Journal DOI: 10.36713/epra1013 | SJIF Impact Factor (2025): 8.619 ISSN: 2347-4378
EPRA International Journal of Economics, Business and Management Studies (EBMS)
Volume: 12 | Issue: 10 | October 2025 -Peer-Reviewed Journal

THE RELATIONSHIP BETWEEN FOREIGN DIRECT INVESTMENT (FDI) AND EXCHANGE RATE IN INDIA (1991–2021): A LONG-TERM ANALYSIS

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ABSTRACT

Since India's Liberalisation in 1991, Foreign Direct Investment (FDI) has become a key driver of growth, impacting industrial expansion, jobs, and technological progress.

At the same time, changes in the Exchange Rate have significantly affected how attractive India is for investment.

This study looks at the long-term link between FDI inflows and the Exchange Rate in India over thirty years (1991-2021).

The research aims to see if changes in the Exchange Rate notably influence FDI inflows. It also examines whether increasing FDI levels affect exchange rate shifts through their influence on the balance of payments, capital account, and overall economic stability.

The study uses Correlation and Regression analysis to explore the strength, direction, and significance of the relationship between these two important economic factors.

Data on FDI inflows comes from official sources like the Reserve Bank of India (RBI), Economic Survey, and Database on Indian Economy (DBIE).

Exchange Rate data is sourced from the Foreign Exchange Dealer's Association of India (FEDAI), the RBI and the World Bank.

Initial analysis shows a dynamic and bidirectional relationship. Exchange rate depreciation may encourage FDI inflows by making local assets cheaper for foreign investors. Meanwhile, consistent FDI inflows can help stabilize or even raise the exchange rate over time.

This study enhances our understanding of how economic and policy elements interact and shape foreign investment trends in a developing country like India. The findings also offer useful insights for policymakers working on strategies to promote exchange rate stability and sustainable FDI growth.

KEYWORDS: *Foreign Direct Investment (FDI), Exchange Rate, Economic Liberalization, Capital Flows, Monetary Stability.*

INTRODUCTION

1.1 Background of the Study

Parameters like Foreign Direct Investment (FDI) wield a fundamental influence on the growth of a developing economy especially in emerging markets. FDI has become the main external funding source that complements domestic savings and stimulates industrial growth. Corporations entering the local market through FDI are vehicles of new technologies, faster creation of job opportunities, skill development and help upgrade the overall economic friendliness of their host countries to compete at a global level. The importance of FDI to a developing country like India is far beyond just cash inflow; it also serves as a device for local modernization and opening into the global economic system.

The economic reforms of 1991 were a turning point in structure of the Indian economy, the trio of Liberalization, Privatization, and Globalization policies did away with the heavy restrictions on trade and investment that affected almost all the sectors. This change attracted foreign investors to enter many sectors. India has since transitioned from a relatively closed economy to one of the major global sources of FDI. The FDI inflow has been the primary driver of the industrial revolutions like the manufacturing, telecommunications, financial services, and information technology sectors. However, while FDI has broadly gone up since the early 1990s, the trend has been somewhat irregular. Among various macroeconomic factors that substantially influence FDI movements is Exchange Rate.

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1.2 Conceptual Framework: FDI and Exchange Rate

The Exchange Rate is the value at which a country's currency can be traded for another and this functions as a price signal in international trade.

Long-term investments are more likely to be made under a stable exchange rate as this assures a less volatile environment. On the other hand, a high level of volatility increases risk and thus raises the likelihood that foreign investors will withdraw their capital. Generally, the depreciation of the domestic currency could make local assets cheaper and thus attract more FDI. Still, the uncertainty about the future earnings due to fluctuations will nullify the benefit provided by the devaluation. Hence, the connection between exchange rate volatility and foreign direct investment is non-trivial and heavily dependent on the particular situation, thus requiring empirical investigation.

1.3 Exchange Rate Regime in India

The Exchange Rate in India has undergone a series of reforms since the early 1990s. Coming into the reform, India was operating a Fixed exchange rate system, which pegged the Indian rupee to a basket of major currencies. Although this method limited the fluctuation of the Exchange Rate, it also limited the flexibility of monetary policy and the country's competitiveness.

India moved towards a market-driven exchange rate system in 1993 that was consistent with the Liberalization program. Due to this change, the rupee became open to global demand and supply forces which gave it more flexibility but at the same time, it became more vulnerable to volatility. Because of this, the rupee value has been affected by both internal and external factors such as trade deficits, capital flows, global interest rates, and geopolitical events.

1.4 Importance of the Study

Knowing how FDI inflows and Exchange Rate fluctuations link is really important for decision-makers and economists. One of the determining factors for capital movement in a globalized world is not only growth potential but also macroeconomic stability. A fluctuating Exchange Rate can turn off investors by increasing their cost of hedging and lessening the competitiveness of local markets. Alternatively, a credible Exchange Rate can play a significant role in attracting regular FDI inflows which is beneficial in the long run.

This study is a good source for guiding monetary, fiscal and trade policies to go hand in hand in bringing Exchange Rate stability and thus attracting viable investments.

1.5 Scope

This work is concerned with the exploration of the long term relationship between FDI inflows and exchange rate volatility in India, spanning for a period of thirty years (1991-2021). This research uses quantitative methodologies like Pearson's Correlation and Linear Regression analysis to statistically evaluate the direction, strength, and significance of the relationship. The data on FDI is sourced from the Reserve Bank of India, Economic Survey, and Database on Indian Economy (DBIE), whereas the Exchange Rate data is obtained from the Foreign Exchange Dealer's Association of India (FEDAI), the RBI and the World Bank.

VARIABLES

I. FOREIGN DIRECT INVESTTMENT (FDI)

Dependent Variable

Foreign direct investment (FDI) simply refers to an ownership stake in a foreign company or project made by an investor, company, or government from another country.

FDI has been a key driver of India's economic growth since the 1991 Liberalization reforms. It brings financial resources, technology, and managerial expertise, fostering industrial growth, employment, and global integration. However, the inflow of FDI is also a result of the country's macroeconomic stability and to a large extent, the Exchange Rate. A slight depreciation of the rupee may attract FDI by making the domestic assets more affordable, while an excessive fluctuation of the currency increases the level of uncertainty and therefore, investors are discouraged.

II. EXCHANGE RATE

Independent Variable

Exchange Rate is a relative price of one currency expressed in terms of another currency (or group of currencies). The Exchange Rate, representing the value of the Indian rupee against the US dollar, serves as a key determinant of external stability.

India has been experiencing both stable and volatile periods of Exchange Rate since it moved to a market-determined system in 1993, which has affected FDI inflows to the country. This dissertation emphasizes on the long-term association (1991–2021) between the inflow of FDI and the changes in the Exchange Rate in India.

HYPOTHESIS

NULL HYPOTHESIS (H_0):

"There is no statistically significant relationship between Foreign Direct Investment (FDI) and the Exchange Rate in India."

This means that fluctuations in the Exchange Rate do not have a measurable impact on FDI inflows, implying that movements in the rupee's value do not significantly influence Foreign Investment decisions in India during the study period.

ALTERNATE HYPOTHESIS (H_1)

"There is a statistically significant relationship between Foreign Direct Investment (FDI) and the Exchange Rate in India."

This means that changes in the Exchange Rate do have a measurable impact on FDI inflows, implying that variations in the rupee's value significantly influence the level of Foreign Investment in India from 1991 to 2021.

REVIEW OF LITERATURE

1. Ali, S., Khan, M., & Farooq, R. (2024). Long- and short-term dynamics of FDI, exchange rate, and macroeconomic variables: Evidence from India. *MPRA Paper 122185.*
https://mpra.ub.uni-muenchen.de/122185/2/MPRA_paper_122185.pdf

This study investigates the complex Relationship between Foreign Direct Investment (FDI), Exchange Rates (LEXR), GDP per Capita (LGDPPC), Inflation (LINF), and Natural Resources (LNR). Understanding these dynamics is pivotal for formulating effective economic policies and enhancing economic sustainability. The primary objective is to analyse the long-term and short-term relationships among these variables and to identify their impacts on FDI. The study aims to address how each variable influences FDI and to assess the policy implications of these relationships.

2. Hussain, M., & Goswami, B. (2022). Sector Specific Determinants of Foreign Portfolio Investment Inflows in India: A Panel ARDL Approach. *Global Business Review.*
https://doi.org/10.1177/09721509221137204

This study investigates the factors influencing foreign portfolio investment (FPI) inflows across sectors in India from February 2012 to July 2020 using a panel ARDL (Autoregressive Distributed Lag) approach.. The study highlights that exchange rate dynamics play a critical role in foreign investment decisions across sectors in India, emphasizing the need for policies that promote a stable and conducive investment climate.

3. Singhania, M., & Gupta, A. (2011). Determinants of Foreign Direct Investment in India. *Journal of International Trade Law and Policy, 10*(1), 64–82.
https://doi.org/10.1108/14770021111116142

This study explores the macroeconomic determinants of FDI inflows in India. The analysis incorporates key variables such as GDP, inflation rate, interest rate, patents, money supply growth, and foreign trade to identify the factors most influencing FDI. The results indicate that GDP, inflation rate, and scientific research output are the most significant determinants of FDI inflows, while FDI policy reforms during 1995–1997 also had a major positive impact. The authors suggest that continued liberalization and stable macroeconomic management are crucial to attracting sustained FDI in India.

4. Sharma, N., & Bhatt, P. (2023). *Relationship Between FDI and India's Foreign Trade: A Cointegration and VECM Approach. International Journal for Multidisciplinary Research, 5*(4), 1–11.
https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4504665

This study investigates the long-term relationship between foreign direct investment (FDI) and India's foreign trade using the Johansen Cointegration and Vector Error Correction Model (VECM) techniques for the period leading up to 2023. The authors highlight the role of foreign capital inflows as a catalyst for technological transfer

and industrial development, emphasizing that globalization has deepened India's integration into the world economy. Empirical findings reveal a long-run cointegrating relationship between FDI inflows and export performance, indicating that FDI not only enhances export capacity but also fosters trade openness. The VECM results confirm that FDI acts as a significant driver of India's trade expansion while ensuring equilibrium adjustments in the short run. The study concludes that FDI serves as a bridge between domestic savings and investment needs, promoting bilateral trade and sustaining India's growth trajectory in the global economy.

5. Zakari, M. (2017). *The Impact of Exchange Rate Fluctuations on Foreign Direct Investment in Nigeria. Journal of Finance and Accounting, 5*(4), 1–12.
https://www.sciencepublishinggroup.com/article/10.11648/j.jfa.20170504.17

This study explores the relationship between exchange rate fluctuations and foreign direct investment (FDI), along with their joint impact on gross domestic product (GDP)**,** using Nigeria as a case study. Covering the period from 1990 to 2015, the research applies regression and correlation analysis to examine how changes in exchange rate influence the flow of FDI and economic growth. The findings reveal a strong positive correlation between exchange rate and FDI, suggesting that currency depreciation tends to attract foreign investors by lowering relative investment costs. The study concludes that exchange rate stability and liberalization are essential for sustaining FDI inflows and long-term economic development.

Although the research focuses on Nigeria, its implications resonate with the Indian context, where exchange rate volatility similarly affects foreign investment decisions. The study reinforces the broader argument that stable exchange rate regimes enhance investor confidence and can play a decisive role in driving sustainable foreign investment inflows into emerging economies.

METHADOLOGY

The research methodology refers to the systematic and scientific processes that are employed to explore and analyse the research problem. This research is about the long-term association between **Foreign Direct Investment (FDI) and the Exchange Rate** in India from the year 1991 to 2021. Here, the FDI inflows represent the dependent variable, and the Exchange Rate is the independent variable. The primary objective is to find out if the changes in the exchange rate have a considerable impact on the level of FDI inflows in India in the 30 years after the economic liberalization.

The data for both the variables is taken from official and trustworthy sources. The main sources are the Reserve Bank of India (RBI), Economic Survey, Database on Indian Economy (DBIE), and the World Bank databases. This research is based on secondary data collected over a period of thirty years to give a long-term perspective of the relationship between the Exchange Rate changes and FDI in India.

The clarification of the relationship between these variables has been obtained from a comprehensive review of the secondary data that includes research papers, economic journals, government reports, and international financial databases. These references, which are discussed in the literature review section, have been instrumental in the development of the theoretical framework and the formation of the hypothesis of the study.

SAMPLE SIZE: **31** Observations
TIME PERIOD: **1991 to 2021**
Among the statistical methods employed in this study are:

CORRELATION ANALYSIS

Correlation refers to a statistical tool which enables measurement of the extent to which two variables (Repo rate and Gini coefficient) are linearly related (implying that they change together at a constant rate). The sample correlation coefficient, *r*, quantifies the strength of the relationship ranging from -1 (negative correlation) to +1 (positive correlation) with 0 implying no correlation between the variables in focus. Correlations are also tested for statistical significance (*f*) or p-level which result in rejecting or accepting the null hypothesis implying if there is or is not a correlation between the concerned variables.

SIMPLE REGRESSION ANALYSIS

Simple linear regression is used to understand the relationship between two continuous variables. Usually, the objective is to predict the value of an output variable (response or dependent or Y variable) based on the value of an input (predictor or independent or X) variable. Regression tool can be used to determine which variables have a significant effect on the response or the dependent variable and what explains the variance in the dependent variable and to what extent can this variance be explained by the given independent variable.

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This approach makes it possible to assess how Exchange Rate Instability, during particular phases of the economy, for instance, the post-liberalization period, may have affected foreign investors' capital inflows in India. Although the study concentrates solely on the Exchange Rate and FDI, it is evident that other macroeconomic variables such as GDP growth, Inflation, and Trade Openness can have indirect effects on a country's economy.

DATA SOURCES

FOREIGN DIRECT INVESTMENT (DEPENDENT VARIABLE):

1. Reserve Bank of India (RBI)
2. Database on Indian Economy (DBIE).
3. Economic Survey

EXCHANGE RATE (INDEPENDEDENT VARIABLE):

1. Reserve Bank of India (RBI)
2. World Development Indicators (World Bank)
3. Foreign Exchange Dealer's Association of India (FEDAI)

RESEARCH QUESTIONS AND OBJECTIVES

RESEARCH QUESTIONS

1. Whether there is any correlation between the two variables, i.e., Foreign Direct Investment (FDI) inflows and the Exchange Rate in India?
2. Whether the independent variable, Exchange Rate, has a significant positive or negative long-term impact on the dependent variable, FDI inflows, in the Indian context?

RESEARCH OBJECTIVES

1. To examine the correlation between the exchange rate and FDI inflows in India during the period 1991–2021.
2. To assess whether fluctuations in the exchange rate have a long-term effect on enhancing or discouraging foreign direct investment in India.

DATA SET

YEAR	FDI INFLOWS (Y)	EXCHANGE RATE (X) (INR)
1991-92	$73.54M	24.4737
1992-93	$276.51M	30.6488
1993-94	$550.37M	31.3655
1994-95	$973.27M	31.3986
1995-96	$2.14B	33.4498
1996-97	$2.43B	35.4999
1997-98	$3.58B	37.1648
1998-99	$2.63B	42.0706
1999-2000	$2.17B	43.3327
2000-01	$3.58B	45.6844
2001-02	$5.13B	47.6919
2002-03	$5.21B	48.3953
2003-04	$3.68B	45.9516
2004-05	$5.43B	44.9315
2005-06	$7.27B	44.2735
2006-07	$20.03B	45.2495
2007-08	$25.23B	40.2607
2008-09	$43.41B	45.9933
2009-10	$35.58B	47.4433
2010-11	$27.40B	45.5626

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2011-12	$36.50B	47.9229
2012-13	$24.00B	54.4099
2013-14	$28.15B	60.5019
2014-15	$34.58B	61.1436
2015-16	$44.01B	65.4685
2016-17	$44.46B	67.072
2017-18	$39.97B	64.4549
2018-19	$42.12B	69.9229
2019-20	$50.61B	74.5321
2020-21	$64.36B	73.2256
2021-22	$44.73B	82.44

Table1.1

Source: ***World Bank***
Source: ***Reserve Bank of India (RBI Official Data)***

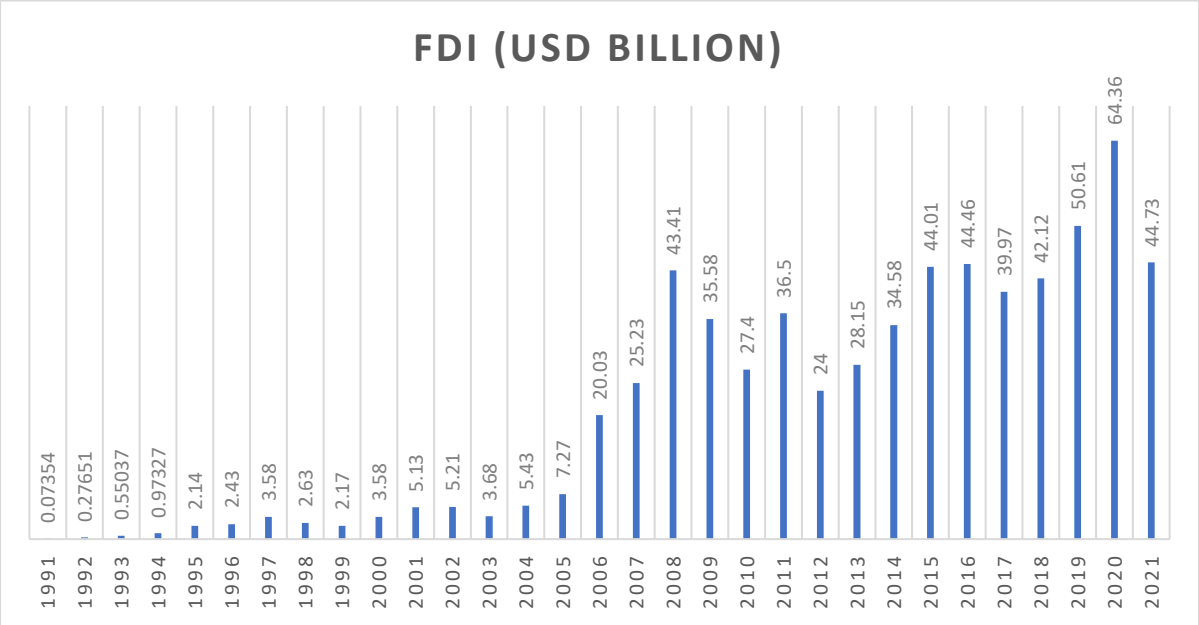


Figure 1.1

Source: ***Database on Indian Economy (DBIE)***

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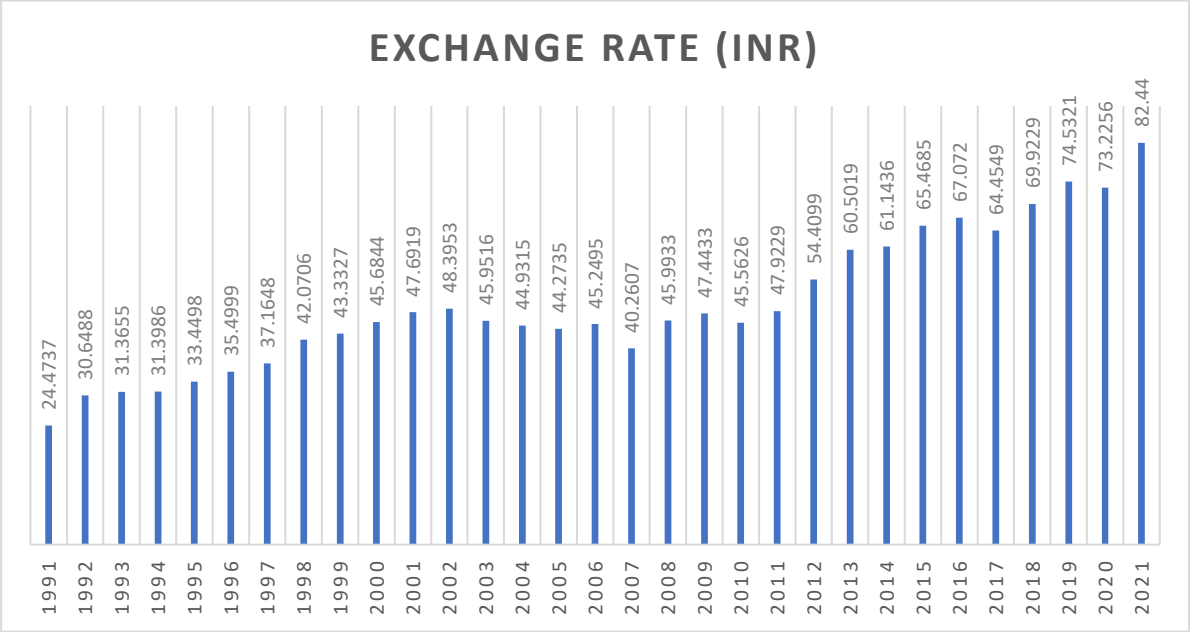


Figure 1.2

Source: ***Foreign Exchange Dealer's Association of India (FEDAI)***

CORRELATION TABLE AND ANALYSIS

	EXCHANGE RATE (X) (INR)	FDI (Y) (USD BILLION)
EXCHANGE RATE (X) (INR)	1	
FDI (Y) (USD BILLION)	0.837374173	1

Table 1.2

Source: ***Data Analysis-MS Excel***

CORRELATION ANALYSIS

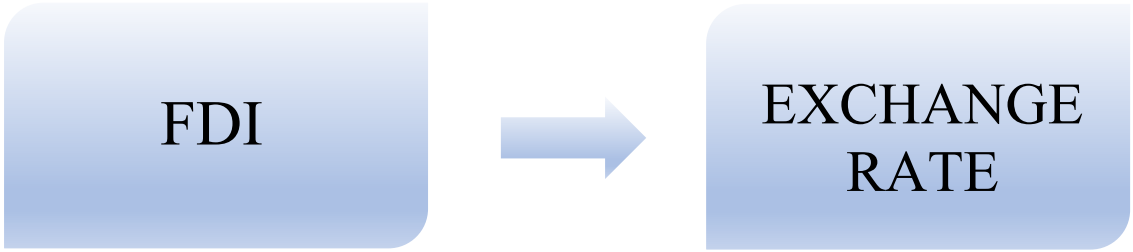
To examine and understand the relationship between the two variables in the study, a correlation analysis was conducted which helps analyse the strength and direction of linear relationship between any two variables.

The method of Pearson's Correlation coefficient was applied which resulted in a correlation coefficient value of 0.837374173 (***r* =0.837374173**)

The correlation coefficient of 0.83737417 indicates a **positive high degree correlation** between both variables. The correlation means that if the exchange rate (INR per USD) goes up, i.e., the Indian Rupee depreciates, then the FDI inflows into India increase.

Such a relationship implies that a decline in rupee makes Indian assets and industries relatively cheaper and more attractive to foreign investors, thus FDI inflows go up. Nevertheless, it is also an indication of investor confidence in India's long-term growth despite a short-term currency depreciation.

Consequently, the changes in the exchange rate have a considerable impact on the fluctuation of FDI inflows, thereby demonstrating that both variables co-move in the same direction over the long term.



POSITIVE HIGH DEGREE CORRELATION

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REGRESSION TABLE

SUMMARY OUTPUT

Regression Statistics	
Multiple R	0.837374173
R Square	0.701195506
Adjusted R Square	0.690891902
Standard Error	10.82999193
Observations	31

ANOVA

	df	*SS*	*MS*	*F*	*Significance F*
Regression	1	7981.899627	7981.899627	68.05342637	4.27958E-09
Residual	29	3401.373032	117.2887252		
Total	30	11383.27266			

	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*	*Lower 95.0%*	*Upper 95.0%*
Intercept	-34.58355742	7.010231041	-4.933297807	3.05333E-05	-48.92108975	-20.2460251	-48.92108975	-20.2460251
Exchange Rate	1.124298687	0.136287713	8.249450064	4.27958E-09	0.845559015	1.403038358	0.845559015	1.403038358

REGRESSION ANALYSIS

REGRESSION STATISTICS	
Multiple R	0.837374173
R Square	0.701195506
Adjusted R Square	0.690891902
Standard Error	10.82999193
Observations	31

Table 1.4

Source: ***Data Analysis-MS Excel***

Regression Analysis Interpretation:

The regression analysis provides us with the following information:

Multiple R – 0.8373

The is a measure of the correlation between the variables of the experiment, ranging from -1 to 1. The value 0.83 indicates a **high positive relationship** between the variables, i.e., Exchange Rate and FDI inflows in India.

R Square – 0.7011

The number here shows the changes in the Dependent variable (FDI inflows) that are due to the Independent variable (Exchange Rate). About 70.11% of the variation in FDI inflows can be explained by fluctuations in the exchange rate, suggesting that the model has a strong explanatory power.

Standard Error – 10.83

It measures the average distance that the observed values fall from the regression line. A smaller value like such indicates that the regression line is a closer fit to the data.

Significance F – $4.279*10^{-9}$

The F-statistic tests the overall significance of the regression model. Given that the Significance F value is much lower than 0.05, the model of regression is **significant statistically** and hence, it is quite safe to assert that the Exchange Rate has a **meaningful impact** on FDI inflows.

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Regression Coefficients:
Interception: -34.5836
Exchange Rate Coefficient: 1.1243

The simplest way of interpreting the Exchange Rate coefficient would be that every single time the Exchange Rate goes up by 1 unit, the FDI inflow would go up by 1.12 units approximately on average.

This tells us that these two variables are **directly related** to each other; as the rupee depreciates, foreign investors are encouraged to invest more in India due to favourable currency conditions.

p-value – 4.27958E-09
The p-value, which is considerably smaller than 0.05, leads us to conclusively **reject the Null Hypothesis** and decide that the Exchange Rate has a statistically significant positive effect on FDI inflows in India.
Thus, the **Alternate Hypothesis is accepted.**

CONCLUSION

This regression analysis strongly supports that the Exchange Rate significantly influenced FDI inflows in India during 1991–2021. The result shows that FDI increases when a currency is devalued as foreign investors would find Indian assets cheap and highly profitable. The Null Hypothesis, therefore, is rejected and the Alternate Hypothesis — that there is a **long-term relationship statistically significant between FDI and exchange rate** — is accepted.

THEREFORE, WE CAN CLEARLY CONCLUDE THAT THE EXCHANGE RATE HAS A **REAL, STATISTICALLY SIGNIFICANT** RELATIONSHIP WITH THE FDI INFLOWS WHICH CAN ALSO BE CORROBORATED BY **THE STRONG EVIDENCE (AT THE 95% CONFIDENCE LEVEL)** THAT CHANGES IN THE EXCHANGE RATE ARE ASSOCIATED WITH CHANGES IN THE FDI.

CONCLUSION

The current study looked at the long-term connection between Foreign Direct Investment (FDI) inflows and Exchange Rate changes in India from 1991 to 2021. The statistical findings from correlation and regression analyses show a strong and **significant positive link** between the Exchange Rate and FDI inflows in India. The results suggest that when the Indian rupee loses value against the U.S. dollar, FDI inflows tend to rise. This means that a weaker domestic currency makes Indian assets more appealing and affordable for foreign investors.

Furthermore, the long-term analysis highlights that India's liberalization policies since 1991, coupled with gradual Exchange Rate adjustments, have played a pivotal role in attracting sustained foreign investment. The flexibility of the rupee, managed within a market-determined Exchange Rate system, has allowed India to maintain competitiveness while ensuring investor confidence. However, excessive volatility can deter investors due to uncertainty in future returns. Hence, maintaining a balance between currency competitiveness and stability becomes essential for long-term investment growth.

Thus, we can conclude that stability in Exchange Rates and predictable currency movements are essential for maintaining and boosting FDI inflows in India. Policymakers should regard Exchange Rate management as a key part of the broader economic strategy to draw in long-term capital investments. The study emphasizes the need to keep a positive investment environment backed by stable economic fundamentals to ensure steady foreign investment and economic growth.

POLICY IMPLICATIONS

This research's outcomes provide great leverage to India for sustaining and elevating Foreign Direct Investments (FDI) inflows. The data exhibits a **significant positive correlation** between the variables Exchange Rate and FDI inflows. So, the maintenance of exchange rates at levels that count not only for India but also will be competitive for the global market is a task of great importance to the policy-makers. High volatility in exchange rates can create an uneasy feeling of insecurity among foreign investors which might affect their long-term investment decisions. Therefore, the Reserve Bank of India (RBI) and the Ministry of Finance should come together to chart out policy plans that will ensure a steady but adaptable exchange rate that is capable of responding to market conditions without unexpected changes.

Moreover, a policy that encourages a depreciating rupee can be one of the essentials in attracting the foreign investors since the losses in the local asset would turn cheaper and therefore more attractive to foreign investors. However, the policymakers are also required to ensure that there is a good balance between competitiveness and the prevention of the over-devaluation of the rupee. An excessive amount of devaluation can lead to such a situation wherein the country would suffer from inflation and economic instability. Establishing a **managed floating exchange rate system**, as well as being prepared to face targeted actions during periods of high volatility, can go a long way in solving this problem.

Improving the local environment for investments should be on the agenda of the government as well. Infrastructure that is up to date, transparent tax policies, and further liberalization of some sectors can help in turning investors into long-term partners. Moreover, the provision of **sector-specific incentives**, most especially in high-potential sectors such as technology, renewable energy, and the manufacturing industry, can facilitate the use of effective exchange rate movements to target foreign investment and create a pool of long-term FDI.

At last, it is highly necessary to keep a track on the prominent indicators of the external economy such as exchange rate trends, balance of payments, and capital inflows for the implementation of better policies. By consistent efforts, fiscal and monetary authorities are able to ensure that both exchange rate management and investment promotion strategies complement each other, fostering **macroeconomic stability and sustainable growth.**

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