27 June 2025

India's Economic Growth: A Mixed Bag Amid Rising External Headwinds

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- Despite the US trade policy uncertainty, the global economy has remained relatively resilient owing to a mix of favourable underlying fundamentals and, in select economies, easier monetary policy.
- Recent escalation in the Middle East has added further uncertainty to the global economic outlook and oil prices. While tensions appeared to be de-escalating at the time of writing, this will remain a key monitorable ahead.
- Should Middle East tensions re-escalate, potential actions by Iran, particularly closing the Strait of Hormuz or attacking oil infrastructure in Iraq/Saudi Arabia, could significantly disrupt global oil supplies and inflate prices. However, a sustained Strait closure is unlikely, given the economic self-harm it would inflict on Iran and the probable US intervention.
- India’s economic growth surprised on the upside in Q4 FY25 with real GDP growing by a four-quarter high of 7.4% YoY. Nonetheless, the overall real GDP growth for FY25 printed at a four-year low of 6.5%, slightly above our expectations of 6.3%.
- High-frequency indicators show signs of uneven recovery as FY26 progresses. We expect economic growth to be around 6.2% in FY26.
- Rural demand is expected to support the growth, supported by a buoyant agricultural outlook. Urban consumption is expected to show a moderate recovery, aided by monetary policy easing, income tax cuts, and lower inflation.
- Investment is expected to be supported by government capital expenditure, as recovery in private investment is anticipated to be cautious amid heightened global uncertainty, along with muted urban demand.
- The recent tensions in the Middle East could impact the external sector's trade, in addition to US trade-related uncertainty. While we expect near-term pressure on the CAD to be manageable, any sustained disruptions in the global supply chain, such as a blockage of the Strait of Hormuz, could significantly impact India's trade pushing up the oil prices along with freight and insurance costs.
- Headline inflation moderated to a 6-year low of 2.82% in May led by the continued easing of food prices. Meanwhile, core inflation inched up slightly to 4.2% due to a rise in gold prices.
- In the June meeting, the RBI front-loaded the repo rate cut by 50 bps to 5.50% along with a CRR cut of 100 bps to accelerate the transmission process and support economic growth.
- Furthermore, it also changed the policy stance to neutral, raising the bar for future rate cuts. Accordingly, we believe that while further monetary easing is possible, it is not imminent and would require a material downside surprise to growth. As such, we expect a pause in the next MPC meeting in August.

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.

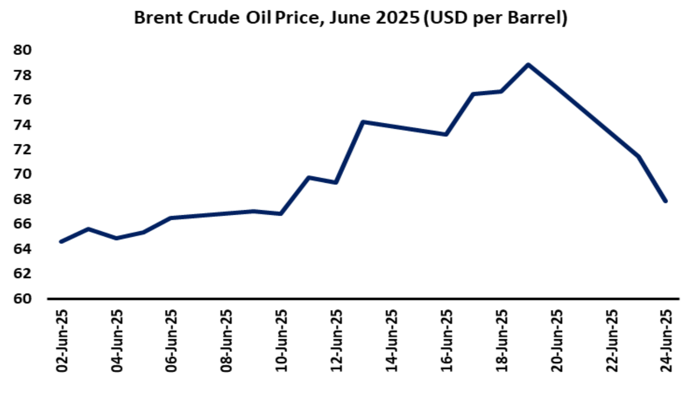
Global Economy Shows Signs of Resilience Despite the Heightened Uncertainty from US Trade Policy and, More Recently, the Middle East Conflict

As the calendar year approaches its midpoint, three notable macro trends stand out, with implications for the global economy over the remainder of 2025 and into early 2026. The dominant global trend in the first half of 2025 has been US-engineered trade policy uncertainty. Yet despite elevated policy uncertainty, economic activity throughout much of the world has remained relatively resilient, owing to a mix of favourable underlying fundamentals and, in select economies, easier monetary policy. Perpetuating that easier monetary policy – and the likelihood of still easier policy ahead – has been better-than-expected core inflation across much of the world.

In prior months, we have detailed US President Trump's desire to alter decades of global trade policy and the ensuing tumult and uncertainty those efforts have spawned. Currently, the effective US tariff rate stands at roughly 14 percentage points (pp), nearly 10 pp higher than at the start of his current presidential term and 12 pp higher than the rate prevailing on balance from 2000 to 2017. The prevailing US effective tariff rate is the highest by far in the post-World War II era and prevails in a highly interconnected global economy. The upshot has been rising risk aversion among businesses (as proxied by surveys gauging sentiment and expansion plans), reduced global trade volumes – especially between the US and China – and a challenging generalised operating environment.

Recent Middle East geopolitical tensions, including kinetic activity, have the potential to bring additional complexity and uncertainty to the global economic backdrop. As of this writing, it appears that tensions are de-escalating, which, if sustained, would be a positive development on both the human and economic dimension, due to the likely dampening effect on the price of oil.

Brent Crude Oil Prices Eased as Tensions Appear to be De-Escalating



Source: Bloomberg

Nonetheless, given the actors involved and the historical tensions, there remains some likelihood that situation could reignite. Economically, Iran has a few options that could significantly drive-up oil prices—the most prominent being a potential attempt to close the Strait of Hormuz. Roughly one-fifth of the world's transported oil moves through the Strait, and a durable closure would catapult oil prices. But such action would not be cost-free for Iran, as its own oil moves through the Strait, so a closure would be an act of economic self-harm and would starve the government of revenue. Moreover, 85% to 90% of Iran's oil exports go to China, one of the few countries in the world to maintain cordial relations with Iran, so such action would risk damaging that relationship. Separately, the US has deployed significant naval assets into the region and would not hesitate to take the necessary action to reopen the Strait. Another possibility would be an attempt to damage oil fields and related infrastructure in Iraq and Saudi Arabia, which, if successful, could have a longer-lasting impact on oil supply and, in turn, prices.

Despite various headwinds, the global economy has remained, on balance, resilient. To be sure, the pace of growth has moderated in many countries around the world, but pronounced slowdowns – much less recession(s) – have not been in the offing. While trade volumes have declined precipitously between the world's two largest economies, the pace of overall economic activity in both the US and China has been little affected. In the US, this is a by-product of favourable underlying fundamentals and what appears to be some degree of employee hoarding by businesses, resulting in only a modest cooling of the labour market. In China, robust exports to Europe and Asia have helped offset the decline in exports to the US; this, combined with policy support and a surprisingly firm tone in household demand amidst ongoing weakness in employment and the property sector, has sustained moderate economic growth in the Mainland. Likewise, the moderate pace of economic expansion in the European Union has persisted despite the EU's large exposure to global trade. The same holds for developing economies broadly, recognising the considerable dispersion within the group.

Better-than-expected underlying inflation in much of the world has helped buffer economic growth year-to-date and is expected to continue doing so in the quarters ahead. Easing inflationary pressures at a time of still solid nominal labour income growth has lifted households' real purchasing power in many countries, helping to sustain solid consumer demand. At the same time, cooling inflationary pressures have provided policymakers with scope to loosen macroeconomic policy, primarily in the form of easier monetary policy (lower interest rates and/or ample liquidity provisions), as well as, in select cases, easier fiscal policy. Barring a near-term tightening of labour markets and/or a maximalist tariff regime, akin to early April by the US, core inflation rates are likely to continue trending somewhat lower in the coming quarters. Such a development will enable additional policy support in many economies, including, importantly, in the US, from the Federal Reserve.

Economic Growth in FY25 Slowed to a Four-Year Low of 6.5%; Growth for FY26 is Expected to be Moderate Amidst Rising Headwinds

Economic growth surprised on the upside in Q4 FY25 with real GDP growing by a four-quarter high of 7.4% YoY. The growth was led by temporary factors such as a rise in net indirect taxes and a one-time push from Kumbh festivities, along with the continued government's strong CAPEX, and a greater contribution from net exports. Nonetheless, the overall real GDP growth for FY25 printed at a four-year low of 6.5%, slightly above our expectations of 6.3% (full report here).

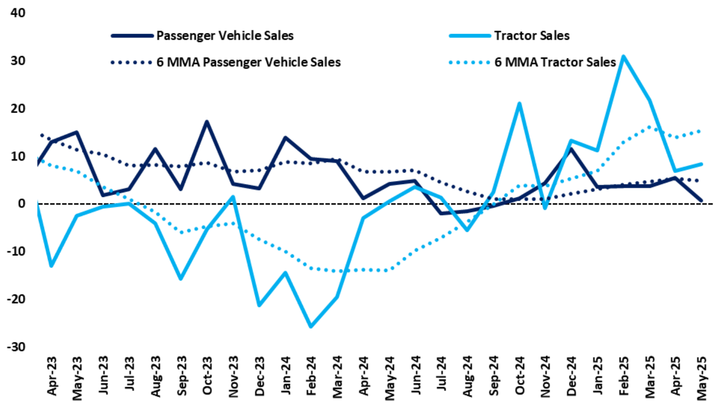
High-frequency indicators show signs of uneven recovery as FY26 progresses. For the outlook ahead, we expect FY26 real GDP growth to be around 6.2%, a moderate pace influenced by heightened global uncertainty and a likely subdued private investment outlook. Ongoing global trade tension and weaker external demand are expected to weigh on exports. Escalating Middle East tensions and surging crude oil prices further add to trade risks. While current oil prices suggest manageable pressure on the Current Account Deficit (CAD), any sustained supply-side disruption, like a blockage of the Strait of Hormuz, could have significant implications for the external sector. Amidst these global headwinds, 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 expected to see moderate improvement, driven by expected lower inflation, income tax relief, and monetary policy easing.

Rural Demand Supported Private Consumption, While Urban Demand Likely Remained Modest

Private consumption growth slowed to a five-quarter low of 6.0% in Q4 FY25; however, as discussed below, it appears poised to pick up in the period ahead. This recovery was primarily fuelled by robust rural demand, supported by a buoyant agricultural sector. Based on the third advance estimates, food grain production in FY25 is estimated to have increased by 6.5%, marking the highest growth in eight years. High-frequency indicators for May also suggest that rural demand is likely faring better than urban demand. Tractor sales improved in May (8.4% vs 7.0% in April) amidst an early monsoon boost. Two-wheeler sales also rebounded in positive territory (2.2% vs -16.7% in April) after showing weakness in April. According to NielsenIQ's Retail Audit Service, FMCG volume growth in rural areas continues to exceed above 8% growth in April[1] (trend seen in previous two quarters). The outlook for rural demand is positive given the expectations of another favourable monsoon this year.

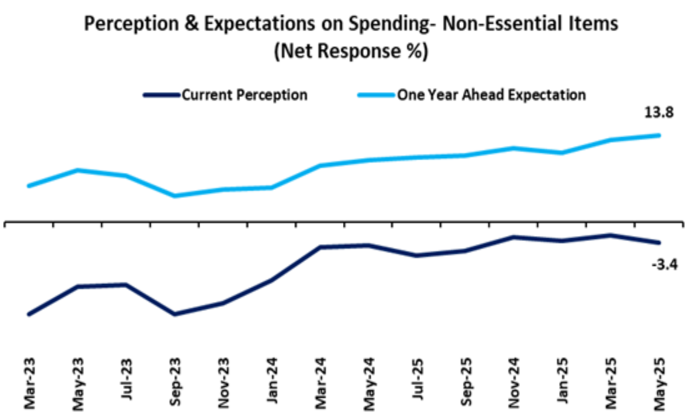
In contrast, the high-frequency data for urban demand shows a feeble momentum. Passenger vehicle sales dipped to 0.8% YoY in May'25 after showing modest improvement in April (5.5%). Other indicators, such as fuel consumption, credit growth, etc., while suggesting some improvement, still reflect weak momentum.

Passenger Vehicle Sales Remain Low, Suggesting Subdued Urban Demand, While Tractor Sale (a Proxy for Rural Demand) is Faring Well



Source: CMIE; Note: 6MMA refers to 6-month moving average.

RBI's Urban Consumer Confidence Survey Suggests that Current Urban Discretionary Spending is Weak but is Expected to Pick Up in Future



Source: CMIE

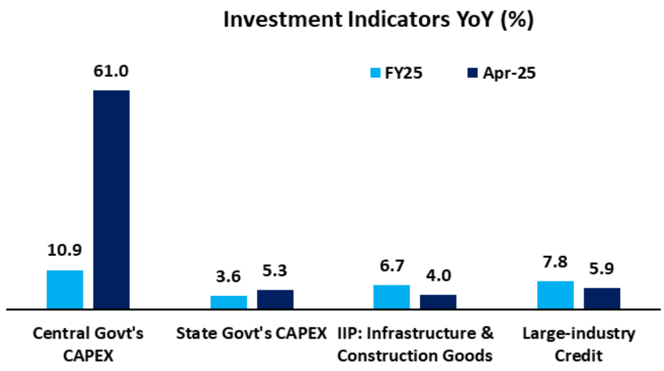
[1] Based on Governor Statement. 6th June 2025.

For the outlook ahead, we expect a moderate recovery in urban demand driven by expected lower inflation, income tax relief, and monetary policy easing. This is also corroborated by the RBI's Urban Consumer Confidence Survey. Based on the latest survey results, while the current spending on non-essentials is weak, as reflected in negative net responses, the one-year-ahead expectation is positive. It is gradually rising, suggesting an improved outlook for urban consumption.

Investment Outlook is Expected to be Supported by Government Capital Expenditure, as Private Investment Faces Downside Risks from Global Uncertainty

Investment was one of the major drivers of growth, with real Gross Fixed Capital Formation growing by a five-quarter high of 9.4% in Q4 FY25. This was largely due to government expenditure picking up pace in H2 FY25, as private investment growth is likely to have remained muted. Evolving high-frequency data for FY2026 so far continues to suggest a similar picture. The government capital expenditure began on a strong note in FY26 with the centre's capital expenditure growing by ~61% in April 2025, while state government capital expenditure also showed improvement[2]. However, the softening readings on infrastructure-related output, banking credit to large industries, and lower project announcements (sourced from CMIE) suggest that private sector investments are still likely subdued.

Investment Indicators Suggest a Mixed Picture



Source: CMIE; Note: Large Industry Credit refers to the banking credit extended to large industries.

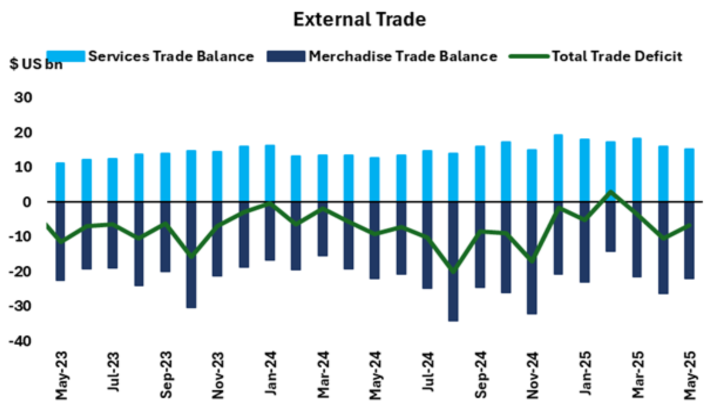
For the outlook ahead, continued government support for investment growth is expected. Further, the larger-than-expected dividend transfer from the RBI could also provide some room for additional capital spending. The recovery in private sector investment is likely to be cautious given the heightened uncertainties on the global front, including the US tariff policy and recent escalations in the Middle East, along with muted urban demand.

Rising Geopolitical Tensions, Along With the US Tariff Policy, Pose Risks to External Trade

After remaining flat in FY25 (0.1% YoY), export growth is holding up in the first two months of FY26, despite rising global uncertainties, primarily due to the front-loading of exports to the US ahead of reciprocal tariffs. After surging by 9.2% YoY in April, the export growth contracted by 2.2% YoY mainly due to the base effect, placing the average growth for FY26 till date (April-May) at 3.5%. On a sequential basis, the exports rose by 0.5% MoM in May while the imports contracted by 6.6% MoM, primarily due to a decline in oil imports, causing the deficit to narrow to US $21.9 billion (vs US $26.4 billion in April).

Meanwhile, the service surplus remained robust in May at US $15.3 billion (vs. US $15.9 billion in April), with services exports growth remaining strong at 9.4% YoY. Looking ahead, while we expect service exports to stay robust, some segments may face headwinds from a potential US economic slowdown and changes in US trade policies.

Trade Deficit Narrowed in May, While the Services Surplus Remained Robust



Source: CMIE

On the other hand, expected weaker global growth due to tariff-induced uncertainty is likely to weigh on merchandise trade exports. The trade outlook is further clouded by the escalating Iran-Israel conflict and the subsequent rise in global crude prices, with the 7-day moving average currently tracking at approximately US $75 per barrel (data till June 24th), up from US $64 per barrel at the end of May. Should oil prices sustain around this level, the near-term pressure on India's current account deficit (CAD) would be manageable. Based on the RBI's earlier study, a US $10 per barrel increase in oil prices will push up the CAD by around 0.4% of GDP, adding an upside risk to our estimate of 1.2% for FY26. However, while the immediate risk to the

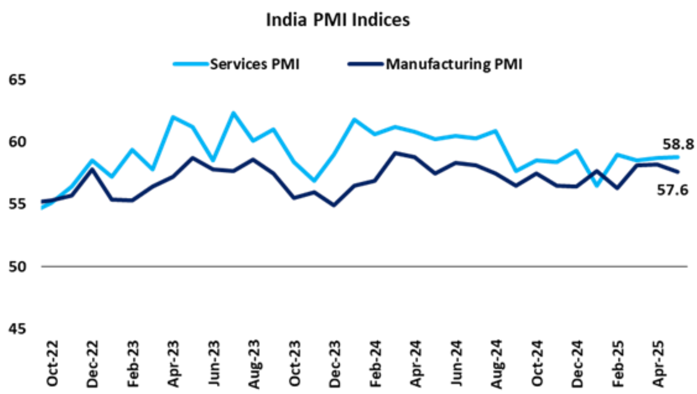
[2] Based on data of 20 states.

CAD is contained, any sustained disruptions in the global supply chain - such as a blockage of the Strait of Hormuz (About 40-50% of India's crude oil imports pass through this route[3]) could significantly impact India's trade by pushing up the oil prices along with freight and insurance costs.

Supply-Side Indicators also suggest Uneven Recovery; Services Sector Likely to be Resilient, the Agriculture Outlook is Expected to Remain Robust, While Industrial Activity Will Face Headwinds from Rising Global Uncertainty

The high-frequency indicators from the supply side of the economy also confirm the uneven recovery. The services sector continues its decent expansion in FY26, as shown by strong PMI readings for April and May, largely supported by robust external demand for Indian services. Meanwhile, industrial activity has slowed with the Index of Industrial Production (IIP) moderating to 2.7% YoY in April, down from 3.9% in the previous month. It was led by a broad-based slowdown in manufacturing, mining and electricity. The manufacturing PMI in May 2025 also hit a three-month low of 57.6, indicating that while activity is still expanding, its pace has slowed amidst rising global uncertainties. We expect a moderate recovery in industrial activity in FY26, and performance is likely to remain uneven due to heightened global uncertainty.

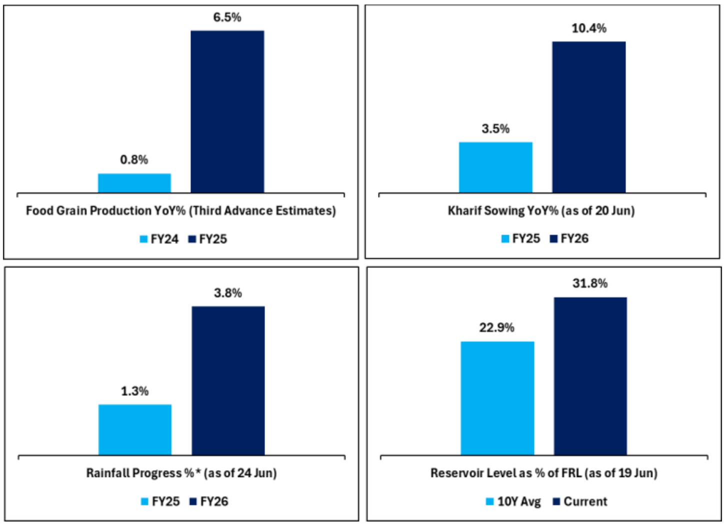
Services PMI remained flat while manufacturing PMI slowed to a three-month low



Source: S&P Global

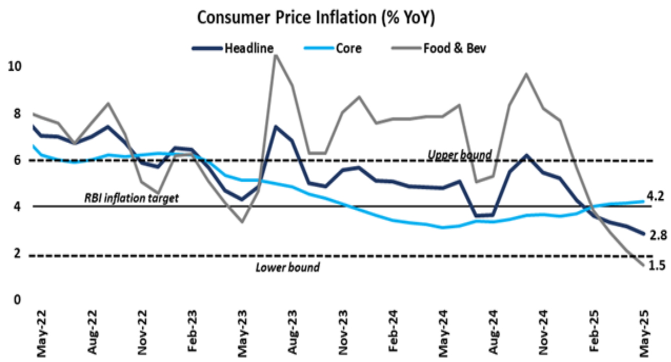
In contrast, the agriculture sector is expected to remain strong in FY26. Based on recent data, the cumulative rainfall (as of June 24th) is tracking 3.8% above normal rainfall. With that, the Kharif sowing is tracking well above the previous year's level (~10.4%) as of June 20th. Above-normal monsoon (IMD pegged the 2025 monsoon rainfall at 106% above the long-term average), healthy Kharif sowing, and comfortable reservoir levels bode well for the agricultural sector's outlook and, thereby, for rural demand.

Above normal monsoon, Healthy Kharif Sowing, and Reservoir Level Bode Well for the Agricultural Outlook



Source: CMIE; Note: Foodgrain production is Rabi & Kharif combined; * Rainfall is measured as % cumulative deviation from normal.

Inflation Drops to near 6-Year Low of 2.82% in May



Source: CMIE

Inflation remained on a downward trajectory for the seventh consecutive month, aligning with the RBI's revised expectations and providing space for the MPC to front-load the rate cut cycle in the June meeting. In May 2025, headline CPI inflation fell to 2.82% YoY—the lowest level in almost 6 years and the fourth consecutive month of printing below RBI's target of 4%. With food inflation leading the overall easing trend, food and beverage inflation softened to a near 6-year low of 1.5%, supported by a sharp and continued deflation in vegetable prices by 13.7% (compared to 11% in April), as well as deflation in pulses (-8.2% vs -5.2% in April). Other categories, including cereals, eggs, fruits, and sugar, also showed signs of moderation. However, oil and fats prices inched up to a 17.9% - 38-month high, partly offsetting the decline in other categories. Meanwhile, core inflation showed a marginal uptick,

[3] Based on media articles.

primarily due to personal care and effects, reflecting a rise in gold prices.

Looking ahead, we expect inflation to remain contained in FY26 (around ~3.7%) due to the following reasons. Firstly, despite a slow start to the monsoon season, the rainfall has picked up pace, with the cumulative rainfall (as of 24th June) tracking 3.8% above normal, which is expected to support Kharif sowing. Secondly, the government recently announced a reduction in basic customs duty on edible oil from 20% to 10%, which should help contain the inflation in edible oil (which is currently tracking in double digits). Thirdly, the recent rise in global oil prices due to the Iran-Israel conflict should have a limited impact on headline inflation as the retail petrol and diesel prices are largely regulated by the government. However, we'll be closely monitoring any global supply chain disruptions stemming from trade tensions and the Middle East conflict, as these could still pose a risk.

RBI Front-Loaded the Policy Rate Cut; Expect a Pause in the Next Meeting

Against the continued easing of inflation and growth below aspiration, the RBI surprised the market by front-loading the repo rate cut in the latest meeting with a 50-bps cut. Additionally, the stance was also changed from accommodative to neutral to signal limited policy space going ahead. This essentially raises the bar for any future policy rate cuts. With the inflation projection for FY26 at 3.7% and the repo rate now at 5.5%, the real policy rate is estimated to be around 1.8%, which is still relatively high; therefore, we do not rule out the possibility of a future rate cut. We believe that while further monetary easing is possible, it is not imminent and would require a material downside surprise to growth. Consequently, we believe MPC will be on pause in the August meeting.

The RBI also complemented the latest repo rate cut with a CRR cut of 100 bps (spread over September-November) to 3% to accelerate the policy transmission. This is expected to inject Rs 2.5 lakh crore in durable liquidity by December 2025, thereby lowering the cost of funding. So far, the banking system liquidity has already risen to an average of Rs. 2.8 lakh crore (data till June 24th) compared to an average of Rs. 1.7 lakh crore in May. With ample liquidity, the overnight call rate is tracking below the policy rate at 5.27% (data as of 24th June). This has likely caused the RBI to announce VRRR auctions to bring the operative target closer to the policy rate. Looking ahead, surplus liquidity is expected to expand, driven by the CRR cut, expectation of higher government expenditure supported by the Rs 2.7 lakh crore RBI dividend transfer and G-Sec buyback. This will likely offset the liquidity drain from the maturity of the RBI's net short position in the forward book and push out the need for a larger quantum of OMOs to the latter part of the year.

Market Update

Equity Market: Despite persistent volatility, Indian equities posted positive returns for the third consecutive month in May—Nifty50 gaining 1.7% MoM, as tensions eased mid-May following a ceasefire between India and Pakistan, along with a US-China trade agreement on tariffs that helped reduce global trade uncertainties. June began on an optimistic note with a higher-than-expected Q4 FY25 GDP print, followed by the RBI's front-loaded repo rate cut and a 100 bps CRR cut. Reflecting improved investor sentiment, the NIFTY50 rose 1.4% on June 9 from its May-end close. Market volatility resurfaced in mid-June due to escalating tensions in the Middle East and a consequent surge in oil prices. However, Indian equities showed resilience, with the NIFTY50 closing 1.2% by June 24th. This was driven mainly by the announcement of a ceasefire in the Middle East post the US intervention. Despite this, broader market sentiment remains cautious amid US involvement in the conflict, as investors await further developments.

Bond Market: The bond market experienced a steepening of the G-sec yield curve in June. Short-term G-sec yields softened, with 3-month yields down by ~25 bps and 1-year yields down by ~3 bps since the June MPC meeting. However, longer-end G-Sec yields rose due to the RBI's shift to a neutral policy stance and reduced expectations for open market operations (OMOs), prompting profit-booking. The G-sec benchmark yields came under further pressure as cautious investors re-evaluated their holdings amid concerns over rising oil prices following U.S. involvement in the Middle East conflict during the week ended June 20. With the announcement of the ceasefire, bond yields are already tracking lower (10-year benchmark G-sec yield is at 6.25%) and are expected to ease further, provided there is no further escalation in the Israel-Iran conflict.

Currency Market: In May, the Indian currency appreciated mildly by 0.4% to trade at an average of 85.3 against the US dollar, largely supported by FII inflows, moderating crude oil prices and some weakness in the dollar strength. The rupee mainly remained range-bound in June until the Middle East conflict, which led the rupee to hit a three-month low of 86.7 against the US Dollar by week ending June 20th, reflecting risk-off sentiment and rising oil prices. However, increased FII inflows in the last two sessions, a softer dollar index, the recent ceasefire announcement, and likely RBI intervention helped the rupee recover to 85.98 (as of June 24th). Going forward, the development in the Middle East will be critical in shaping the rupee outlook.

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