDI) and long-maturity debt. Yet, reliance on portfolio flows exposes the country to the risk of sudden stops, which can pressure the exchange rate and domestic financial conditions.

Strengthening external resilience, therefore, also requires careful calibration of capital-account policies, development of local-currency bond markets, and maintenance of credible monetary and fiscal frameworks. These measures reduce the likelihood that global shocks translate into domestic financial instability, preserving the external sector's role as a growth enabler rather than a constraint.

Geopolitics, Strategy and Policy Priorities- No Case for “*Islands in the Stream*” (Ernest Hemingway)

External vulnerability today is as much a function of geopolitical positioning as of traditional macroeconomic indicators. For India, strategic choices on alliances, trade agreements, technology partnerships and security cooperation will shape market access, investment flows and supply-chain participation. A coherent external-sector strategy in this environment would prioritise:

- Building diversified trade and investment linkages across regions to avoid over-dependence on any single market or bloc.
- Proactively engaging in setting standards and rules in emerging domains such as digital trade, data flows, green technology and payment systems.
- Using economic diplomacy to secure long-term energy and critical-mineral supply arrangements, including through joint ventures and offtake agreements.

By combining macro-prudence with strategic economic statecraft, India can tilt the balance towards resilience while acknowledging that a degree of vulnerability is inherent in an open, globally integrated economy (Rajan, 2016).

Domestic Growth –“*A Tale of Two Cities*” (Charles Dickens)?

The macroeconomic overlay is under strain from rising crude oil prices and a growing import bill, which are squeezing both the fiscal and current account deficits. These challenges are compounded by persistent inflationary pressures, capital outflows, declines in the Nifty and Sensex, rupee depreciation, slowing private consumption, widening income and wealth inequality, agricultural distress, infrastructure and urban bottlenecks, and deficiencies in human capital development.

The trajectory of the Indian rupee over the last two decades reveals a clear shift from relative stability to a phase of sustained depreciation against the US dollar. Between 2000 and 2004, the rupee was remarkably stable, depreciating by an average of 0.4% per annum. However, this changed significantly thereafter. During 2005–2014, the rupee weakened at an average annual rate of about 3.4%, reflecting rising trade deficits, greater integration with global capital flows, and periodic episodes of external volatility. The trend persisted during 2015–2025, with the rupee depreciating at an average annual rate of around 3.5%, indicating that a moderate but steady weakening of the currency has become a structural feature of India’s external sector.

More recently, however, the pace of depreciation has intensified. Among major emerging-market economies operating flexible exchange-rate regimes rather than fixed or tightly managed currency systems, the Indian rupee has been one of the weakest performers over

the past year. While currencies such as the Japanese yen, South Korean won, Indonesian rupiah and Philippine peso have depreciated by approximately 6.6%, 7.0%, 9.3% and 10.3%, respectively, the rupee has declined by around 11.2% against the US dollar. This underperformance reflects a combination of factors, including a strong dollar environment, persistent demand for foreign exchange, portfolio capital outflows, elevated crude oil import costs, and widening pressures on India's current account. The recent trend suggests that, despite India's relatively strong macroeconomic fundamentals, the rupee remains vulnerable to global financial conditions and shifts in investor sentiment. The non-linear external sector (EPW Research Foundation, 2008) crisis assumes significance due to ongoing instability in West Asia, rising geoeconomic fragmentation, persistent oil price volatility, tightening global financial conditions, and repeated safe-haven capital flows into advanced economies.

For a large and globally integrated economy such as India, external-sector resilience is no longer merely a matter of trade performance; it is increasingly linked to capital flows, currency stability, reserve adequacy, external debt sustainability, and investor confidence (Bajpai, 1994). There's a battle inside and a war outside. Assessing India's external vulnerability requires a holistic view of interconnected factors rather than a narrow focus on any single indicator. For, as Sahir Ludhianvi cogently argued,

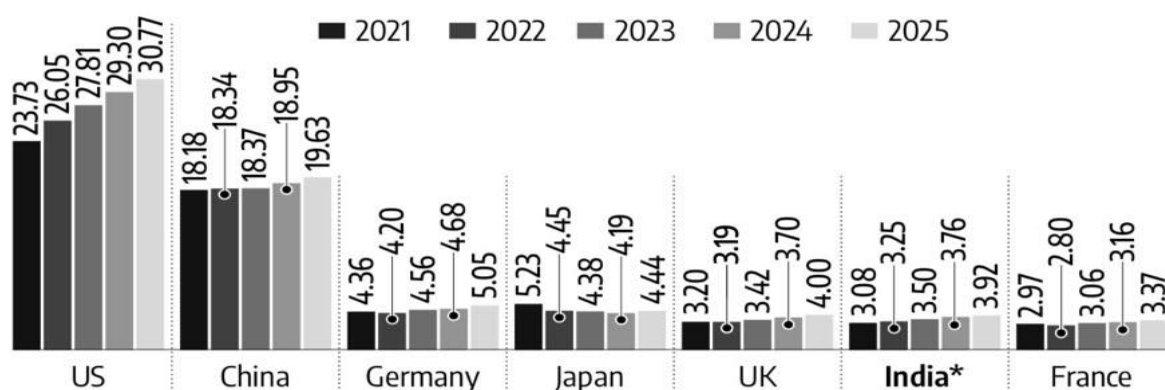
“नहीं है नाउम्मीद इक़बाल अपनी किशत-ए-वीराँ से,

बड़ी ज़रखेज है मिट्टी, ज़रा नम हो तो ये साक़ी”

Translation: Iqbal is not hopeless about his barren field;
The soil is highly fertile—if only it receives a little moisture, O cupbearer.

Nominal GDP report card

Gross domestic product at current prices (in \$ trn)



Domestic growth still strong despite ranking drop

GDP at current prices in respective currency (in trillion)

	2021	2022	2023	2024	2025
United States	23.73	26.05	27.81	29.30	30.77
China	117.31	123.34	129.43	134.92	140.19
Germany	3.68	3.99	4.22	4.33	4.47
Japan	573.57	584.90	616.03	634.23	663.76
United Kingdom	2.32	2.58	2.75	2.89	3.04
India*	229.81	261.18	289.84	318.07	346.36
France	2.51	2.65	2.83	2.92	2.98

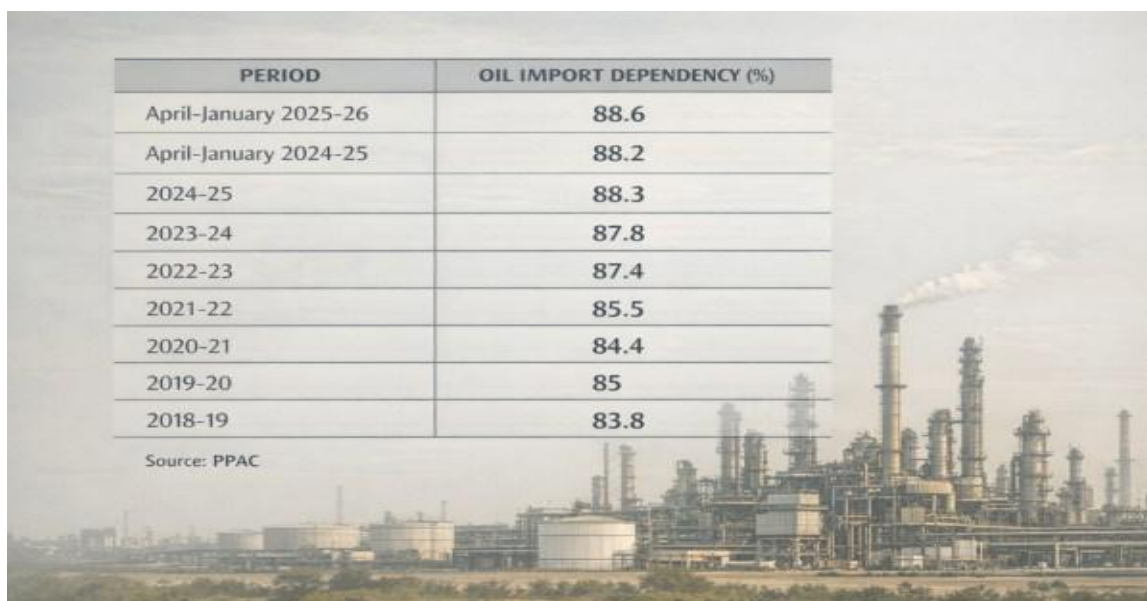
Currency weakness underpins the slip

Appreciation/depreciation of national currency against \$ (Y-o- Y %)

	2021	2022	2023	2024	2025
China	6.45	6.73	7.05	7.12	7.14
(appreciation/depreciation)	6.52	-4.34	-4.75	-0.99	-0.28
United Kingdom	0.73	0.81	0.8	0.78	0.76
(appreciation/depreciation)	-6.41	10.96	-1.23	-2.5	-2.56
Germany	0.84	0.95	0.92	0.92	0.89
(appreciation/depreciation)	-4.55	13.1	-3.16	0	-3.26
France	0.84	0.95	0.92	0.92	0.89
(appreciation/depreciation)	-4.55	13.1	-3.16	0	-3.26
Japan	109.76	131.5	140.49	151.37	149.66
(appreciation/depreciation)	-2.8	-19.81	-6.84	-7.74	1.13
India*	74.5	80.37	82.79	84.58	88.31
(appreciation/depreciation)	-0.38	-7.88	-3.01	-2.16	-4.26

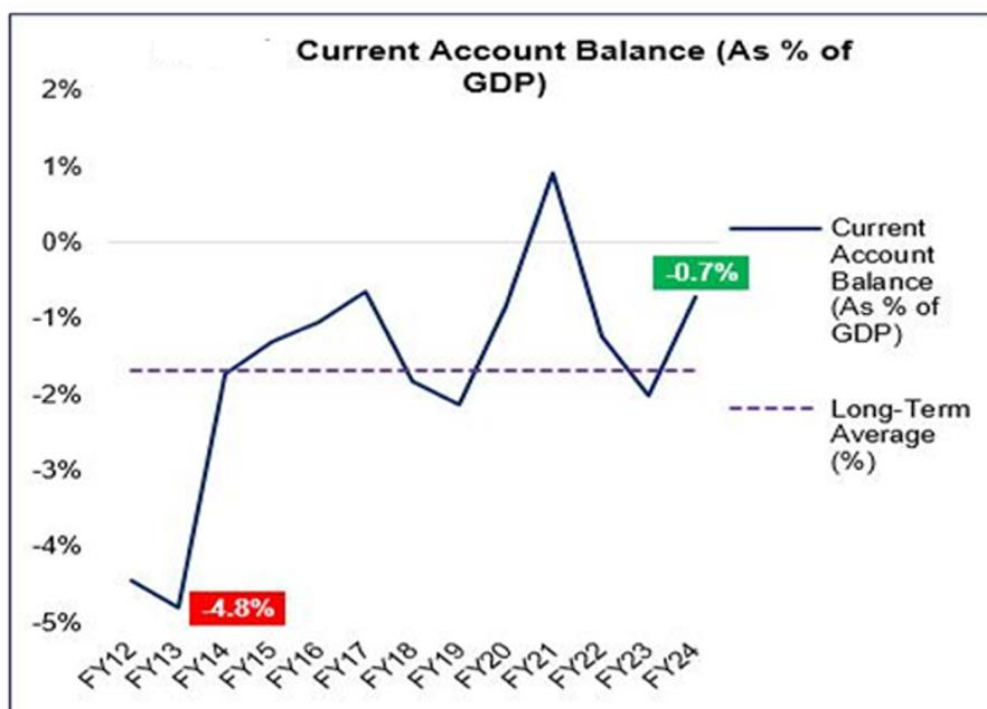
Oil Dependence: A Persistent Structural Weakness

Despite significant progress in renewable energy, India remains heavily dependent on imported crude oil. India imports approximately 85% of its crude oil requirements. Consequently, fluctuations in global oil prices disproportionately influence the current account deficit, inflation, fiscal balances, and exchange-rate stability. Historically, every major episode of external-sector stress in India has coincided with elevated oil prices, e.g., the 1973 oil shock, the 1979 oil shock, the 1990 Gulf War, the 2008 commodity boom, the 2022 Russia-Ukraine conflict, and recent West Asian tensions.



A sustained increase of US\$10 per barrel in crude prices can significantly increase India's import bill and widen the current account deficit. The challenge is compounded because oil imports are denominated largely in US dollars. Higher oil prices, therefore, simultaneously increase import expenditure and foreign-exchange demand. Reducing energy dependence is an important long-term strategy for strengthening external resilience. Accelerated deployment of solar and wind energy, expansion of electric mobility, green hydrogen initiatives and improvements in energy efficiency can gradually reduce exposure to imported fossil fuels, with a concomitant welcome effect on the triple deficits – the trade deficit, the current account deficit and the fiscal deficit.

Volatile Capital Inflows: Basic Risk



India has traditionally financed its current account deficit (CAD) through foreign direct investment (FDI), portfolio investment, external commercial borrowings (ECBs), and remittance inflows. While this financing model has generally worked well, it also leaves the economy exposed to shifts in global risk appetite and international liquidity conditions. The mix of capital inflows is particularly important (Sanyal, et al, 2004). FDI is long-term, productivity-enhancing, and relatively stable even during periods of global turbulence. Portfolio investments, by contrast, are highly sensitive to interest-rate differentials, geopolitical uncertainty, exchange-rate expectations, and changes in investor sentiment. Consequently, sudden reversals in portfolio flows exacerbate pressure on the rupee and foreign exchange reserves, despite sound underlying economic fundamentals.

The vulnerability of capital flows in an economy is largely a function of the degree of its financial integration with the global economy, reflecting the extent of capital mobility and the ease with which funds can move across borders (OECD, 2012). Economies more open to international financial markets often benefit from greater access to foreign capital, but they are also more exposed to sudden reversals in investor sentiment, global liquidity conditions, and external financial shocks.

Capital inflows into developing economies are shaped by a combination of external “*push*” factors and domestic “*pull*” factors. Push factors originate in the global economic and

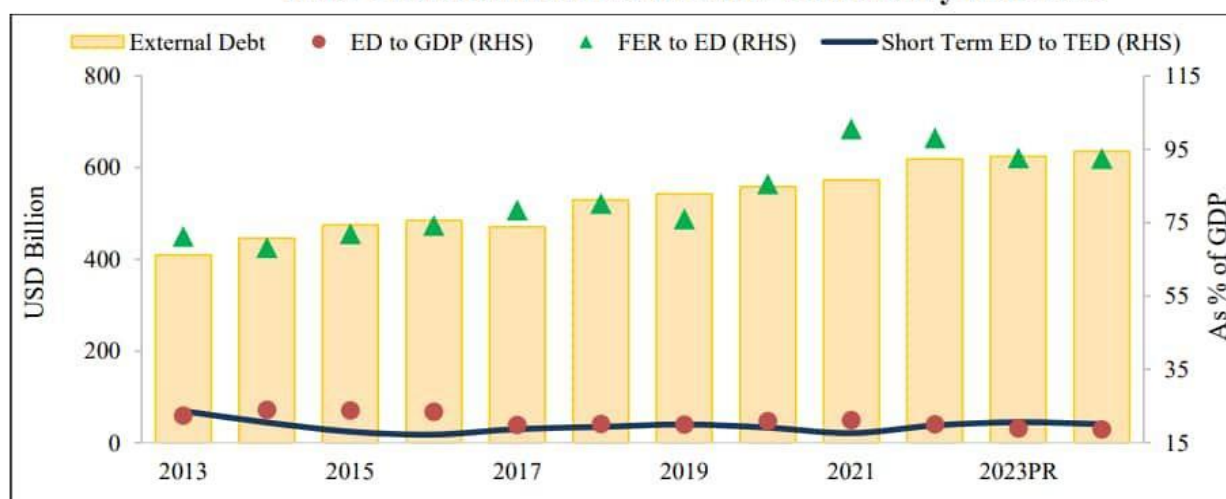
financial environment and influence the overall availability and direction of international capital. These include global growth prospects, expectations regarding future economic performance, international interest rates and interest-rate differentials, the availability of global liquidity arising from monetary policies in advanced economies, and the prevailing level of risk appetite or risk aversion among international investors. Periods of abundant liquidity, low interest rates in advanced economies, and strong investor confidence typically encourage larger capital flows toward emerging and developing markets.

Domestic pull factors determine a country's attractiveness relative to other investment destinations. Key determinants include the strength of economic fundamentals, GDP size and growth prospects, macroeconomic stability, sovereign credit ratings, domestic interest rates, the quality of institutions and governance, and the overall investment climate. Countries with higher growth potential, sound fiscal and monetary policies, stable political environments, and favourable returns on investment are generally better positioned to attract and retain foreign capital (Singh, et al, 2004).

Consequently, capital flows to developing economies are the outcome of a complex interaction between global financial conditions and country-specific fundamentals. While strong domestic fundamentals can enhance resilience and attract sustained investment, adverse global shocks can still trigger significant capital outflows, highlighting the importance of maintaining macroeconomic stability and prudent financial-sector management.

India's relatively comfortable external debt indicators provide an important cushion (IMF, 2000). India's projected 55.6% central government debt-to-GDP ratio in FY27 remains moderate by international standards; the share of short-term debt in total external debt at 18.4% at end-September 2025 is manageable; and debt-service indicators (external debt service ratio at 6.0%, total external debt at 19.2% of GDP, foreign exchange reserves cover 93.8% of India's total external debt) remain broadly benign. The sustainability of external financing, however, depends not only on the quantity but also on the quality and stability of capital inflows. Therefore, the central policy challenge is not a lack of foreign capital but ensuring that a larger share of incoming capital is stable, long-term, and less prone to sudden reversals.

India's External Debt Position and Vulnerability Indicators



Source: RBI; Note: PR - Partially Revised, P - Provisional; ED – external debt, FER – foreign exchange reserves, TED – total external debt

India's Need for Foreign Capital and Its Capacity to Attract It

A distinction between the demand for foreign capital and the economy's attractiveness as a global investment destination is necessary. India continues to attract substantial FDI across manufacturing, digital services, infrastructure, renewable energy, financial services, and emerging technology sectors. India's large domestic market, improving digital infrastructure, expanding middle class, and ongoing structural reforms support its investment appeal.

Moreover, India's external vulnerability indicators do not presage a financing crisis. A robust services trade surplus, particularly in information technology (IT) and business services, together with consistently strong remittance inflows from overseas Indians, makes foreign exchange earnings durable. The challenge lies primarily in volatile financial flows rather than in any structural inability to attract capital. Consequently, policy efforts must focus on improving investment certainty, strengthening institutions, reducing regulatory frictions, and expanding investment opportunities rather than responding in a crisis-management mode.

Services Exports: India's Strong External Buffer

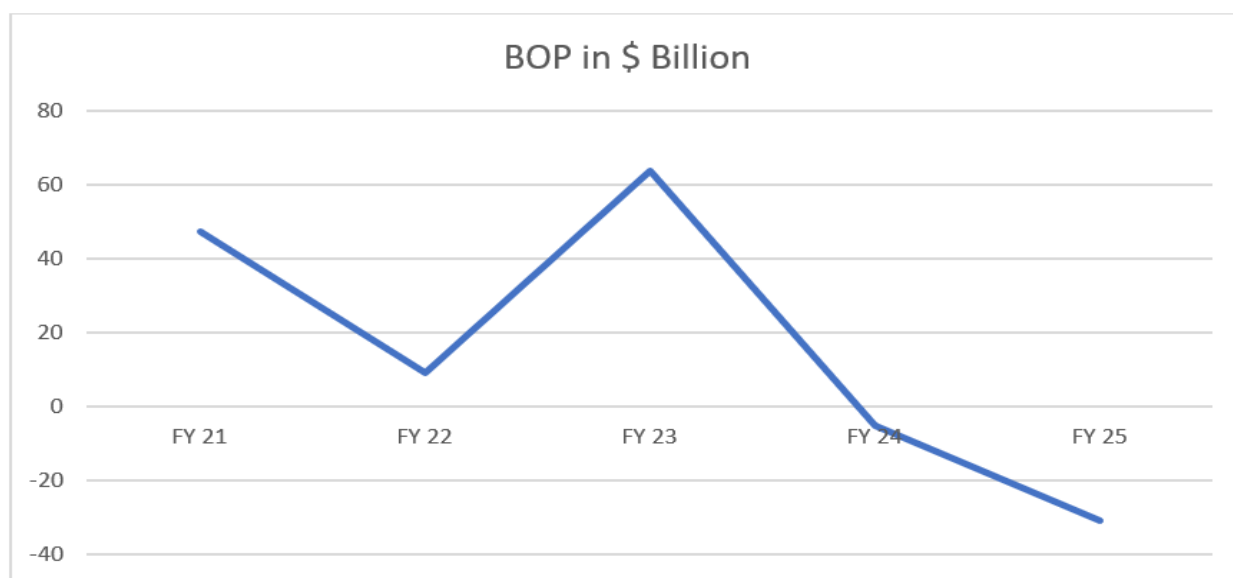
Services exports represent India's greatest structural strength. Unlike commodity exports, services exports rely primarily on human capital, technological capability and knowledge-intensive activities. India's information technology industry has evolved into a globally competitive sector generating substantial foreign-exchange earnings.

Services exports now go beyond traditional IT outsourcing and increasingly include business-process management, financial services, engineering design, research and development, legal services, digital platforms, and artificial intelligence and analytics. The significance of services exports transcends their size. They tend to be less volatile than

capital flows and less vulnerable to commodity-price fluctuations. This provides a stable source of foreign exchange that partially offsets India's chronic merchandise trade deficit. The services sector effectively functions as India's invisible export engine.

Tax Incentives and Market Deepening: A Strategic, Not Defensive, Approach

Global investors increasingly prefer economies with stable and predictable policy environments in all their forms and manifestations. In India, concerns regarding retrospective taxation, regulatory unpredictability and compliance burdens have affected investor sentiment. Recent measures by the RBI and the Government of India aimed at enhancing the attractiveness of Indian financial markets, including tax concessions and capital-gains relief on selected government securities, should be viewed within the broader framework of capital-market deepening, easing pressure on the rupee and narrowing part of the balance of payments gap.



Source: RBI Annual Report 2025-26.

The RBI's plan comprises

- FCNR(B) deposits of three to five years are to be exempt from Cash Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR), lowering the cost of mobilising such funds.
- For external commercial borrowings (ECBs), RBI has set a swap cost of 1.5 %, making overseas loans attractive for top-rated PSUs compared with domestic funding
- FCNR(B) swap window will remain open until October 16, 2026, for deposits mobilised up to September 30.
- The ECB and OFCB swap facility will run until January 15, 2027, for drawdowns up to December 31, 2026.

Such contextually significant measures broaden investor base, improve market liquidity, reduce financing costs, and integrate domestic financial markets more closely with global capital markets. They are consistent with practices followed by many emerging and advanced economies seeking to attract long-term institutional investors. The rationale transcends inflows. A deeper and more diversified investor base reduces concentration risks and enhances market resilience during volatile periods. While greater foreign participation inevitably causes susceptibility to global market fluctuations, the overall objective is to improve the efficiency and depth of domestic capital markets. These measures, therefore, represent a strategic effort to strengthen India's long-term financial architecture rather than a response to immediate external stress.

Capital Account vs. Current Account: Which Presents the Greater Risk?

Conventional discussions of external vulnerability often focus on the current account deficit. However, in contemporary emerging-market economies (EMEs), instability frequently originates from the capital account. India's current account dynamics remain relatively manageable (Ranjan, et al, 2004). The merchandise trade deficit is partially offset by a substantial services surplus and a large remittance inflow. While fluctuations in global commodity prices, especially crude oil, can widen the CAD, these pressures have generally remained manageable.

The capital account is more complex. Portfolio flows can reverse rapidly in response to external developments unrelated to domestic fundamentals. Changes in US monetary policy, geopolitical conflicts, financial-market stress, or global risk aversion can trigger large-scale capital movements.

International cross-country experience demonstrates that many external crises emerge not from excessive current account deficits, but also because of sudden stops or reversals in capital flows. Consequently, close monitoring of the composition, maturity profile, and stability of capital inflows is essential. From an external-sector risk perspective, instability in capital flows warrants greater attention than the current account deficit.

Remittances: The Silent Stabiliser

India has consistently ranked among the world's largest recipients of remittances. The Indian diaspora is spread across North America, Europe, the Gulf region, Australia and Southeast Asia (Sahoo, et al, 2012; Jayaram, et al, 2004; Hegde, et al, 2018). Unlike portfolio flows, remittances are remarkably resilient during periods of financial turbulence and provide a reliable source of foreign exchange. Remittance inflow of \$110.47 billion in FY 26 is a natural shock absorber and a key differentiator.

Reserve Adequacy: Are India's Reserves Sufficient?

Foreign-exchange reserves remain India's most visible line of defence against external shocks. Reserve adequacy can be evaluated through several metrics:

Import Cover

India's reserves currently cover roughly eleven months of imports. The traditional benchmark is three months. India, therefore, comfortably exceeds conventional standards.

External Debt Coverage

High coverage, i.e., the ratio of reserves to total external debt, implies greater ability to meet external obligations during periods of market stress.

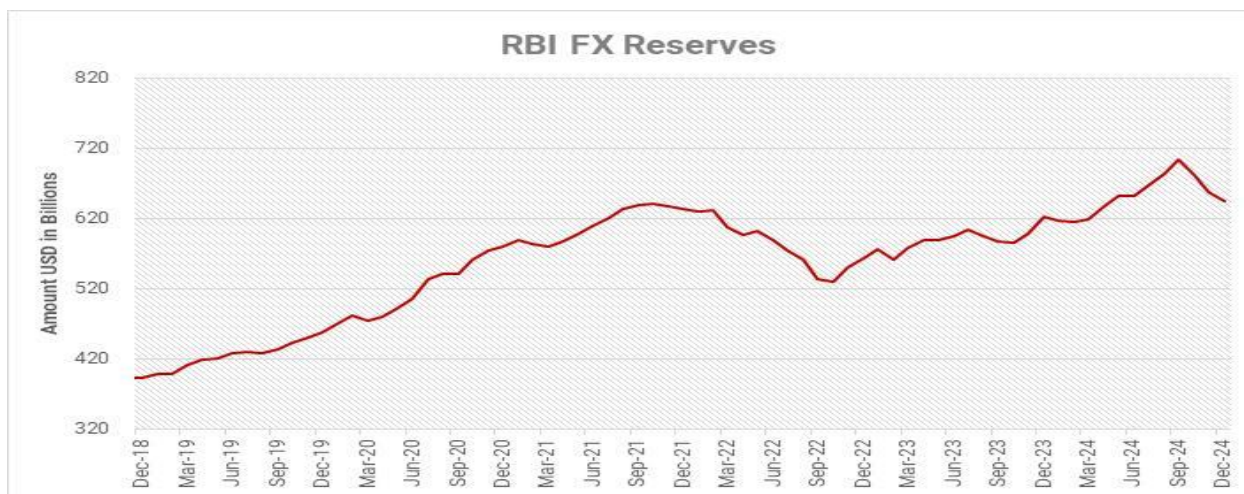
Guidotti-Greenspan Rule

This rule suggests that countries should maintain reserves sufficient to cover all short-term external debt falling due within one year. India currently remains well-positioned under this benchmark. Nevertheless, reserve adequacy should not create complacency. Reserve accumulation is necessary but not sufficient. The best protection against external crises remains sustained foreign-exchange earning capacity.

If Capital Inflows Weaken, Where Would Pressure Manifest First?

Should capital inflows weaken significantly, the pressure would likely emerge first in the foreign exchange market. Reduced capital inflows lower the supply of foreign currency, exerting downward pressure on the rupee. While moderate depreciation can help improve export competitiveness, sharp or disorderly movements can increase imported inflation, raise external financing costs, and affect investor confidence.

Subsequently, foreign exchange reserves would be hit, requiring the RBI's intervention to smooth excessive currency volatility, drawing upon reserve buffers. India's forex reserves at \$682.32 billion as on May 29, 2026 (constituting about eleven months of imports) are substantial by historical standards. But prolonged intervention could gradually erode these cushions, leading to a tightening of domestic liquidity conditions as foreign capital availability declines. Higher bond yields, increased financing costs, and tighter credit conditions may then hamper investment and growth prospects.



Therefore, the stress would transmit sequentially: decelerating capital flows would lead to rupee depreciation, prompting reserve drawdowns. That, in turn, would tighten liquidity, raise borrowing costs, and moderate growth. This vicious cycle would cause extensive concern, if not consternation, wouldn't it? India's sizeable reserve stockpile significantly slows this transmission mechanism, but exchange-rate volatility remains the most immediate manifestation of external stress.

India's Greatest Buffer and Key Vulnerability

Unlike portfolio flows, services exports are driven by long-term competitiveness, global outsourcing trends, technological capabilities, and accumulated human capital. Remittance inflows constitute a second important stabilising force. Foreign exchange reserves represent the third and most visible line of defence. They provide the capacity to smooth exchange-rate volatility, meet external payment obligations, and reassure financial markets regarding India's ability to withstand shocks.

Paradoxically, however, reserves are also most exposed during severe global financial turbulence. Their effectiveness depends on the scale and duration of external pressures. Reserves can absorb shocks, but they cannot permanently offset persistent capital outflows. Consequently, India must strengthen its structural foreign-exchange earning capacity through services exports, remittances, export diversification, and sustained productivity growth, rather than rely solely on reserve accumulation.

Key Indicators of External Financing Stress - The Form and Substance

Given the complexity of multi-layered issues at work, policymakers need to track a broad set of indicators, not a single metric. Red flags include portfolio outflows and sustained withdrawals by foreign investors; rapid rupee depreciation and volatility; reserve depletion from prolonged intervention; widening current account deficits, especially due to oil imports; slowing FDI inflows; rising external debt, particularly short-term debt relative to reserves; increasing debt-service burdens; weakening import-cover ratios; higher sovereign

and corporate external borrowing costs; and persistent gaps between domestic and global interest rates that may trigger capital outflows. While no single threshold automatically signals crisis conditions, policymakers should be increasingly concerned if rapid currency depreciation, sustained reserve losses, widening CADs, and significant portfolio outflows occur simultaneously. External-sector crises rarely emerge suddenly; a gradual deterioration across multiple indicators usually precedes them, as Nobel Laureate Ernest Hemingway wrote (“*Two ways. Gradually, then suddenly*”) in his novel *The Sun Also Rises*, a point that resonates deeply with the dynamics of global change.

Manufacturing and Export Competitiveness

India’s manufacturing export performance remains structurally weaker than that of the East Asian economies, and closing this gap requires undivided attention to cost, quality, scale, and deep global value chain (GVC) integration. A stronger manufacturing export base would not only diversify foreign-exchange earnings but also reduce macro-external vulnerability by broadening the range of competitive sectors and markets.

Structural Gaps Versus East Asia

While China, Vietnam, South Korea and Taiwan leveraged export-oriented industrialisation and early, aggressive integration into GVCs, India’s export base is still relatively concentrated in a few products and markets. East Asia systematically used SEZs, trade agreements, and FDI-driven assembly platforms to build dense manufacturing ecosystems; India’s integration into such production networks remains partial and uneven across sectors.

India’s manufacturing competitiveness is hampered by lower labour productivity, higher input and material costs, and relatively modest technology intensity compared with regional peers. In addition, a large MSME segment with limited access to scale, technology and formal finance constrains the transition from low-value to higher-value, export-oriented production.

Key Cost and Logistics Constraints

Historically, India has suffered from high logistics costs owing to fragmented transport modes, infrastructure gaps and procedural bottlenecks across ports, customs and hinterland connectivity. Recent data suggesting logistics costs declining to below 8 per cent of GDP highlights progress from initiatives like PM GatiShakti and dedicated freight corridors, but the cost gap with best-in-class East Asian hubs persists.

For firms, high freight costs, longer turnaround times and unreliable last-mile connectivity erode price competitiveness and narrow the universe of products that can be exported profitably at scale. Addressing these constraints requires not only hard infrastructure (ports,

rail, warehousing, multimodal parks) but also soft infrastructure such as digital tracking, simplified documentation and efficient dispute resolution in logistics contracts.

Regulatory and Factor-Market Rigidities

Complex regulations, overlapping compliances and a still-cumbersome business environment deter investment in large-scale, export-oriented manufacturing. Land market rigidities and opaque acquisition processes raise entry barriers for greenfield projects and discourage the development of large industrial clusters with integrated logistics and utilities.

Rigid and fragmented labour regulations, especially at the state level, have historically discouraged firms from expanding formal employment beyond certain thresholds, limiting scale and mechanisation. Streamlining land acquisition, clarifying titles, and modernising labour laws to balance flexibility with worker protection are central to creating globally competitive manufacturing platforms.

Skill, Technology and Innovation Deficits

India's skills ecosystem is still not fully aligned with the demands of modern, high-precision manufacturing that characterises advanced segments of GVCs. Skill gaps in areas such as advanced machining, electronics assembly, quality control, data-driven process management and industrial design reduce the ability of firms to climb the value chain.

Underinvestment in R&D and innovation relative to East Asian competitors limits both product differentiation and quality upgrading, making it harder to compete beyond price. Raising R&D intensity, fostering industry–academia collaboration, and embedding design, testing and standards capabilities within clusters are critical to shift from low-value assembly to higher-value manufacturing niches.

Role and limits of PLI schemes

In a series of industry analyses, macroeconomic publications, my speeches and interactions with the print and electronic media, I have repeatedly demonstrated that the Production Linked Incentive (PLI) schemes, now spanning 14 strategic sectors, are an important attempt to nudge firms towards scale, formalisation and export orientation by offering 4–6 per cent incentives on incremental sales of domestically manufactured goods. They seek to attract both domestic and foreign investment, reduce import dependence, and catalyse capacity build-out in electronics, pharmaceuticals, automobiles, textiles and other priority sectors.

Early evidence suggests PLI has helped anchor new investments, create jobs and improve the export potential of select sectors, particularly electronics and mobile manufacturing.

However, its long-term impact on overall export competitiveness will depend on whether it triggers durable ecosystem development—supplier deepening, skill formation, innovation and cluster-level infrastructure—rather than remaining a time-bound fiscal support.

Integrating into global value chains

Deeper Global Value Chain (GVC) integration demands more than incentive schemes; it requires consistent, predictable trade policy and open, rules-based engagement with major markets and Free Trade Agreements (FTAs). India will need to reduce policy volatility, address inverted duty structures and use trade agreements to secure preferential access while also ensuring that domestic firms can withstand import competition through productivity gains.

To move up the value chain, India must invest in export-quality infrastructure, viz., testing labs, certification bodies, standards harmonisation, and digital trade facilitation, to meet stringent global norms. Strategically positioning itself in sunrise GVC segments, such as electronics components, electric vehicle (EV) and battery value chains, specialty chemicals, and medical devices, can generate learning effects and spillovers across the wider manufacturing base.

Policy Priorities for Long-term Competitiveness

Beyond PLI, a coherent long-term strategy to strengthen manufacturing and export competitiveness would emphasise:

- Reducing economy-wide logistics costs further through integrated transport planning, digitalisation and competition in logistics services.
- Deep regulatory simplification with time-bound approvals, stable policy signals and risk-based, faceless compliance regimes.
- Factor market reforms in land and labour, including transparent land-use policies and flexible labour contracts with robust social protection.
- Large-scale skill development aligned to industry needs, with modular, industry-certified programmes for advanced manufacturing and services.
- Higher R&D spending, innovation incentives and strong IP protection to support quality upgrading and technology-intensive exports.

If executed well, such reforms, combined with targeted industrial policies like PLI, can gradually transform India into a more competitive manufacturing exporter, widen its foreign-exchange base, and materially reduce its vulnerability to external shocks in the medium to long term.

current account deficit and dependence on foreign capital. Between May and August 2013, the rupee depreciated sharply, touching record lows, while bond yields rose and equity markets were significantly volatile. The episode underscored how quickly external financing conditions can change when global investors reassess risk.

The most recent example occurred during the post-pandemic monetary tightening cycle of 2022-24. Following the surge in global inflation after COVID-19 and the Russia-Ukraine conflict, the Federal Reserve implemented one of the fastest interest-rate hiking cycles in decades. Higher US yields attracted capital back to American financial markets, leading to substantial portfolio outflows from many emerging economies. India also experienced episodes of FPI withdrawals, exchange-rate pressures, and heightened market volatility. Although India's macroeconomic fundamentals were stronger than during previous episodes, the experience brought to the fore the continuing influence of global financial conditions on domestic financial markets.

The composition of capital flows matters because not all foreign capital is equally stable. FDI is generally the most dependable source of external financing, as it is tied to long-term productive investment. However, FDI itself varies in quality. Real FDI (RFDI) comes from multinational firms that bring technology, brands, and production capabilities. Financial investors, viz., private equity, venture capital, and asset management funds, primarily seek capital gains and eventual exits. Diaspora investments and special purpose vehicles (SPVs) channel overseas capital through offshore centres and may sometimes involve the round-tripping of domestic funds.

Portfolio flows into equity and debt markets, by contrast, can be highly volatile and sensitive to changes in global interest rates, geopolitical risks, and investor sentiment. Consequently, a country may appear externally comfortable during periods of strong inflows but face sudden financing pressures when global conditions change.

India's growing integration with global financial markets has increased both opportunities and vulnerabilities. Greater access to foreign capital has supported infrastructure development, technological upgrading, startup financing, and corporate expansion. India has also benefited from inclusion in major global bond and equity indices, which have broadened the investor base and improved market liquidity. Yet greater integration also means that external shocks can be transmitted more rapidly into domestic financial markets.

A key concern is the possibility of a “*sudden stop*” in capital inflows. Such episodes occur when foreign investors abruptly reduce their exposure to emerging markets in response to global shocks rather than country-specific weaknesses. A sudden stop can trigger currency depreciation, higher borrowing costs, declining asset prices, and pressure on foreign

exchange reserves. Countries with large external financing requirements are particularly vulnerable. Although India's external position is stronger than in the past, policymakers must monitor these risks.

To manage the challenges posed by the global financial cycle, India has adopted a multi-layered strategy. First, the country has accumulated substantial foreign exchange reserves, which serve as a buffer against external shocks and help maintain confidence during periods of capital outflows. India's reserves have generally remained among the largest in the world, providing the RBI with significant intervention capacity.

Second, the RBI has developed considerable credibility in conducting monetary policy and managing exchange-rate volatility. While the rupee is allowed to adjust to market conditions, excessive volatility is often moderated through foreign exchange market interventions. This approach helps reduce the risk of destabilising currency movements without attempting to maintain a fixed exchange rate.

Third, maintaining fiscal discipline remains essential. Countries with large fiscal deficits are often perceived as riskier during periods of global financial stress because investors worry about macroeconomic stability. Sustainable public finances strengthen investor confidence and reduce vulnerability to external shocks.

Fourth, India has sought to deepen domestic financial markets. A broader and more diversified domestic investor base, including banks, insurance companies, pension funds, mutual funds, and retail investors, can reduce dependence on foreign capital. The increasing participation of domestic institutional investors in Indian equity and bond markets has helped cushion the impact of foreign portfolio outflows in recent years.

Fifth, policymakers are increasingly emphasising the quality rather than merely the quantity of capital inflows. Encouraging stable FDI, long-term infrastructure financing, sovereign wealth fund participation, and strategic investments can reduce reliance on volatile portfolio flows. Improved ease of doing business, strengthened regulatory frameworks, and enhanced investor protection are important.

India's external sector will continue to operate in an environment shaped by global financial cycles, geopolitical uncertainty, technological change, and evolving patterns of international capital movement. The rise of geoeconomic fragmentation, growing public debt in advanced economies, shifts in global supply chains, and increasing climate-related financial risks could further complicate the dynamics of capital flow (Jorion, 2009). Consequently, external sector management can no longer focus solely on trade balances or current account deficits; it must also account for the behaviour of global financial markets and cross-border capital flows (Rayoo, 2004).

Climate Change and External Vulnerability

An emerging dimension of external vulnerability is climate risk. Extreme weather events can affect agricultural exports, food inflation, rural incomes, energy demand, and insurance costs. Climate-related trade measures, including carbon border adjustment mechanisms in advanced economies, may also affect India's export competitiveness. External-sector strategy increasingly needs to incorporate sustainability considerations. Green exports, renewable-energy manufacturing and climate-resilient infrastructure are becoming economic imperatives rather than environmental luxuries.

Echoes of the 1991 Balance-of-Payments Crisis?

Comparing India's current external position with the 1991 balance-of-payments crisis is odious. In 1991, India faced a compelling external financing emergency characterised by precariously low foreign exchange reserves, weak export competitiveness, large fiscal imbalances, limited access to international capital markets, and a narrow foreign-exchange-earning base. Reserves had fallen to levels sufficient for only a few weeks of imports, forcing India to seek emergency external assistance and pledge gold as collateral.

India is, however, not immune to external shocks. Rising oil prices, geopolitical tensions, and sudden shifts in global capital flows continue to pose risks. However, the major vulnerability is not external insolvency but financial volatility. Episodes such as the global financial crisis of 2008, the taper tantrum of 2013, and the post-pandemic tightening cycle revealed that even economies with strong fundamentals can experience capital outflows, currency pressure, and financial-market turbulence when global conditions deteriorate.

The policy challenge, therefore, is not crisis management but risk management, necessitating prudent macroeconomic policies, adequate reserve buffers, diversified export earnings, stable long-term capital inflows, deeper domestic financial markets, and reduced dependence on imported energy. Sustained institutional credibility and investor confidence are also important. India possesses substantial foreign exchange reserves, a diversified export basket, a globally competitive services sector, strong remittance inflows, deeper financial markets, a flexible exchange-rate regime, and significantly stronger macroeconomic institutions. External debt remains manageable, while reserve adequacy indicators are far stronger than those prevailing in the early 1990s.

Where Do We Go Now?

India's external sector today is fundamentally different from the fragile economy of 1991. This thesis is borne out by large foreign-exchange reserves, a globally competitive services sector, strong remittance inflows, a relatively manageable external debt profile, and more sophisticated policy institutions, all of which provide substantial protection against external shocks and reinforce the basic message of hope and renewal. Yet resilience should not be

confused with invulnerability. The principal risks stem from volatile capital flows, energy dependence, geopolitical instability, and an increasingly fragmented global economy. However, external vulnerability should not be assessed through isolated prisms or alarmist comparisons with past crises. The challenge is not merely to accumulate reserves but to strengthen the underlying capacity to earn foreign exchange through diversified exports, technological upgrading, manufacturing competitiveness, and sustained productivity growth. This too shall pass! As Faiz Ahmed Faiz wrote powerfully,

“दिल न-उम्मीद तो नहीं, नाकाम ही तो है

लम्बी है ग़म की शाम, मगर शाम ही तो है”

Translation: The heart has not lost hope; it has merely faced setbacks. The evening of sorrow may be long, but it is still only an evening; it will pass.

I have long held, perhaps not unjustifiably, that India’s external sector remains supported by a strong services trade surplus, steady remittance inflows, a manageable external debt profile, and substantial foreign exchange reserves. The greater vulnerability lies in volatile capital flows, particularly foreign portfolio investment, which are highly sensitive to global financial conditions. Policy should therefore focus on improving the quality and stability of external financing, deepening domestic financial markets, enhancing export competitiveness, and maintaining adequate reserve buffers. Strengthening trade integration with ASEAN and the European Union, strengthening incentives for setting up Global Capability Centers (GCCs), and deepening support for India’s start-up ecosystem can boost exports and facilitate greater participation in global value chains.

Production-linked incentive schemes should be expanded to labour-intensive sectors to support manufacturing growth and employment generation. Reducing dependence on imported energy is equally critical for external stability. Bringing petroleum products and electricity under the GST framework could improve efficiency and lower costs. India must also deepen its corporate bond market and strengthen domestic sources of long-term capital to reduce reliance on volatile portfolio flows. These reforms would cumulatively enhance external sector resilience, improve the economy’s capacity to absorb global shocks, and ensure greater stability amid future economic and geopolitical uncertainties.

Dr. C. Rangarajan succinctly summed up the underlying issues at work and placed the whole thing in a proper historical and comparative perspective, when he stressed, “*We need to increase the competitiveness of our exports, which requires among other things an efficient and well-knit infrastructure. We should not underestimate the importance of domestic price stability as a contributing factor to prevent a rise in the REER. The surpluses on the services sector will also need nurturing. Hard work is needed to maintain our leadership in information technology. A significant part of the invisibles comes from*

transfers, which will also depend upon the state of the world economy. We have so far managed our BOP well. However, we need to be conscious of our vulnerabilities in relation to imports and exports and this will require advanced action. There is no doubt that a well-managed external sector can be an important driving force of economic growth” (Rangarajan, 2018).

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