

India's Economic Momentum Slows as Deepening Disinflation Strengthens the Case for Further Policy Easing


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- The US economy remains resilient but faces headwinds from signs of slowing household spending, high interest rates, and tariff-related uncertainty.
- In this backdrop, the US Fed is expected to begin easing from September, delivering 75-bps in rate cuts by early 2026, with inflation risks likely to remain contained.
- India's GDP growth is expected to slow to ~6.2% YoY in FY26 from 6.5% last year, amid global headwinds, trade tensions, and subdued private investment sentiment.
- In FY26, goods exports and private investment are expected to remain lacklustre; however, rural demand is anticipated to remain resilient, backed by a normal monsoon, while urban demand is expected to recover moderately due to lower inflation and policy support.
- According to the high-frequency data for early Q1 FY26, economic growth likely moderated in Q1 as expected, as most of the one-off drivers that had pushed up growth in the previous quarter faded, and uncertainty rose due to a slew of announcements on US trade policies.
- Supply-side performance remains uneven, with strong agriculture and resilient services partly offset by weak industrial output due to the global uncertainties and muted domestic demand impulse.
- Rural consumption shows resilience, aided by a good monsoon, rising rural wages, and robust sowing, while urban demand remains on a moderate and uneven recovery path.
- Investment activity is still led by the government CAPEX, as private sector sentiment remains cautious amid global uncertainty and lacklustre domestic demand.
- External trade continues to face headwinds, with India's goods exports weakening in Q1 despite a front-loading of shipments to the US, while services exports remain resilient. The India-UK trade deal is likely to support trade going forward; however, uncertainty surrounding India-US trade negotiations and the risk of higher tariffs on Indian oil imports from Russia pose downside risks.
- CPI inflation eased to over six-year low of 2.1% in June, driven by food deflation; the FY26 average inflation is projected at ~3.2%.
- The RBI is likely to deliver a 25-bps repo rate cut going forward, with softening inflation and uneven economic growth creating space for further monetary easing.
- We expect a 25-bps repo rate cut in Q3 FY26, when the RBI will have better clarity on monsoon progress, US Fed policy, Q1 GDP data, and inflation trends. However, a rate cut in the upcoming policy meeting in August remains a possibility.

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US Fed to Begin Easing in 2025 as Inflation Risks are Likely to Remain Contained

The US Federal Reserve is poised to resume its monetary easing campaign over the balance of 2025. Since Donald Trump's return as US President, the Fed has been quasi-paralysed, unsure of the net effects of Mr. Trump's heterodox economic policy agenda and afraid to make a policy error in the aftermath of its 2021/22 inflation misjudgement. The result has been repeated statements of US monetary policy "being in a good place" and that officials are "waiting for more data" to provide clarity.

To be clear, the Federal Reserve's decision to hold off on action hasn't caused any major problems for the U.S. economy or the global economy, which is heavily influenced by the U.S. But the hesitancy and, at times, seeming indecision have highlighted a shortcoming of the US central bank's policy-making approach in recent years: Namely, that the Fed is overly data-dependent – and thereby backwards-looking – rather than having a sufficiently forward-looking policymaking framework.

This heavily data-dependent approach is a by-product of a year-on-year core inflation rate that remains above target, as well as scarring from recent years' incorrect inflation projections. That combination has the Fed nervous about the possibility of consumer inflation expectations becoming cemented at an elevated level and/or core inflation accelerating higher. In the judgment of most Fed officials, President Trump's ongoing tariff impositions augment these underlying concerns, with many officials concerned that a tariff-induced rise in select consumer prices could bolster broad inflation expectations, perpetuating a self-reinforcing cycle of higher prices and an expectation – and willingness to accept – higher prices.

It is our judgment that such an outcome is quite unlikely, as the underlying macro fundamentals are not supportive of such a price spiral. The prevailing macro setting differs markedly from 2021-H2 and 2022, when higher consumer prices did seem to beget higher inflation expectations, with some feedback on to still higher consumer prices.

Households at that time enjoyed substantially more discretionary spending power than they do now. The labour market was among the hottest in the post-WWII era, characterised by rampant job switching, double-digit percentage compensation gains for job changers, a record shortfall in the supply of workers compared to job openings, and a strong desire by businesses to do whatever was necessary to get back to business following Covid disruptions. Consumers were flush with disposable income, thanks to repeated fiscal transfers and accumulated savings resulting from public health measures that limited economic activity. Interest rates were also multiple

percentage points lower, with favourable implications for debt service and disposable income expectations.

While the US economy continues to exhibit resiliency, households do not have the capacity – be it through prevailing rates of income growth or (liquid) discretionary savings – to underwrite a sustained, troubling pick-up in inflation. Nominal income growth has moderated to a 3½% to 4% range – healthy but consistent with a 2% to 2½% trend core inflation rate. Moreover, consumer spending and price data underscore households' budget constraints: Prices for the most discretionary type of consumer outlays have been cooling for months. Likewise, as import duties have nudged up prices of consumer goods, spending and prices of consumer services have eased. Interest rates at two-decade highs are also siphoning off income for debt service, capping overall consumer purchasing power.

While uncertainty remains high regarding the precise details of the new US tariff regime, the prevailing effective tariff rate has been in the teens for multiple months now – up by more than 10 percentage points – and the price-level effects to date are small. Partly, this reflects inventory building following President Trump's election in anticipation of a new tariff regime. Importantly, however, it also reflects consumers' recalcitrance toward higher prices generally as outlined above and businesses' desire to maximise profit, not just the selling price.

The evolving US tariff regime will likely affect US consumer prices in the months ahead. However, we are confident in our assessment that these will be price-level effects (i.e. one-time) rather than recurring (i.e. inflationary). Absent a near-term notable strengthening in the labour market, which continues to experience an extremely low hiring rate but also – at least to date – a low layoff rate, the inflation backdrop ahead will provide the Fed the comfort it is seeking to begin lowering its policy interest rate again. In our judgment, the inflation outlook justifies easing policy sooner rather than later. However, the Fed will want to see inflation data reflect this outcome before taking action.

As a result, the September monetary policy meeting is likely to be the earliest the Fed will decide to reduce rates again. Once they resume easing, we would expect about 75-bps of reductions, likely in the form of three 25-bps cuts. We are agnostic about whether these cuts will be implemented at consecutive meetings or not, but we expect them to be completed by early spring 2026.

The resumption of Fed easing will provide additional headroom for other central banks and other policymakers (such as fiscal) around the world to support their domestic economies as they judge necessary. Fed easing of roughly 75-bps in the next 6 to 8 months should cap the value of the

US Dollar, helping global currencies to appreciate modestly further.

India: High-frequency Indicators Suggest Economic Momentum Likely to Have Moderated in Q1 FY26

The Indian economy continues to expand unevenly with pockets of solid activity and resilience, but also areas of sluggishness. We expect that the RBI will provide some additional policy support to the economy in the months ahead. Reaching a trade framework with the US will also be helpful in alleviating some of the businesses' uncertainty.

India's economic growth momentum appears to have moderated in Q1 FY26, reversing the acceleration seen in the final quarter of FY25. As highlighted in our previous reports, the stronger-than-expected growth in Q4 FY25 was driven by a confluence of temporary factors, including a statistical boost from higher net indirect taxes, economic activity related to the Maha Kumbh, a sharp fall in imports, and robust central government capital expenditure. With most of these transient drivers fading (except for govt CAPEX), underlying momentum appears to have weakened. In addition, elevated uncertainty, particularly around shifts in U.S. trade policies, has likely dampened business sentiment, private investment, and external-facing economic activity. Consequently, several high-frequency indicators have softened during the April–June period.

As this moderation aligns with our expectations, we maintain our FY26 real GDP growth projection at 6.2% YoY, with Q1 growth likely at around 6.0%. For the full year, economic growth is expected to be supported by continued government spending and resilient rural demand, aided by a favourable agricultural outlook. A gradual, moderate recovery in urban consumption is also anticipated, benefiting from easing inflation, income tax relief, and the transmission of monetary policy rate cuts. Nevertheless, persistent global headwinds remain a key downside risk. These could continue to weigh on exports and industrial momentum, thereby keeping private investment on a cautious footing.

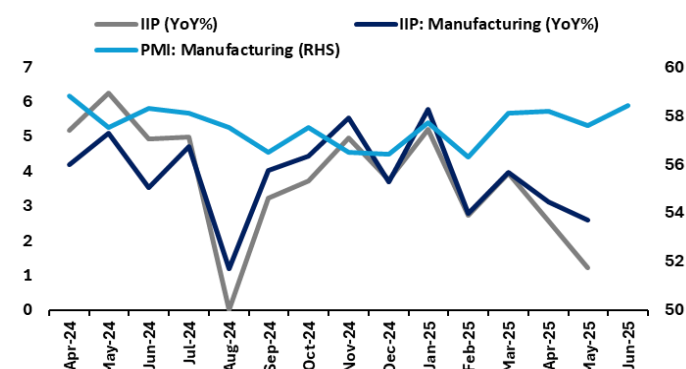
Given that the balance of risks remains tilted to the downside, we believe additional policy support is warranted to stimulate economic growth. While fiscal space appears constrained—particularly after the income tax relief measures announced in the FY26 Budget—the sharp decline in CPI inflation has created room for the RBI to ease monetary policy further. We expect the RBI to deliver at least one more 25-bps rate cut in CY2025, bringing the cumulative reduction in the current easing cycle to 125 bps. However, the exact timing of the next policy action remains uncertain and will depend on evolving domestic and global conditions, as discussed in the subsequent sections.

Supply-Side High-Frequency Data Suggests Lacklustre Industrial Performance, Resilient Services, and Strong Agricultural Momentum in Q1 FY26

High-frequency indicators point to a weakening in industrial sector activity during Q1 FY26. The Index of Industrial Production (IIP) weakened to a nine-month low of just 1.2% YoY in May 2025, down from 2.6% in April. The sharp deceleration is partly attributable to an unfavourable base effect, and broad-based weakness across manufacturing, mining, and electricity. Manufacturing growth decelerated to 2.6% in May, marking a nine-month low, and reflecting subdued urban demand, as well as the ongoing impact of continued global geopolitical uncertainty.

As a result, average IIP growth for Q1 so far (April–May) stands at 1.9%, sharply lower than the 5.7% recorded during the same period last year. A meaningful recovery in June appears unlikely, given that core sector output, which accounts for ~40.3% of the IIP, remained subdued at 1.7% YoY in June, despite a slight sequential improvement.

Industrial Sector Activity Weakened in Q1 F26



Source: CMIE.

In sharp contrast, the manufacturing PMI has remained resilient, climbing to a 14-month high of 58.4 in June. However, recent trends suggest that the PMI may be overstating the underlying strength of the manufacturing. With continued uncertainty around trade policy outcomes and an uneven consumption recovery, the turnaround in manufacturing activity could be further delayed.

Despite Some Softening, Services Indicators Appear Resilient in Q1FY26

High-Frequency Indicators	Apr-24	May-24	Jun-24	Jan-25	Feb-25	Mar-25	Apr-25	May-25	Jun-25
PMI Services #	60.8	60.2	60.5	56.5	59.0	58.5	58.7	58.8	60.4
Domestic Air passenger Traffic	3.8	5.9	6.9	14.1	12.1	9.9	9.7	2.6	
Domestic Air Cargo	0.3	10.4	10.3	6.9	-2.4	5.0	16.6	2.3	
International Cargo traffic	16.2	19.1	19.6	7.2	-6.3	3.3	8.6	6.8	
International Passenger Traffic	16.8	14.6	11.3	11.1	7.7	6.8	13.0	5.0	
Port Cargo Traffic	1.3	3.9	6.8	7.6	3.6	13.3	7.0	4.3	5.6
GST E-way bills	14.5	17.0	16.3	23.1	14.7	20.2	23.4	18.9	19.3
Services Exports	17.1	9.7	3.2	12.1	11.7	18.7	8.8	9.6	14.5

Source: CMIE, RBI. Note: Conditional formatting is from data starting FY25. #PMI Services is level, while the rest of the indicators are YoY%.

Meanwhile, the services sector appears to have largely remained resilient in Q1 FY26, despite some signs of moderation in select indicators. This resilience has been partly supported by global demand for services, which, to date, remains unaffected by the evolving tariff landscape. High-frequency indicators, including the Services PMI, air cargo volumes, and GST E-Way bill generation, have shown an improvement in growth momentum compared to the previous quarter, reinforcing the underlying strength of the services sector.

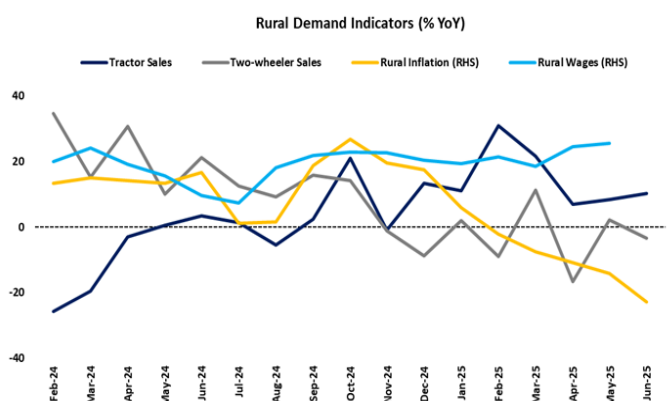
Above Normal Monsoon, Healthy Kharif Sowing, and Reservoir Levels Bode Well for the Agricultural Outlook



Source: CMIE. Note: Rainfall progress is calculated as cumulative deviation from the Normal Rainfall level. FRL stands for Full Reservoir Level.

On a positive note, the agricultural sector's robust performance, supported by a favourable monsoon, is expected to provide a cushion to overall economic growth. As of July 18th, Kharif progress is tracking healthy at ~4.1% YoY, thanks to above normal rainfall. The combination of above-normal monsoon, strong Kharif sowing, and healthy reservoir levels (which are critical for the upcoming Rabi season) bodes well for the agriculture sector's outlook in the coming quarters.

Rural Demand Indicators Held Up Momentum



Source: CMIE.

From a demand-side perspective, high-frequency indicators suggest that rural demand has largely sustained its momentum in Q1 FY26, despite some seasonal moderation. This resilience is being supported by strong crop output, rising rural wages, and easing inflationary pressures. Tractor sales grew by 8.7% in Q1 FY26, moderating from over 20% growth in Q4 FY25 but still significantly higher than the 0.6% growth recorded a year ago. Some signs of weakness remain, with two-wheeler sales, as per SIAM data, contracting in Q1 FY26, following double-digit growth in the previous quarter. However, other data sources, such as retail two-wheeler sales (from Federation of Automobile Dealers Associations), and two-wheeler registrations, improved during the same period, rising by 5.1% in Q1 versus a decline of 0.7% in Q4 FY25, in the lead-up to the upcoming festive season. Overall, we continue to expect rural demand to remain a key driver of consumption in FY26, supported by favourable monsoon conditions and improving rural incomes.

On the other hand, urban demand remains uneven and subdued, with weaker passenger vehicle sales (despite some improvement in June), softer vehicle registrations, and slower retail credit growth in Q1, all signalling a lack of momentum in urban consumption. Nevertheless, we continue to expect a gradual and moderate recovery, supported by lower inflation, income tax relief, and monetary policy easing. Positive developments in the labour market may also provide support, with improving hiring intentions in the formal sector and a notable rise in salaried employment, up by nearly 8 million by the end of Q1 FY26 (as per CMIE data), compared to the end of Q4 FY25. However, the sustainability of these favourable labour market trends will be crucial, particularly as firms continue to grapple with elevated uncertainty and external headwinds.

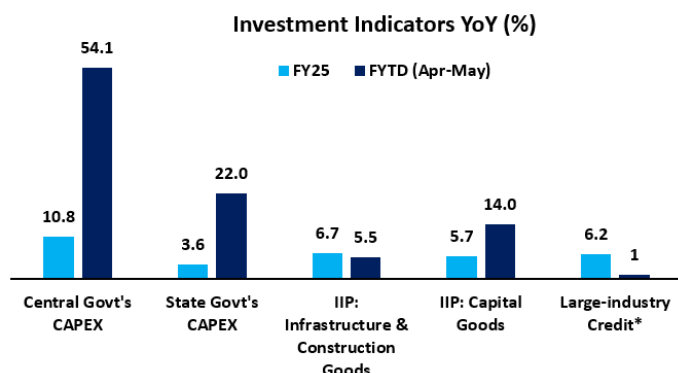
Global Uncertainty Expected to Weigh on Private Investment Outlook

Private sector investment remains subdued, with public sector capex continuing to drive overall investment growth. Central government capital expenditure surged by ~54% YoY during April–May, supported in part by a favourable base effect stemming from the general elections last year. State governments' capital spending has also shown robust growth in the early part of Q1 FY26.

However, the recovery in private investment remains tentative, weighed down by subdued urban demand and likely delays in finalising a comprehensive India–US trade deal. Although new private sector project announcements surged by 224% YoY in Q1 FY26 (as per CMIE data), this spike was largely due to a low base. On a sequential basis, project announcements fell sharply by 66%, indicating

continued caution among private investors. Bank credit to large industries has also slowed, further reinforcing the view that private sector capex remains hesitant amid global uncertainties and domestic demand headwinds. That said, if the India-US trade deal is finalised over August-September, it could provide a much-needed boost to business sentiment, reduce uncertainty, and support a recovery in private investment activity in H2 FY26.

Investment Activity Supported by the Government's Capital Expenditure



Source: CMIE; Note: *Large Industry credit refers to credit extended by SCBs to Large Industries and reported as end of period. State Governments' CAPEX number is for 17 States.

Goods Trade Deficit Narrows in June, but Q1 Deficit Higher; Services Surplus Remains a Key Buffer

India's merchandise trade deficit narrowed to a four-month low of US\$18.8 billion in June, primarily driven by a decline in non-oil non-gold imports. However, for Q1 FY26, the merchandise trade deficit widened to US\$67.2 billion, higher than the US\$62.1 billion recorded in Q1 FY25, driven by a 9.2% YoY increase in non-oil non-gold imports.

On the merchandise export front, overall exports were flat (-0.05%) in June and registered a muted growth of 1.9% YoY in Q1, mainly due to a sharp decline in oil exports, reflecting lower global prices. Encouragingly, non-oil exports rose by 5.9% in Q1, led by a surge in electronics exports, which grew 47% YoY (vs. 21.6% in Q1 FY25). This sharp uptick was likely due to front-loaded shipments to the US ahead of the July 9 deadline (further extended until August 1st), during which the US temporarily paused reciprocal tariffs on Indian goods. Notably, India's exports to the US grew by 22% in Q1 FY26.

Meanwhile, the services trade surplus remained robust. For Q1 FY26, total services exports grew by 11% YoY, while imports rose by 5% YoY, underscoring the sector's resilience despite weak global demand conditions. As a result, the combined (merchandise + services) trade deficit stood at US\$20.3 billion in Q1 FY26, slightly lower than US\$22.4 billion in Q1 FY25.

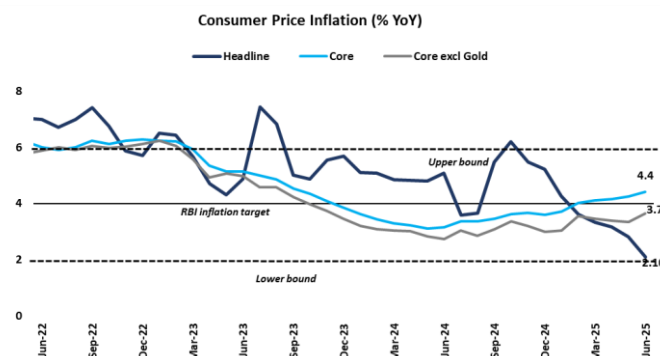
Looking ahead, we anticipate that the services trade will continue to be a key source of strength. However, merchandise exports may face renewed headwinds from slower global growth and delays in finalising the US-India trade deal. Further, the US administration has recently signalled potential tariff hikes on countries importing crude oil from Russia—posing a risk for India, which currently sources ~36% of its crude imports (by volume) from Russia at discounted rates. Any disruption or forced diversification in sourcing could significantly raise India's import bill in the coming quarters.

On a positive note, India and the UK signed a landmark free trade agreement in July 2025, eliminating tariffs on 99% of Indian exports to the UK and reducing India's average tariff on UK goods from ~15% to ~3%. Bilateral trade currently stands at nearly US\$ 56 billion, with an ambitious goal to double this by 2030. The agreement is expected to unlock new opportunities for labour-intensive sectors, including textiles, marine products, leather, footwear, toys, sports goods, and gems and jewellery, as well as fast-growing industries such as engineering goods, auto components, and organic chemicals. It also expands services trade by easing visa norms and enhancing market access for Indian professionals in IT, finance, legal, education, and digital sectors. These significant tariff cuts and broader market access are likely to support export growth, job creation, and improved competitiveness for Indian firms.

Headline CPI Inflation Falls Sharply; Outlook Favours Further Policy Easing

Headline CPI inflation eased significantly to 2.1% in June, marking the lowest reading since January 2019, and down from 2.8% in May. This sharp deceleration was primarily driven by food inflation, which turned negative (-0.2%) for the first time since February 2019. The decline was led by deeper deflation in vegetable prices (-19% YoY vs. -13.7% in May), alongside softening prices for cereals, pulses, and dairy products.

Headline CPI Inflation Falls to its Lowest Level Since January 2019



Source: CMIE

In contrast, core inflation edged up slightly to 4.41% in June from 4.26% in May, reflecting price momentum in select categories such as personal care and effects (notably gold), education, recreation, and transport & communication. However, excluding gold, core inflation is estimated at around 3.7%, indicating that underlying inflation pressures remain relatively well-anchored.

The broader inflation outlook remains favourable. The WPI contracted by 0.1% YoY in June, and agricultural prospects remain favourable. The southwest monsoon covered the entire country nine days ahead of schedule, with cumulative rainfall 4.9% above the long-period average (as of July 23rd) and reservoir levels reaching 57% of full capacity (as of July 17). These factors have supported healthy Kharif sowing. In light of these developments, we revise our FY26 average CPI inflation forecast downward to 3.2%, from an earlier estimate of 3.7%. We expect headline inflation to bottom out in July, likely in the range of 1.4% to 1.8%, before gradually firming up in the second half of the year, primarily due to base effects.

Monetary Policy: Further Easing Likely Amid Benign Inflation and Uneven Economic Recovery

In its June meeting, the RBI's Monetary Policy Committee (MPC) highlighted the need to stimulate domestic private consumption and investment, emphasising the importance of policy support to reinvigorate growth momentum. Reflecting the evolving growth-inflation dynamics, the RBI front-loaded a 50-bps policy repo rate cut along with a 100-bps reduction in the Cash Reserve Ratio (CRR). However, the central bank also shifted its policy stance to 'neutral', signalling limited remaining monetary policy space to support growth going forward.

Since then, inflation has continued to trend below the RBI's projections. With the June CPI print, average headline inflation for Q1 FY26 (Apr–Jun) stood at 2.7%, 20 bps below the RBI's forecast of 2.9%. Given the sustained disinflationary momentum, we believe that FY26 CPI inflation will undershoot the RBI's full-year projection of 3.7%, potentially prompting a downward revision in the August policy review. Meanwhile, the economic recovery remains uneven, with growth concentrated in select sectors. Policy transmission also remains incomplete, and its full impact is expected to play out over the coming quarters. In this context, the balance of risks continues to favour further monetary easing.

The RBI Governor's mid-July interview also raised expectations of another rate cut, especially as both inflation and economic growth are likely to undershoot the central bank's projections. Moreover, the real policy rate, based on the RBI's current 3.7% inflation forecast for FY26, stands at ~1.8%. If the inflation forecast is revised down to 3.2%, the

real rate estimate could rise to ~2.3%, significantly above the estimated neutral range of 1.4–1.9%. This suggests that the current real rate may be too restrictive, bolstering the case for additional easing.

While inflation is expected to firm up in H2 FY26 and into FY27, this is likely to be largely driven by base effects and should not deter the RBI from supporting growth in the near term. We expect a 25-bps repo rate cut in Q3 FY26, once there is greater clarity on monsoon performance, kharif output, progress on the US–India trade deal, the Fed's policy outlook, Q1 GDP data, and the pace of domestic monetary transmission. That said, a rate cut in the upcoming policy meeting in August remains a possibility.

Liquidity Conditions: Comfortable Surplus to Aid Monetary Policy Transmission

In terms of liquidity management, the RBI continues to ensure ample liquidity to support transmission, while mopping up excess liquidity through Variable Rate Reverse Repo (VRRR) and conducting fine-tuning operations as needed.

Surplus liquidity in the banking system surged from Rs 2.8 lakh crore in June to over Rs 4 lakh crore in the first week of July. As of July 23, the average liquidity surplus in the month is tracking close to Rs 3.2 lakh crore. This liquidity glut has led to a decline in the Weighted Average Call Rate (WACR), which eased from an average of ~5.37% in June to ~5.26% in July (till July 18), and fell below the Standing Deposit Facility (SDF) rate of 5.25% on some occasions.

In response to evolving liquidity conditions, the RBI resumed VRRR operations to realign the WACR with the policy repo rate of 5.5%, the midpoint of the Liquidity Adjustment Facility (LAF) corridor. These, coupled with GST outflows, led to WACR rising above the policy repo rate in the last few days, prompting the RBI to inject liquidity through Variable Rate Repo. Going forward, liquidity conditions are expected to remain comfortable, supported by the staggered implementation of the 100-bps CRR cut (announced in June) between September and November, and anticipated front-loading of government spending.

Market Update

Equity Market: Despite persistent global market volatility, Indian equities ended June on a positive note, with the NIFTY50 Index rising 3.1% MoM. Sentiment was buoyed by easing geopolitical tensions in the Middle East and a larger-than-expected rate cut by the RBI. Foreign portfolio investors (FPIs) continued to be net buyers for the third consecutive month, supporting market momentum.

However, volatility resurfaced in July, driven by renewed tariff threats from U.S. President Donald Trump and initial

mixed corporate earnings results. As a result, FPI outflows resumed and market sentiment turned cautious, with the NIFTY50 down 1.2% month-to-date (as of July 23). In the near term, market direction is likely to be guided by corporate earnings, progress in U.S.–India trade negotiations, and any major policy announcements from the U.S. administration.

Bond Market: India's G-sec yield curve steepened following the RBI's June policy meeting, as the central bank shifted its stance to "Neutral" and highlighted limited policy space for future rate actions. The 10-year G-sec yield rose sharply to a high of ~6.37% in June, from pre-policy levels of around 6.24%, reflecting the market's recalibration to a more cautious monetary outlook.

However, the 10-year G-Sec yield has since eased to ~6.31%, supported by consecutive lower-than-expected inflation prints and the RBI Governor's mid-July media interview, which revived expectations of further policy easing. With headline CPI inflation potentially falling below 2% in July and the likelihood of a downward revision in the RBI's inflation forecast at the upcoming policy meeting, bond yields are expected to soften further as the market begins to price in another rate cut in the coming months.

Currency Market: The Indian rupee came under renewed but moderate pressure in recent months. After weakening in May, the rupee depreciated further in June, down by 0.2% MoM against the USD. This occurred despite a decline in the U.S. Dollar Index (-2.5%), as foreign capital outflows amid heightened global risk aversion weighed on the Indian currency. The pressure persisted in July, with the rupee depreciating by an additional 0.8% (as of July 23), breaching the 86/USD mark.

From a valuation perspective, the rupee's overvaluation—based on the 40-currency Real Effective Exchange Rate (REER) index—moderated sharply to 1.1% in May 2025, down from a peak of 8.1% in November 2024. This correction reflects recent depreciation of the INR and narrowing inflation differentials with key trading partners, and should reduce pressure on the currency. Looking ahead, we expect a mild weakening bias in the rupee, driven by persistent global uncertainty and likely subdued capital inflows. However, any positive outcome from US–India trade discussions could provide near-term support to the currency.

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