

India's External Sector Under Stress: Oil Prices, Capital Outflows and Reforms Needed

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India's external sector is witnessing increasing stress due to rising oil prices, geopolitical instability, and volatile foreign capital flows. In 2026, Foreign Portfolio Investors have withdrawn more than ₹2 lakh crore from Indian markets, while the West Asian crisis threatens to push India's Current Account Deficit close to 2% of Gross Domestic Product. At the same time, global capital flows are becoming increasingly fragmented and geopolitical in nature.

What is Capital Outflow?

Capital outflow refers to the movement of financial assets and investments from one country to another. It takes place when foreign investors withdraw investments from domestic markets or when domestic firms and individuals invest heavily abroad. Capital outflows mainly occur through:

- withdrawal of **Foreign Portfolio Investments**,
- overseas expansion of domestic firms,
- repayment of external debt,
- withdrawal of deposits by foreign investors and Non-Resident Indians,

- and panic-driven capital flight during periods of uncertainty.

In emerging economies like India, large capital outflows can weaken the currency, increase inflationary pressures, reduce market confidence and destabilise the **Balance of Payments** position.

Why is India's External Sector Under Stress?

A combination of global uncertainties and domestic structural challenges has increased pressure on India's external sector in recent years.

Rising Oil Prices and Energy Vulnerability

The ongoing conflict in West Asia has increased fears of supply disruptions and rising crude oil prices. **India imports nearly 85% of its crude oil requirement**, making it **highly vulnerable to global energy shocks**.

- The prolonged disruption around the **Strait of Hormuz** has pushed global crude prices close to 120 dollars per barrel.
- Higher oil prices increase India's import bill and widen the **Current Account Deficit**.
- They also create inflationary pressures by increasing transportation and production costs across sectors.
- Rising energy costs eventually weaken domestic demand and reduce industrial profitability.

Foreign Portfolio Investment Outflows

India has witnessed significant Foreign Portfolio Investment outflows in 2026 as global investors increasingly shift towards developed markets.

- High interest rates in the United States and Europe have reduced the attractiveness of emerging market assets.
- United States Treasury yields continue to remain above 4%, narrowing the interest-rate differential between India and advanced economies. As a result, risk-averse global capital is moving back towards safer developed markets.
- Domestic taxation policies have also contributed to investor concerns. Long-term capital gains are taxed at 12.5%, while short-term gains are taxed at 20%. The removal of indexation benefits has further reduced post-tax returns for foreign investors.
- Consequently, **foreign ownership in Indian equities declined to a 14-year low of nearly 16% in March 2026, reflecting weakening investor confidence.**

Structural Shift in Global Capital Flows

Earlier, foreign investors mainly focused on market size, cheap labour, and higher returns. However, investment decisions are now increasingly influenced by geopolitics, strategic alliances, and industrial policies.

- Developed economies such as the United States and European countries are offering large subsidies and incentives to attract industries and supply chains back to their own regions. As a result, global capital is increasingly moving towards advanced economies.

- According to the **United Nations Conference on Trade and Development**, global **Foreign Direct Investment** increased by 14% to nearly 1.6 trillion dollars in 2025.
- However, **flows to developing economies declined by 2%, while developed economies witnessed a sharp rise of 43%.**

This shows that emerging economies like India are facing tougher competition in attracting stable long-term foreign investment.

Balance of Payments and Rupee Pressures

- **India's Balance of Payments position has weakened due to persistent trade deficits and volatile capital inflows.**
- Although remittances and service exports continue to provide support, **rising import bills and capital outflows have increased pressure on external stability.**
- The **Indian Rupee touched record lows against the United States Dollar in 2026** amid growing uncertainty in global markets. **Currency depreciation** further **increases imported inflation and raises the cost of external debt repayment.**
- India's foreign exchange reserves have also witnessed pressure due to interventions aimed at stabilising the rupee and managing volatility.

Regulatory and Policy Uncertainty

Global investors increasingly prefer economies with stable and predictable policy environments.

- In India, concerns regarding retrospective taxation, regulatory unpredictability and compliance burdens have affected investor sentiment.
- Stricter disclosure norms for **Foreign Portfolio Investors** and intensive compliance requirements in certain sectors have increased perceptions of policy uncertainty.

Implications of Rising Capital Outflows on India

The combined impact of rising oil prices and capital outflows is creating multiple macroeconomic challenges for the Indian economy.

Pressure on the Rupee and Imported Inflation

- **Persistent capital outflows weaken the rupee** as investors convert domestic assets into foreign currency.
- **Currency depreciation increases the cost of imports**, particularly crude oil, fertilizers, and industrial inputs.
- As imported inflation rises, the **Reserve Bank of India** may be forced to maintain **tighter monetary conditions, which can slow consumption and investment growth.**

Decline in Foreign Exchange Reserves

The Reserve Bank of India often uses **foreign exchange reserves** to reduce excessive volatility in the currency market.

- **Continuous intervention during periods of heavy outflows can gradually weaken external buffers.**
- **A decline in reserves reduces India's ability to manage future external shocks** and increases vulnerability to global financial instability.

Increase in Borrowing Costs

- Large capital outflows tighten liquidity conditions in financial markets and **increase government bond yields.**
- **India's benchmark 10-year government bond yield crossed 7% in 2026 amid inflation concerns and volatile capital flows.**
- Higher borrowing costs **increase the cost of credit for businesses and households.** This **affects private investment, industrial expansion and overall economic growth.**
- At the same time, liquidity pressures in the banking system can **weaken credit availability for productive sectors.**

Weakening of Private Investment and Employment

Reduced foreign investment weakens capital formation in sectors such as infrastructure, manufacturing, and technology.

- Many private firms postpone expansion plans during periods of uncertainty and expensive credit.
- Recent surveys indicate a decline in planned private capital expenditure by major Indian firms. This slowdown may adversely affect job creation, manufacturing growth, and integration into global value chains.
- The technology startup ecosystem has also witnessed funding pressures, leading to hiring slowdowns and cost rationalisation.

Fiscal Pressures and Subsidy Burden

Rising oil prices and imported inflation increase pressure on government finances.

- To protect vulnerable sections, the government may be forced to expand subsidies on fertilizers, fuel, and food.
- This creates a difficult policy trade-off between welfare spending and productive capital expenditure on infrastructure and development projects.

Reforms Needed to Strengthen India's External Sector

To manage rising external sector pressures and restore investor confidence, India needs reforms at three levels — **short-term stabilisation, improving competitiveness and long-term structural reforms.**

Short-Term Stabilisation Measures

India needs immediate measures to reduce pressure on capital flows and the Balance of Payments position.

- India can consider **reducing the tax burden on foreign investors**. A more investor-friendly capital gains tax system can encourage Foreign Portfolio Investors to stay invested in Indian markets.
- Instead of relying heavily on **Foreign Currency Non-Resident (FCNR) bonds**, India should focus on improving investor confidence through stable policies and tax reforms. FCNR bonds should remain only an emergency tool.
- Efforts must be made to **reduce imports of oil and gold**, as both increase pressure on the Current Account Deficit. Gradual fuel price adjustments and subsidy reforms, especially in fertilizers, can help reduce external and fiscal pressures.
- India can further **liberalise Foreign Direct Investment rules** by allowing more sectors under the automatic approval route and simplifying investment procedures.
- **Faster approvals for foreign investments**, especially in sectors such as electronics and advanced manufacturing, can improve India's attractiveness as a global investment destination.

Improving Competitiveness

Along with stabilisation, India must improve its domestic competitiveness to attract long-term investments and strengthen exports.

- Faster **infrastructure development** in roads, ports, logistics and industrial corridors can reduce production and transport costs, making Indian exports more competitive.
- **Labour reforms** must be implemented effectively across states to support labour-intensive sectors such as textiles, food processing and electronics manufacturing.
- **Increasing labour force participation and supporting agro-processing industries** can create employment opportunities and strengthen India's position in global value chains.
- **Judicial reforms** such as fast-track commercial courts and technology-based case management systems can reduce delays in dispute resolution and improve investor confidence.
- **Improving the national single-window clearance system** can simplify business approvals and reduce bureaucratic hurdles.

Long-Term Structural Reforms

For long-term external sector stability, India needs deeper structural reforms aimed at improving exports and reducing dependence on volatile foreign capital.

- India should **strengthen trade integration with regions such as ASEAN and the European Union** to improve export growth and integration into global value chains.
- **Production Linked Incentive schemes can be expanded** to labour-intensive sectors to increase manufacturing and employment generation.
- **Reducing dependence on imported energy** is essential for external sector stability. Bringing petroleum products and electricity under the **Goods and Services Tax** framework can improve efficiency and reduce

costs.

- India must also **deepen its corporate bond market and strengthen domestic sources of long-term capital** to reduce excessive dependence on volatile Foreign Portfolio Investment flows.

Together, these reforms can strengthen India's external sector resilience and improve the economy's ability to manage future global shocks.

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