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## India's Economic Problems aren't About Currency or Gold: It's About AI

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*India needs to build AI diffusion infrastructure, mobilise savings, and sustain demand. Harnessing gold savings for public investment, pairing supply-side AI initiatives with infrastructure spending, and switching from monetary to fiscal leadership can anchor the rupee in real productive capacity.*

The fundamental anxiety in India's current economic crisis is not gold, not oil, and not even the rupee. It is the fear that the global economy is reorganising around artificial intelligence (AI)-driven productivity and a surge in imported intellectual property, forces that directly threaten India's forex position, domestic competitiveness, and long-run growth. Currency markets are already pricing this risk.

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The fear is that India's dependence on foreign AI models, cloud AI services, and software licenses is rising rapidly, creating a structural foreign exchange outflow, even as the productivity gap between AI-integrating sectors and the rest of the economy widens. The turbulence in currency markets is merely the surface expression of this deeper shift: an economy becoming more reliant on imported AI capability while its domestic demand base struggles to keep pace.

The current depreciation of the rupee is best understood as currency markets pricing in the expectation that India's growth model will become increasingly dependent on imported AI intellectual property, while its domestic non-AI sector struggles to keep pace with the cost base set by AI-integrating firms. In effect, the falling rupee is the market's plain-speak about a structurally fragile economy and doubts about how this internally weak system can withstand the oncoming AI shock. This is an economy whose most dynamic sectors rely on foreign technology rents, and whose domestic sector must absorb the resulting cost pressures without matching productivity gains.

The currency is not merely reacting to short-term flows; it is pricing the long-term question of whether India can build the productive base needed to survive and shape the next technological wave.

This is the same dynamic that pushed many advanced economies into two-speed or dual-economy structures: the hyper-productive foreign enclave sets the national cost base, while the domestic sector, unable to match those productivity levels, adjusts by suppressing wages and chronically underinvesting to remain competitive.

In the developed country bloc, Ireland illustrates this risk. A decade-long, six-to-one productivity gap between the multinational sectors (such as information and communication technologies [ICT] and pharmaceuticals) and the domestic sector has driven up wages, rents, and input costs across the whole economy, leaving local businesses structurally disadvantaged. The domestic sector lacks the productivity to offset higher costs, so it struggles to remain viable amid wage compression and chronic underinvestment.

Countries in Southeast Asia, such as Malaysia, Thailand, and the Philippines, saw export-enclave electronics clusters pull far ahead of domestic services and small and medium enterprises (SMEs). Taiwan and Vietnam illustrate the same tension in different ways. Taiwan's world-leading semiconductor sector operates as a hyper-productive foreign-linked enclave, with productivity levels and capital intensity far beyond what domestic services and SMEs can match. The result is a persistent internal dualism between globally competitive fabs and a lagging domestic economy.

Vietnam's foreign direct investment (FDI)-driven electronics and assembly clusters have grown at an extraordinary pace, but domestic firms remain stuck in low-productivity activities, unable to climb the value chain or match the cost structures set by foreign-owned export enclaves. Several Caribbean economies have also experienced the same pattern, in which foreign-owned tourism and financial enclaves set prices far above what domestic producers can sustain, forcing local sectors into wage compression and chronic underinvestment.

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In these development experiences, a common underlying dynamic recurs: the high-productivity enclave's cost base becomes the economy's cost base, and the domestic sector is forced to adjust by suppressing wages, operating on thin margins, and underinvesting simply to remain viable in export markets. In effect, external competitiveness is maintained only by an internal devaluation of unit production costs, achieved by compressing domestic incomes and productive capacity, thereby locking the economy into a low-investment, low-productivity state.

The lesson for India is unmistakable: when the cost structure of a high-productivity AI sector is imposed on a low-productivity domestic sector, internal devaluation becomes the sole adjustment mechanism, reinforcing the existing structural asymmetry and potentially locking the economy into an underdevelopment trap.

The currency's depreciation, already underway before the US-Iran war, reflects deeper market fears about the domestic economy's resilience in an AI-dominated world. The only way out is to strengthen the domestic sector itself, the part of the economy that anchors demand, stabilises the rupee, and determines whether India escapes or falls into a lower-middle-income developmental trap.

### Structural Trilemma

The rupee's weakness, FDI outflows, profit repatriation, and investor outflows reflect a deeper structural issue in the domestic economy. It is not just about the 10-year US Treasury Bond offering higher returns. If we ask why investors are not investing in India and why private capital expenditure (capex) has stalled, the answer points to India's deeper trilemma: balancing external stability and internal fragility in the AI-powered world, and energy security in a volatile global political economy.

In addition to the investment slowdown, the domestic economy's fragility is evident in wage stagnation and slowing consumption growth. Real wage growth has hovered between -0.4% and 3.9% over the past five years, with a projected 4% in 2025, still below the pre-Covid level of 5.2% in 2019.

Second, the latest official data show that per capita consumption growth slowed to 3.8% in FY2023-24, down from 6.9% in FY2022-23, while the share of private final consumption expenditure (PFCE) in gross domestic product (GDP) fell to 56.9%, the lowest in a decade.

Third, on the saving side, the latest RBI data show that household savings remain high, but much of it is flowing into gold, silver, and cash rather than into productive assets. In FY2023-24, households saved Rs. 54.6 lakh crore, with Rs. 65,000 crore going into gold and silver ornaments, while deposits and pensions grew modestly.

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Weak domestic demand is the primary reason India's private capex cycle has stalled. With stagnant wage growth and real wages eroded by inflation, households prefer to park savings in gold or cash rather than spend. That weak demand leaves corporates with little incentive to expand capacity. The result is a vicious cycle: weak demand discourages domestic reinvestment, capital flows abroad, and the rupee weakens further.

Preserving foreign exchange reserves and designing new instruments to attract inflows, whether by reviving non-resident Indian (NRI) deposit schemes or by offering tax incentives, is not sufficient to address the underlying fragility of the domestic economy.

The RBI measures announced in early June meant to attract FDI and foreign capital, from easing investment norms and expanding access to government securities to widening equity participation and offering concessional forex swaps, may deepen foreign involvement, but they remain supply-side interventions. They do not address weak domestic demand, which lies at the core of India's stalled investment cycle.

### Strategic Mobilisation of Reserves

India's external vulnerability is undeniable: gold imports and surging oil prices drain foreign-exchange reserves. In India, gold is not merely a luxury; it is a trusted savings instrument, a cultural anchor, and an inflation hedge. For millions of households outside the formal banking system, gold remains the most reliable store of value.

Advising them to abandon it without offering credible alternatives risks pushing savings into idle cash or low-yield deposits, which would only weaken consumption, shrink financial intermediation, and slow growth. Abstinence cannot break the vicious cycle: the weaker the rupee, the stronger the urge to buy gold, and the wider the trade deficit. Asking people to abstain from gold is like swimming against the tide.

Abstinence is not a growth strategy. India's reserve strategy must shift from passively preserving foreign exchange to actively generating inflows in an AI-powered world. This means the government needs to break the vicious cycle of weak domestic demand, capital outflows, and rupee depreciation by making private investment profitable again at home.

The shift in strategy becomes even more urgent as India faces a world increasingly shaped by AI and climate shocks. As an AI consumer rather than a producer, India will face high import costs, which will drain foreign exchange reserves and widen the trade deficit. A sustainable way to absorb these costs is to diffuse AI-driven productivity gains across the wider economy, so domestic firms become more competitive rather than more fragile.

|| The question is whether India has the fiscal space for such an ambitious strategy. The answer lies in rethinking how the state mobilises domestic savings for capital formation.

Innovative AI diffusion across sectors can strengthen the domestic economy by boosting productivity where it matters most. Just as Amul's AI Sarlaben initiative (a 24/7 digital voice assistant providing real-time livestock health and breeding guidance) supports dairy farmers, similar AI tools for tracking soil carbon loss from mixed fertilisers and residue burning, issuing early warnings of crop failure, and detecting water stress using monsoon-pattern data would raise yields, improve sustainability, increase rural incomes, and expand domestic demand.

These gains would reinforce the very part of the domestic economy that anchors growth and stabilises the rupee. More importantly, they would reduce the structural asymmetry between high- and low-productivity sectors—the asymmetry that leaves the economy vulnerable to shocks in an AI-powered world.

The real challenge is to maximise the benefits of AI diffusion while minimising labour displacement, and that is where the social responsibility of any innovation truly lies. Drawing on lessons from development patterns in both developed and emerging economies, India must ensure that AI tools strengthen the domestic economy rather than hollow it out, so that productivity gains translate into better jobs, higher incomes, and a more resilient development path.

## Role of the Government

The government must lead in building the AI diffusion infrastructure ecosystem, including regulating diffusion, while the private sector continues to compete in the AI model-building market, dominated by a few corporations in the US and China. The government must pair supply-side initiatives to build AI diffusion infrastructure with an active demand-side push through accelerated investment in housing, logistics, and infrastructure. When households spend and corporates see profits at home, private capex crowds in, capital stays in India, and the rupee gains strength.

The question, of course, is whether India has the fiscal space for such an ambitious strategy. The answer lies in rethinking how the state mobilises domestic savings for capital formation. For instance, instead of asking households to abstain from gold, the government can harness people's desire for gold as a safe-haven asset to mobilise resources for public investment.

Drawing on lessons from previous schemes, the government can design a better scheme that is rupee-linked, gold-anchored, and risk-diversified, protecting household wealth while mobilising long-term capital for national development. Foreign investors gain exposure to India's growth story with built-in hedging, while domestic households retain the psychological comfort of "owning gold". Proceeds should be directed to infrastructure, micro, small, and medium enterprises (MSMEs), and the renewable energy sector to create jobs, reduce dependence on oil, and ensure that every rupee diverted from gold becomes both an investment in growth and a job for its citizens.

For all this, India needs to reverse the policy hierarchy: fiscal policy must be active rather than remain subservient to monetary policy. An activist fiscal stance does more than redirect savings; it multiplies their impact by creating jobs, raising incomes, and sustaining domestic demand.

India must take the road less travelled, in the Robert Frostian sense. A road where the rupee's credibility is not held hostage to external shocks but anchored in the strength and resilience of the domestic economy.

In this context, the key question is not "How big is the deficit?" but "Is the spending functionally appropriate to strengthen internal stability amid external vulnerability?" When fiscal policy takes the lead, households gain confidence that their savings are not only secure but also contribute to livelihoods and national development, thereby reinforcing the foundations that stabilise the economy.

Global capital today is mobile yet highly selective. Countries such as Taiwan, South Korea, and Vietnam have attracted waves of FDI by positioning themselves as hubs for AI integration, offering investors a clear, technology-driven growth narrative. India's export-driven strategy will inevitably push firms towards rapid AI adoption across supply chains. High-productivity, export-oriented firms would upgrade quickly, capturing efficiency gains and lowering their cost base, while the domestic sector, already operating on thin margins, faces intensified competitive pressure without equivalent access to technology, skills, or capital.

The market thus drives a wedge: AI raises efficiency at the top while suppressing domestic demand at the base, leaving the internal economy more fragile, the rupee more vulnerable, and the country at greater risk of remaining stuck in a low- to middle-income trap.

India must take the road less travelled, in the Robert Frostian sense. A road where the rupee's credibility is not held hostage to external shocks but anchored in the strength and resilience of the domestic economy. In an AI-powered global order defined by technology cartels, supply-chain realignments, and strategic competition, the economies that endure will be those whose currencies rest on real productive capacity, not on the fickle sentiments of global capital.

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