Indian Economy · GS - III

Explain how differences in monetary policy and interest rates among major economies influence exchange rates and international capital flows. Discuss the implications for India.

EXAM YEAR	PAPER	SUBJECT
DAILY PRACTICE 20/10/2026	GS - III	Indian Economy

MARKS	WORD LIMIT
10	~150 words

Answer Hint

Interest-rate differentials, central banks, capital flows, currency depreciation, exchange-rate volatility, inflation, exports and imports, foreign exchange reserves, Reserve Bank of India.

Model Answer

Introduction

Exchange rates are influenced by economic fundamentals, investor expectations and monetary policy. Differences in interest rates among major economies can affect the movement of international capital and the relative value of currencies.

Impact of Monetary Policy

When a central bank raises interest rates relative to other economies, its currency may attract capital seeking higher returns. Conversely, expectations of lower interest rates can weaken a currency, although global risk sentiment and other factors also matter.

Currency depreciation may support exports by making them cheaper for foreign buyers, but it can increase the domestic cost of imported oil, machinery and other goods. Currency appreciation may reduce import costs while affecting export competitiveness.

Implications for India

Changes in major currencies and global interest rates can influence foreign portfolio investment, the rupee’s exchange rate, imported inflation and external-sector stability.

Way Forward

The Reserve Bank of India should monitor currency-market volatility, maintain adequate foreign exchange reserves and pursue monetary policy consistent with domestic economic conditions. India should also strengthen export competitiveness and reduce excessive dependence on critical imports.

Conclusion

Global monetary policy spillovers create both opportunities and risks. Macroeconomic stability, resilient external finances and prudent policy coordination can help India manage exchange-rate volatility.

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