29 May 2025

Indian Economy Continues to Face External Headwinds; Cooling Inflation Clears Path for Further Rate Cuts to Support Recovery

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- Despite recent US-China trade de-escalation, persistent policy unpredictability and tariff volatility under the Trump administration continue to weigh on the global economic outlook and business sentiment.
- India's economic recovery remained steady in Q4 FY25, with real GDP growth estimated at 6.9% YoY, driven by a strong agricultural performance and resilient services. However, high uncertainty and subdued industrial activity tempered the overall momentum.
- Growth prospects for FY26 face global headwinds. We revise the real GDP forecast downwards to 6.2% from the earlier projection of 6.4%, reflecting weak external demand, cautious private investment, and elevated uncertainty, partly offset by robust rural demand and policy support.
- Rural demand is expected to remain the primary driver of consumption recovery in FY26, supported by robust farm output and rising rural wages. Urban consumption is expected to show a moderate recovery, aided by monetary policy easing, income tax cuts, and lower inflation.
- Private investment outlook remains subdued due to global uncertainty, with weak project announcements and FY26 capex plans. We expect that public infrastructure spending and government capex will need to shoulder the investment momentum.
- Inflation has moderated significantly, with headline CPI at 3.16% in April 2025—the lowest in nearly six years—expanding space for growth-supportive policy.
- With a strong disinflation trend and a need to support the economic growth impulse, the RBI is expected to cut the policy repo rate by an additional 75 basis points (bps) in FY26, bringing the policy repo rate to 5.25% by October 2025. A front-loaded 50-bps rate cut in June is not ruled out if the Q4 GDP data underwhelms.
- Systemic liquidity has remained in surplus in the early part of FY26, aided by RBI's interventions, and is expected to rise further due to a record dividend transfer. The RBI is expected to maintain systemic liquidity in surplus of ~1% of NDTL in FY26 to ensure effective policy transmission.

Christopher Wiegand
Group Head - Economics & Data
christopher.wiegand@dmifinance.in

Pramod Chowdhary
Chief Economist
pramod.chowdhary1@dmifinance.in

Bhawna Sachdeva
Economist
bhawna.sachdeva@dmifinance.in

Shantanu Sharma
Economist
shantanu.sharma@dmifinance.in

www.dmifinance.in

+91 11 4120 4444

DMI Finance Private Limited
Express Building, 9-10, 3rd Floor,
Bahadur Shah Zafar Marg,
Delhi – 110002.

Uncertainty Clouds Global Economy Despite US-China Trade War De-Escalation

US President Donald Trump's efforts to reshape decades of global trade policy continue to cast a shadow over the global economic outlook. President Trump's numerous trade announcements since his mid-February introduction of the concept of "reciprocal tariffs" have been a rollercoaster, leaving households, businesses, policymakers, and markets uncertain about the prospective trading rules of the game, at least as dictated by the United States for trade with the world's largest economy. The constellation of Mr. Trump's trade announcements leaves little doubt that US trade policy, for at least the next four years of the Trump Administration, has left behind that of prior decades. While the depth and breadth of import duties may not survive the next US Administration, effects such as the relocation of supply chains and production by US and global businesses will not be reversed easily.

As we have outlined in prior reports, two tenets underpin his trade protectionism – a belief that global producers should pay for the privilege of having access to the world's largest and most dynamic consumer market and a desire to reshore manufacturing activity, particularly in high-profile industries. Despite the de-escalation in select trade policies in recent weeks, especially in US-China trade tensions, Mr. Trump's strong conviction on the merits of some degree of trade protection remains resolute.

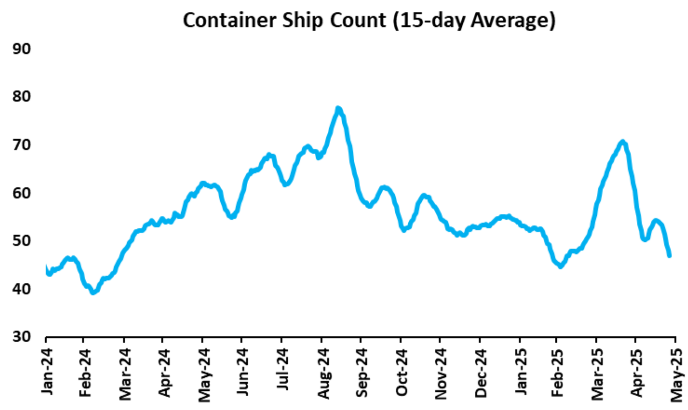
The framework trade deal between the US and the United Kingdom – the US's most stalwart ally and a country with which the US has a goods trade surplus– locks in a minimum 10% tariff duty on UK exports into the United States. Meanwhile, other countries that are close US allies and/or whose leader enjoys strong ties to Mr. Trump – e.g. Japan, Korea, India – have been rumoured for weeks to be close to announcing positive trade-related developments, but these deals supposedly are being held up by the Trump Administration's insistence on market access terms for US goods that are sacrosanct to these US trading partners. Moreover, in recent days, President Trump has threatened sector-specific import duties on advanced smartphones if production is not domiciled in the US and tariff rates of 50% on the European Union, ostensibly due to the EU's lack of alacrity in negotiations.

Various measures tracking sentiment, expectations and future spending and investment plans have cratered in response to Mr. Trump's trade moves. This has been especially true within the US business sector and for businesses outside the US with the most direct exposure to US end demand. These survey measures, plus business leaders' comments during recent corporate earnings reports, plus other business-sector anecdotes, point to an elevated level of paralysis among such businesses

Nonetheless, key measures of economic activity – particularly in the United States – are not showing any evidence of a significant deterioration. Consumer spending on some types of discretionary goods and services (e.g. airfares, jewellery) has cooled somewhat. But aggregate consumer outlays are tracking at roughly the same pace they have been on average for the past year. Job switching has decreased considerably – typically a sign of caution among both employers (fewer job offers) and employees (who prefer the perceived security of their current position) – but layoffs, as underscored by weekly jobless claims figures, remain at exceptionally low levels historically.

This is less the case outside the US, where production and freight traffic have softened. Non-US production has been hit by a combination of US importers aggressively front-loading orders and seeking to receive shipments ahead of US tariffs and reduced confidence about the strength of global demand in the second half of the year. In the event US demand continues to expand close to its prevailing pace, the headwind attributable to the former should lessen in intensity over the balance of the summer. However, given President Trump's impulsiveness – as demonstrated frequently these past three months – with respect to tariffs, considerable ongoing uncertainties regarding US-China trade, and the fact that best case scenarios for tariffs still leave the global economy encumbered with the highest effective tariff rates in more than 80 years, we expect that producers will continue to be quite hesitant to produce and stockpile products for sale much in advance.

Shipments from China to the US slide sharply after front-loading in early April



Source: Bloomberg, Note: 15-day moving average is between 1st Jan 2024 and 26th May 2025.

On balance, worst-case outcomes, such as a US bond market financial crisis or an abrupt halt in US-China trade, have abated due to President Trump's tariff de-escalation since mid-April; however, vulnerabilities persist. The combination of heightened business uncertainty and caution, roughly 10 percentage point hike in the effective tariff rate and the associated complications on forecasting future demand and supply chain issues, seemingly ad hoc bilateral trade negotiations and the whims of Mr. Trump create a wobbly foundation, especially for businesses and countries with large exposure to the US market.

The recent ruling from the US Court of International Trade does not alter our assessments. While it is an immediate-term blow against Mr. Trump's sweeping tariff campaign, the Administration has multiple appellate options, including the US Supreme Court. Perhaps counterintuitively, this court decision may prolong business uncertainty by extending the timeline - possibly significantly - of what the trade "rules of the game" are going to be.

India's Economic Recovery Steady in Q4 FY25; FY26 Outlook Clouded by Global Uncertainty

India's economic recovery extended into Q4 FY25, supported by a robust agriculture sector output and continued resilience in the services sector, which helped offset a subdued industrial activity. The Maha Kumbh festival also likely stimulated economic activity in Q4, particularly benefiting the unorganised sector. Taking these factors into account, we estimate real GDP growth at around 6.9% YoY in Q4 FY25, lower than the 7.6%-7.7% suggested by the Second Advance Estimates from the CSO, but higher than the 6.2% growth recorded in Q3. Consequently, we estimate FY25 real GDP growth at 6.3% up from our previous forecast of 6.1%, though it remains far below the 9.2% growth seen in FY24, primarily due to a sharp deceleration in H1 FY25.

Looking ahead, we have revised our FY26 real GDP growth forecast downward to 6.2% from 6.4% previously, reflecting the impact of global headwinds, persistent high uncertainty, and a subdued private investment outlook. Ongoing global trade tension and weaker external demand are expected to weigh on exports. Amidst these global headwinds and high uncertainty, investment sentiment is likely to remain cautious. Nevertheless, rural consumption is expected to remain robust, buoyed by expectations of strong agricultural output supported by a normal monsoon forecast. Urban demand is anticipated to see moderate improvement, driven by expected lower inflation, income tax relief, and monetary policy easing.

We anticipate the RBI will cut the policy repo rate by an additional 75-bps in FY26, following 50-bps total cuts already delivered since February 2025, bringing the cumulative rate cuts in the current monetary policy easing cycle to 125-bps and the terminal policy repo rate to 5.25%. While we expect a 25-bps policy rate cut each in June, August, and October, a front-loaded 50-bps cut in June is not ruled out if Q4 FY25 GDP data (due to release by May-end) underperforms expectations. Any additional cuts beyond these 75-bps would almost certainly require a significant weakening in domestic economic growth and/or the US ratcheting up tariffs to levels initially announced by US President Trump.

High-Frequency Supply-Side Data Points to Sluggish Industrial Activity, Resilient Services, And Strong Agricultural Performance in Q4 FY25

High-frequency indicators suggest industrial activity remained subdued in Q4 FY25. The Index of Industrial Production (IIP) grew 3.9% YoY in March, slightly above February's 2.7%. The Q4 average IIP growth was 4.0%, down from 4.1% in Q3, dragged down by slower manufacturing production growth. The manufacturing PMI, however, reached a 10-month high of 58.2 in April, indicating a strong start to FY26, with robust orders and employment gains. Nevertheless, PMI manufacturing may be overstating sector strength compared to IIP manufacturing. The latter appears more closely aligned with subdued corporate sales data in Q4, despite relatively stable margins resulting from lower input prices. We expect industrial activity to improve moderately in FY26, though performance will likely remain uneven due to global uncertainties.

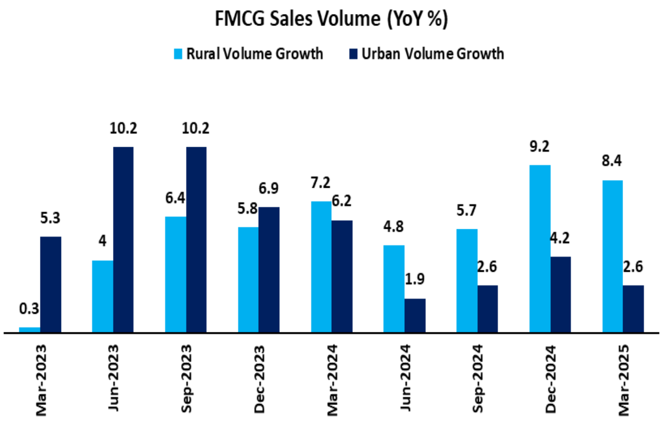
The services sector continued to demonstrate resilience in Q4 FY25. Compared to the prior quarter, domestic air passenger traffic increased, partly due to the Maha Kumbh, and domestic air cargo traffic momentum eased in Q4 FY25. Based on early corporate Q4 earnings data, non-financial services firms' sales growth remained steady, with strong results in IT and Hotel & Tourism, offsetting weakness in trade and communications. Steel and Cement production indicated improved construction activity in Q4. In the banking sector, deposit growth picked up and credit growth fell modestly in Q4 compared to the prior quarter. In terms of outlook, India's services PMI climbed to 58.7 in April 2025 (from 58.5 in March), indicating robust expansion. Service firms reported a sharp rise in new business inflows – the quickest in eight months. Export orders for services also picked up markedly, rising at the fastest pace since mid-2024. We expect the services sector to continue to show resilience in FY26.

The agriculture sector has been a bright spot for the economy in FY25. Following a robust Kharif output growth, a strong Rabi harvest is expected to boost farm output and rural incomes. Foodgrain production growth is estimated to have grown sharply in FY25. Summer crop sowing has progressed strongly, with the cumulative summer average up 11.9% YoY by mid-May. The forecast of a normal monsoon, combined with its early arrival, bodes favourably for the upcoming kharif season in FY26.

Rural Demand is Expected to Remain the Key Driver of Consumption in FY26, While Urban Demand is Likely to See a Moderate Recovery

Rural demand continues to lead the recovery in consumption, outperforming urban consumption indicators. High-frequency indicators underscore this divergence: tractor sales (a rural demand proxy) surged by an average of 21% YoY in Q4 FY25 (up from 11% in Q3), even as the two-wheeler segment showed continued weakness. Meanwhile, passenger vehicle sales (a gauge of urban demand) grew by an average of 3.6% (down from 5.6% in Q3). Rural FMCG volumes rose by 8.4% in Q4, over three times the growth seen in urban markets, even though both slowed moderately from Q3 levels. Overall, rural demand continues to lead the recovery in consumption, while urban demand remains subdued.

Rural FMCG Volume Growth Continued to Outperform Urban Growth

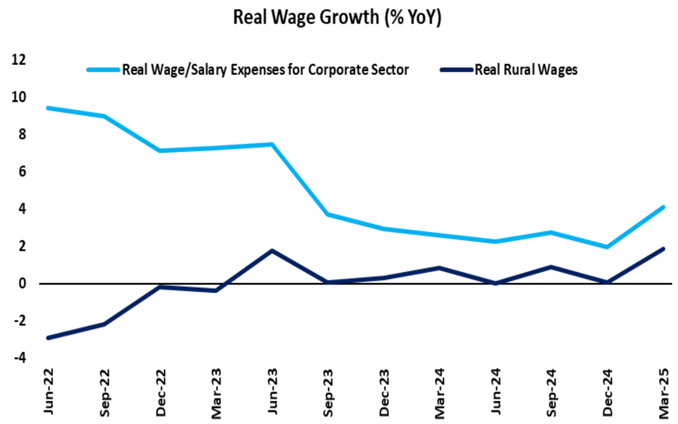


Source: Nielsen IQ

In FY26, rural consumption is expected to remain robust, buoyed by expectations of strong agricultural output, and urban demand is likely to see moderate improvement, supported by anticipated lower inflation, income tax relief, and monetary policy easing. A healthy monsoon and a bumper harvest have boosted rural incomes, with food grain production growing at its fastest pace in five years and robust oilseed output. Moreover, real rural wages also rose by approximately 1.8% YoY in Q4 FY25, one of the highest increases in recent years. A forecast for another normal monsoon and expectations of inflation remaining benign suggest that rural spending will remain a key pillar of demand in FY26.

In contrast, urban consumption has been relatively sluggish, with households facing weaker real income growth. Real salary/wages expenses in the non-financial corporate sector slowed from 8.2% YoY in FY23 to about 4.2% in FY24, and 2.8% in FY25 (based on the average of four quarters, with Q4 data sample still limited). There was a slight uptick in Q4 FY25 (around 4.1%- based on data of around 1127 firms which have reported their earnings so far) from just 2% in the prior quarter, the recovery is uneven and subject to revision as more data becomes available.

Real Wage/Salary Growth Remained Muted, though Showed Modest Improvement in Q4 FY25



Source: CMIE. Note: March 2025 figures for rural areas are based on the average for January-February.

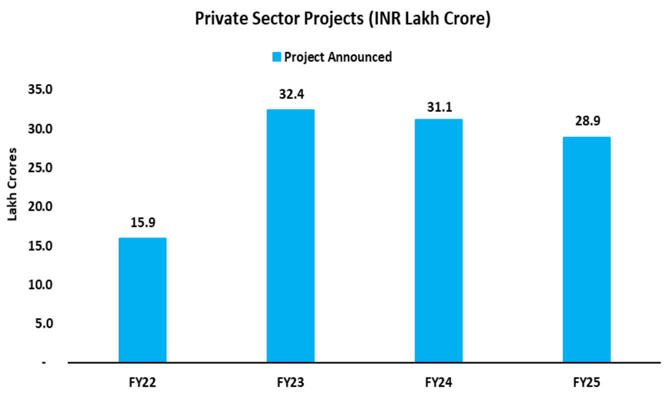
India's labour market showed mixed signals in early FY26. As per CMIE data, total employment increased by 14.3 million in April 2025, raising the employment rate to 38.9%, the highest level since March 2020. However, job creation was skewed toward informal and low-wage roles—small traders and labourers accounted for 8.8 million of the new jobs, while salaried jobs rose just 3.8 million in April. On a positive note, formal sector hiring rebounded: the Naukri JobSpeak Index jumped 8.9% YoY in April, with 33 of 37 industries reporting hiring growth. Nonetheless, we remain cautious about the labour market outlook for FY26 due to high uncertainty and expectations of muted private investment growth.

Global Headwinds and High Uncertainty Clouds the Investment Outlook

Private investment shows signs of strain amid global uncertainty. As per CMIE data, new investment project announcements in FY25 fell 7.1% YoY (following a 3.8% contraction in FY24), indicating further weakening in investment intentions. This decline reflects growing corporate caution in the face of persistent external risks and soft urban demand. Manufacturing and power projects dominated announcements, indicating that investment activity is concentrated in a few sectors.

A recent government survey suggests a ~25.5% YoY plunge in the proposed private capex for FY26, pointing to a lacklustre and concentrated investment revival ahead as businesses delay or scale down expansion amid high global uncertainty. Public infrastructure spending and government capex are expected to play a larger role in supporting investment in FY26.

Private Investment Outlook Remains Subdued- Weakest Investment Intent Since FY23



Source: CMIE

External Trade Environment Remains Marred with High Uncertainty

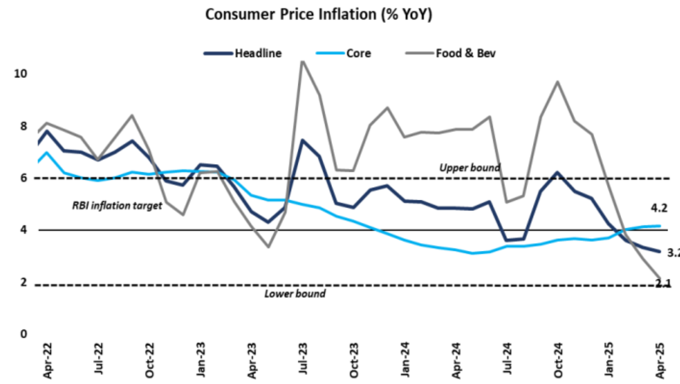
On the external trade front, merchandise exports posted a weak performance in FY25, while the services sector maintained robust growth, though slightly moderated compared to the prior year. For FY25, goods exports were flat (+0.1%), following a 3% contraction in FY24, reflecting weak global demand and commodity price moderation. Meanwhile, imports rose 6.2%, following a 5.2% contraction in FY24, driven by higher oil and core goods demand. Services exports grew 13.6% versus 4.8% in FY24, maintaining a strong surplus. Despite the widening goods gap, the current account deficit is likely to be contained at approximately 0.9% of GDP in FY25, supported by robust services and remittances. It may edge up to around 1.2% in FY26 amid shifting trade dynamics, partly offset by likely lower commodity prices.

Early indications of the impact of US tariffs show goods exports rose 9.0% YoY in April (versus +0.6% in March), aided by a rush to ship ahead of higher US tariffs and strong non-oil export growth. Imports also surged 19.1% (versus +11.3% in March), driven by sharp rises in oil, electronics, and silver imports, widening the trade deficit to a five-month high. Services exports grew 17% YoY (versus +18.6% in March), with resilient IT and business services, while imports rose 4.7%, narrowing the net surplus. We expect subdued growth in merchandise trade, although an early US-India trade deal could provide a boost in the second half of FY26. The services export growth is likely to remain robust, though some segments could face headwinds from a US economic slowdown and changes in US trade policies.

Inflation Drops Further, Opening up More Space for Monetary Policy Easing

Inflation has eased significantly in recent months, providing relief and creating policy space to support growth. In April 2025, headline CPI inflation fell to 3.16% YoY—the lowest level in 69 months and the third straight month below the RBI's 4% target midpoint. Food inflation cooled sharply, with the food and beverages index up just 2.1% YoY—a 42-month low—driven by an 11% drop in vegetable prices. Core inflation remained stable at around 4.2%, indicating that demand-side pressures were contained.

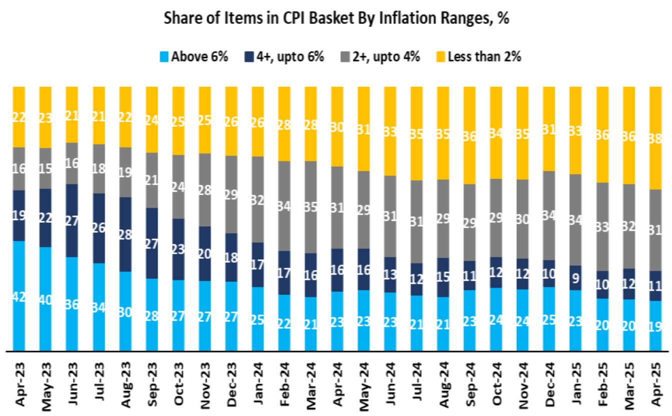
CPI Headline Inflation Eased Further to a 69-month Low in April 2025



Source: CMIE

Very importantly, disinflation has been broad-based, supported by favourable base effects and easing price pressures across categories. The share of CPI items with less than 2% inflation rose to 38% in April 2025 (from 30% in April 2024), while items with more than 6% inflation fell to approximately 19% (from 23% a year ago).

Broad-Based Disinflationary Trends Among CPI Basket Items



Source: CMIE

WPI inflation also softened significantly. April 2025 WPI rose just 0.9% YoY—a 13-month low—with primary articles and fuel in deflation. These trends reinforce that pipeline price pressures remain weak. With both CPI and WPI well-behaved, inflation has retreated into the comfort zone, giving policymakers greater flexibility, assuming no major commodity price shocks or weather disruptions.

RBI to Cut Policy Rate by Additional 75-bps in FY26

Against this backdrop, monetary policy has turned decisively accommodative in FY26. The RBI has cut the repo rate by 25-bps each in February and April 2025, bringing it down to 6.00%. The April MPC statement marked a clear pivot to growth-supportive policy, with the stance changed from neutral to accommodative.

The RBI projects CPI inflation to be at 4% in FY26, remaining below 4% through the first three quarters. We expect CPI to average ~ 3.7% in FY26 (versus 4.6% in FY25), lower than the RBI forecast, given the broader disinflationary trend. We expect the RBI to revise down its FY26 forecasts for inflation (currently 4.0%) and economic growth (currently 6.5%) in the upcoming June policy meeting.

Given the favourable inflation outlook and need to support demand, we expect an additional 75-bps of policy cuts in FY26, taking the policy rate repo to 5.25% by October. Our base case assumes a 25-bps cut each in June, August, and October, though a front-loaded 50-bps cut in June is not ruled out if Q4 FY25 GDP data (due to be released by the end of May) disappoints.

We also expect the RBI to ensure ample systemic liquidity to facilitate faster transmission of policy rate cuts to lending rates. The RBI has signalled its intent to maintain accommodative liquidity conditions to facilitate more rapid transmission of policy rate cuts to the real economy. Thanks to the RBI's several liquidity injection measures since December 2024, systemic liquidity has swung back into surplus in late FY25 and early FY26. The RBI has injected liquidity of Rs 2.65 lakh crore in FY26 (till 19th May) through Rs 2.4 Lakh crore of OMOs and balance through VRRR. This has lifted liquidity to a comfortable surplus. In May so far (till 23rd May), average surplus liquidity stood at Rs 1.7 lakh crore, up from Rs 1.4 lakh crore in April. The systemic liquidity surplus has kept the overnight weighted average call rate (around 5.81% last week) consistently below the policy repo rate, reinforcing accommodative monetary conditions. With the RBI announcing a record dividend transfer of ~Rs 2.7 lakh crore to the government, surplus liquidity could rise further in the coming weeks. In FY26, we expect the RBI to maintain an average surplus liquidity of around 1% of NDTL, which should facilitate the faster transmission of policy rate cuts.

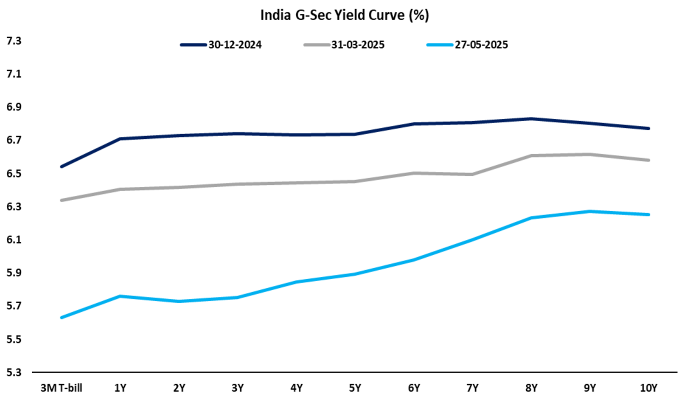
Market Update

Equity Market: Despite high volatility, Indian equities ended April on a strong note. The NIFTY50 Index posted a 3.5% MoM gain in April, driven by the RBI's accommodative monetary stance and the 90-day suspension of U.S. reciprocal tariffs. This upward momentum boosted foreign institutional investor confidence, as FPIs turned net buyers with inflows of Rs 42 billion after three consecutive months of capital outflows. Notably, as of March 2025, for the first time, domestic institutional investors (DIIs) have surpassed foreign institutional investors (FIIs) in ownership of Nifty 500 companies, highlighting a significant shift in market participation.

India's equity market faced renewed headwinds in early May due to escalating tensions between India and Pakistan alongside broader global uncertainties. Despite this, the NIFTY50 surged following the announcement of a ceasefire, more than recovering the prior week's losses. Although some profit booking occurred afterwards, as of May 27, the index remained 2% above its close at the end of April.

Bond Market: Expectations of further policy rate cuts and the RBI's liquidity injection measures, including OMOs, led to a rally in India's bond market. Indian G-sec yields softened sharply, with the 10-year yield falling to 6.25% by May 27 from 6.58% at the end of FY25, supported by the RBI's OMO purchases and lower inflation, which boosted expectations of further monetary easing. Lower crude oil prices also supported the sentiment. With short-term rates falling relatively more than longer-term bonds, India's G-Sec yield curve is exhibiting a bull steepening bias. We expect a further fall in government bond yields in the coming months, supported by expected policy rate cuts and surplus liquidity.

Government Bond Yields Softened with the Yield Curve Shifting Downward and Exhibiting Some Steepening



Source: Bloomberg

Currency Market: In April, the Indian rupee appreciated 1.1% MoM to 84.5 against the US Dollar, supported by FII inflows, softening crude oil prices, and broad dollar weakness with the Dollar Index. In real effective terms, the rupee depreciated by 0.7% MoM in April, due to a sharper fall in domestic inflation compared to peers, bringing the REER index (trade weighted, 40-curency basket) to 100.8, below its 10-year average, indicating that the currency overvaluation, which had prevailed last year, has corrected.

The rupee faced pressure during the week ending May 9, depreciating to Rs 85.4 amid escalating geopolitical tensions and renewed foreign institutional investor (FII) outflows. The subsequent ceasefire announcement and easing of US-China trade tensions provided temporary relief, enabling a marginal recovery in the currency, though it remains 1% weaker than April's closing levels at ~Rs 85.3 against the USD. Looking ahead, market participants anticipate that expectations of deeper rate cuts and persistent global uncertainty may continue to exert moderate downward pressure on the rupee's trajectory.

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