

India's Moderating Growth Amid External Headwinds Reinforces Reform Push; Low Inflation Keeps Door Open for Rate Cut



- US Fed Chair Powell's Jackson Hole speech marks a shift from "policy in a good place" to readiness to ease, as labour market fragilities outweigh tariff-related inflation concerns. We expect ~75 bps of total rate cuts starting in September, supporting household demand, and giving other central banks flexibility to cut rates as needed.
- India's economic growth momentum moderated in Q1 FY26, with real GDP growth forecasted at ~6.5%, down from the last quarter's 7.4%.
- In Q1, industrial output slowed sharply, while robust agriculture and resilient services continued to anchor overall economic growth.
- On the demand side, economic growth has been supported by front-loaded government spending and resilient rural demand, but urban demand improved only modestly, and private investment remained lacklustre.
- External trade has been volatile; goods exports were front-loaded ahead of US tariffs, but overall momentum remained subdued, while imports rose faster, widening the trade deficit.
- Trade tensions escalated as the US imposed a 50% tariff on Indian exports, with a potential 25–35 bps direct impact on GDP in FY26 (assuming a partial rollback in Q4).
- Amid rising external risks, the government stepped up reform efforts. It proposed a major GST rationalisation, moving from a complex four-tier structure to two principal rates, aimed at boosting consumption, improving ease of doing business and competitiveness.
- This GST reform, coupled with front-loading of government spending in Q1 amid signs of weaker revenue growth, poses risks of fiscal slippage, necessitating expenditure rationalisation in H2-FY26.
- The government's strong commitment to fiscal consolidation, along with improved quality of spending, has finally been rewarded with India's sovereign rating upgrade by S&P from BBB- to BBB.
- Inflation remains firmly on a disinflationary trajectory. CPI inflation fell to an eight-year low of ~1.6% in July, with core easing to ~4.2%. We revise FY26 CPI inflation forecast to ~2.8%, aided by a favourable food inflation outlook, contained crude oil prices, and muted WPI.
- In its August meeting, the RBI's MPC kept the repo rate unchanged at 5.5% and maintained a neutral stance. The minutes indicate that while some members noted space for easing, they preferred caution amid ongoing transmission and global uncertainty from US tariffs.
- The improved inflation backdrop and rising downside risks to growth should nudge the RBI to ease further in FY26. We continue to expect a 25-bps repo rate cut in Q3 FY26.

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Powell's Jackson Hole Speech Raises Hopes of September Rate Cut; Cumulative 75-bps Rate Cut Expected by March 2026

US Federal Reserve Chairman Powell, in his final Jackson Hole speech, signalled that the US central bank likely will resume reducing its policy interest rate at the September monetary policy committee meeting. Chair Powell did not provide an explicit commitment to lower rates next month. But his labour market characterisation, plus his statement that “risks may warrant adjusting our policy stance,” is about as strong a signal a Fed Chair will provide that interest rates are highly likely to be adjusted at the next policy meeting.

For much of 2025, Mr. Powell has characterised monetary policy as “being in a good place” and that he and his colleagues have been “waiting for more data” to assess how the economy has been evolving in response to the heterodox Trump 2.0 economic policy mix. Left unsaid by the Fed Chair is that he and other officials have been trying to buy time to see if the tension between their two Congressional mandates – stable prices and maximum employment – might clearly resolve itself. By tension between the Fed's two mandates, we refer to the fact that the prevailing inflation rate remains above the Fed's medium-term target (and its move back toward target has paused) and that the unemployment rate is at close to 4% and the low level of job losses has suggested a healthy employment environment.

Our assessment of the US labour market has been less rosy than the Fed's throughout 2025 and is a key reason we wrote in last month's Economic Monitor Report that the Fed was likely to resume lowering interest rates as soon as September. Despite a relatively steady unemployment rate close to 4%, developments below the surface have been hinting at a potentially brittle labour market, one potentially quite sensitive to any adverse economic developments. The hiring rate has been exceptionally low; the rate of job changes also has been very low, indicating caution by both employers and employees; nominal wage growth has moderated and, notably, the premium wage increase that job switchers typically receive has fallen sharply; job growth in cyclically-sensitive sectors has been tepid or worse.

The most recent US monthly employment data seem to have brought Chair Powell closer to our assessment of the labour market. The data showed tepid job growth in the latest month (July) and outsized downward revisions in prior months (May and June). Month-to-month employment figures are notoriously volatile, so upcoming data may further revise these figures (for better or worse). Nonetheless, these latest monthly employment figures have highlighted the labour market's brittleness beneath

the surface, and a single month (or two) of better data will not alter that reality.

Meanwhile, the Fed Chair also moderated his view on the risk of tariffs producing a sustained rise in inflation. To be sure, he remains attentive to the possibility of such an outcome and was clear that the Fed will not tolerate an environment where President Trump's tariffs lead to a cycle of sustained inflation. But he, nonetheless, explicitly noted that the balance of risks is such that tariffs are likely to be a price-level effect – i.e. have a one-time effect – and that, combined with the balance of risks in the labour market, leaves monetary policy positioned to provide some cushioning effect.

We remain of the judgment that households do not currently have the nominal income growth/discretionary spending power for the tariffs to result in recurring price gains. The present is not 2021 and 2022 when the labour market was among the hottest in the post-WWII era with rampant job switching, double-digit percentage compensation gains for job switching, record shortfall in the supply of workers vis-à-vis job openings and tremendous desire by businesses to do whatever necessary to get back to business following the Covid disruptions. Instead, nominal income growth is growing at a 3½% to 4% pace – healthy but consistent with a 2% to 2½% trend core inflation rate and modest enough to result in consumer substitution away from goods/services whose prices rise meaningfully.

Post Chair Powell's Jackson Hole speech, we continue to expect about 75-bps of interest rate reductions, likely in the form of three 25-bps cuts. Given several Fed policymakers' ongoing concerns about the spot rate of inflation and possible inflationary effects from tariffs, we remain agnostic whether these three cuts will happen at consecutive meetings (September, October, December) or be spread out between September and March 2026.

The pending resumption of US monetary easing will provide additional scope for non-US central banks to provide policy support to their respective economies should they judge it necessary. Such a development is positive for the global economy writ large.

India's Economic Momentum Moderates in Q1; Increased Trade Tensions Pose Headwinds

India's economic momentum likely moderated in Q1 FY26, marking a sharp deceleration from the previous quarter when transient factors had pushed growth to a four-quarter high of 7.4%. The June quarter highlighted an uneven growth profile, with areas of resilience but also signs of sluggishness. We forecast real GDP growth at ~6.5% in Q1 FY26, as lower deflator, higher net indirect taxes, and front-

loading of government spending likely provided an additional boost than previously anticipated.

On the supply side, industrial activity weakened considerably, although agricultural performance remained robust and services continued to exhibit resilience, thereby sustaining overall economic activity. On the demand side, government expenditure was the crucial driver, with strong front-loading of capital outlays and revenue spending. Rural consumption remained the mainstay of demand recovery, while urban consumption registered only moderate improvement. Meanwhile, elevated uncertainty around trade policy continues to weigh on the outlook, particularly for export-dependent sectors. Private investment remained subdued, constrained by global volatility and uneven domestic demand recovery, delaying prospects of a broader investment cycle.

Looking ahead, domestic policy measures could support demand over the remainder of the year. The proposed rationalisation of GST rates, combined with previously announced income tax cuts, ongoing easing of inflation and the resulting support for real income, and continued pass-through of policy rate cuts, should provide a boost to consumption recovery. This could, in turn, encourage selective private investment in domestic demand-oriented sectors. However, significant external headwinds remain. The recent imposition of an additional 25% tariff by the US, on top of the previously announced 25%, poses headwinds. Delays in finalising a US–India trade agreement also risk dampening investment in industries like electronics and pharmaceuticals, despite their temporary exemption from higher tariffs.

Moreover, fiscal spending is expected to moderate in the coming quarters, both to preserve fiscal discipline and to offset revenue pressures from weaker tax collections and planned GST cuts. Taken together, these dynamics point to a continuation of uneven growth, with resilience in select sectors but downside risks from external shocks and softer fiscal support. Overall, we expect real GDP growth to ease to around 6.2% in FY26 from 6.5% in FY25, with risks skewed to the downside.

Given these downside risks, combined with the improved inflation backdrop, should nudge the RBI to cut the policy repo rate by 25-bps in Q3 FY26. More broadly, as long as inflation remains well-behaved, the RBI is well-positioned to help buffer adverse economic impulses.

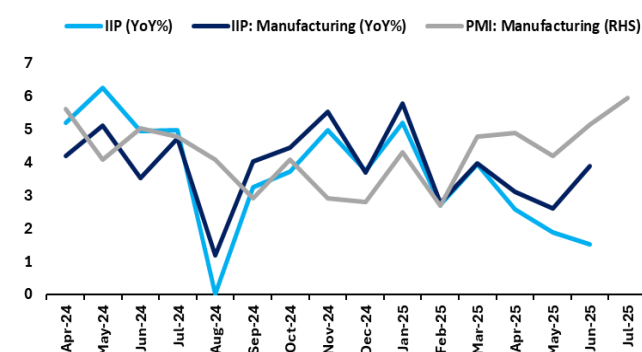
High-frequency Indicators Signal a Marked Industrial Slowdown; Agriculture and Services Remain Resilient

Industrial activity weakened sharply in Q1 FY26, with the Index of Industrial Production (IIP) growth slowing to a three-year low of 2.0% YoY, down from 5.4% YoY recorded

in the same period last year. The slowdown was broad-based, reflecting subdued manufacturing momentum alongside contractions in both mining and electricity output. Within the use-based classification, capital goods and infrastructure & construction goods held up relatively well, likely supported by accelerated government capex, while consumer-related and primary goods categories showed weakness.

High-frequency indicators have offered contrasting signals for early Q2. Core sector activity remained weak in July, but the Manufacturing PMI rose to 59.1, its highest level in the past 16 months, on the back of stronger new orders, robust output, and resilience in intermediate goods. That said, business confidence has eased to a three-year low. Looking ahead, industrial momentum may recover marginally in the near term as seasonal drags on mining and electricity begin to fade, but manufacturing is likely to remain subdued and uneven, given uneven domestic consumer demand and increased external headwinds.

Industrial Sector Activity Weakened in Q1 F26



Source: CMIE.

Agricultural activity remained a relative bright spot in Q1 FY26, supported by robust rabi production, normal monsoon rainfall, and strong Kharif sowing (tracking 3.7% YoY by mid-August) performance. Prospects for the upcoming Rabi season (winter crops) are also positive, underpinned by healthy reservoir levels. Overall, agriculture is expected to provide stability to the growth momentum in FY26, supporting rural consumption demand.

The Services sector is estimated to have remained the main growth anchor in Q1 FY26, with services real GVA likely expanding close to FY25's pace of around 7.2%, with some modest upside. The sector resilience is underpinned by growth in financial, real estate, professional services and public administration, defence and other services, which likely helped offset softer momentum in trade, hotels, transport and communication. Listed corporate earnings data point to a marked slowdown in communication services and wholesale/retail trade, even as lower input costs cushioned margins. Public administration activity is expected to have remained resilient, underpinned by higher

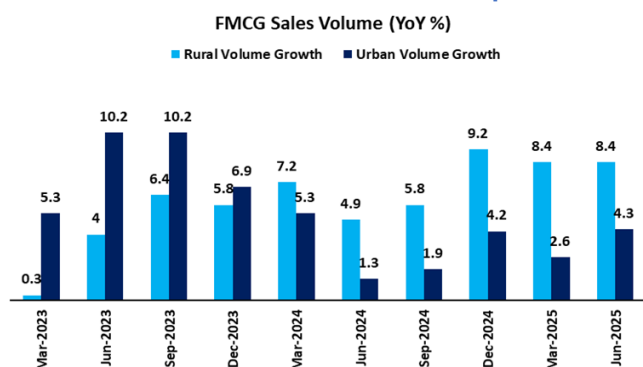
government revenue expenditure (excluding interest payments and subsidies). The financial sector is expected to show a modest pickup, with a slower pace of nominal credit and deposit growth in Q1 compared to the previous quarter, likely offset by lower deflators. On balance, services are expected to remain the primary driver of overall GVA growth. Looking ahead, India's Services PMI rose to an 11-month high of 60.5 in July, supported by strong domestic and external demand, indicating stable demand dynamics in the sector.

Rural Demand Leads the Consumption Recovery; Urban Demand Recovery Remains Uneven

Private consumption dynamics in Q1 FY26 broadly played out as expected, with rural demand providing the main impetus while urban consumption improved only moderately and remained uneven. NielsenIQ data highlight this continued divergence, with rural FMCG volumes rising by 8.4% YoY compared with 4.3% in urban markets. Two-wheeler registrations (a proxy for rural discretionary spending) rose by an average of 5.3% YoY in Q1, reversing a 0.7% contraction in Q4 FY25 and reinforcing signs of rural resilience. An improvement in rural real wages and stronger Rabi output underpinned this strength. The trend is expected to continue with a favourable farm sector outlook.

Urban consumption, in contrast, remained softer despite a sequential pickup. Passenger vehicle registrations growth moderated to an average of 4.1% YoY in Q1 (versus 4.6% in Q4 FY25), underscoring lingering pressures in discretionary spending. While FMCG demand saw moderate gains, the broader trend was restrained due to subdued real wage growth. Non-financial listed corporates' real wages & salary expenses growth slowed to 2.6% in FY25 from 4.2% the previous year, with Q1 FY26 improving to ~3.9% but still below the FY23–24 trend.

Rural Areas Continued to Lead Consumption Recovery



Source: NielsenIQ, RBI, Media Reports

A robust consumption recovery remains contingent on a sustained improvement in labour market conditions. High-frequency labour-market prints remain mixed. As per CMIE data, India's unemployment rate eased to a 34-month low of 6.8% in July, driven mainly by rural improvement. Formal

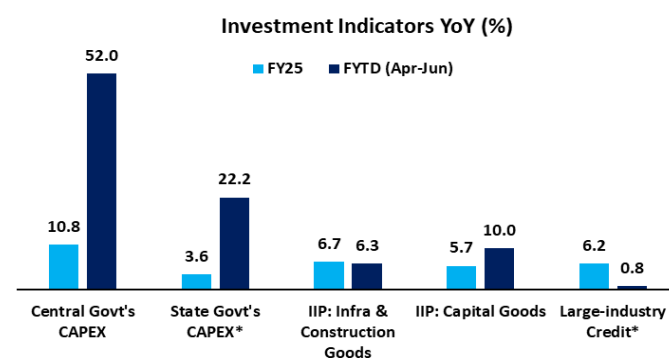
hiring momentum softened, with Naukri JobSpeak Index growth easing in July compared to June. Hiring risks remain tilted toward downside for export-facing sectors such as textiles and gems & jewellery, impacted by US tariffs, though domestic-facing sectors may gain from the announced GST rationalisation. Overall, rural demand is expected to continue to lead recovery. We also expect a moderate pick-up in urban demand supported by a gradual pick-up in wages, income-tax cuts (announced in the Budget) and planned GST rationalisation.

Government-led Capex Continues to Drive Investment; Private Investment Remains Subdued

Government spending continued to anchor the investment cycle in Q1, with strong front-loading of capex providing the primary support to overall fixed capital formation. In contrast, private investment remained subdued, reinforcing the broader pattern of government capex-led recovery.

Moreover, forward-looking indicators suggest private sector investment will likely remain tentative. CMIE data show that new private-sector project announcements surged over 200% YoY to Rs 5.2 lakh crore in Q1 FY26. However, this sharp increase is primarily due to the favourable base effect from last year when general elections kept the investment environment muted. Compared to the average of the past three years' Q1-FY, the growth is only marginal, indicating that a meaningful private capex recovery is yet to take hold. Overall, the trend reflects continued corporate caution in the face of elevated global uncertainties, weak external demand, and uneven domestic consumption growth.

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 is based on 18 States' data.

Trade Tensions Escalate as US Imposes 50% Tariff on India's Exports

India's external sector remained under strain in Q1 FY26, weighed down by weak global demand and escalating trade-policy headwinds. Total exports (Goods & Services) rose by 5.4% in Q1 (vs 3.5% in Q4 FY25), led by robust services exports as goods exports showed subdued

momentum despite shipment front-loading to the US. Meanwhile, the imports also widened, growing by 3.6% YoY (vs 1.9% in Q4), backed by higher goods imports. The narrower services surplus, combined with a wider merchandise deficit, led to further deterioration in the overall trade balance.

Exports rose 7.3% YoY in July, boosted by shipment front loading, with exports to the US up 19.9% YoY ahead of tariff implementation. Imports rebounded strongly (+8.6% YoY) after two months of contraction, with gains across major categories. However, services exports slowed sharply to a 16-month low of just 1.4% YoY in July, while services imports contracted by 3.4%. As a result, the overall trade deficit widened to an eight-month high in July.

The external trade environment has turned more challenging, with a sharp escalation in trade tensions. The US administration announced an additional 25% tariff on Indian exports, effective August 27, 2025, in relation to India's continued crude oil imports from Russia, raising the cumulative tariff burden on India to 50%, significantly higher than for peer economies. With India's exports to the US at about 2.2% of GDP, a prolonged 50% tariff regime could have direct impact of ~40–50 bps of the FY26 GDP—excluding second round effects such as trade diversion, weaker investor sentiment, or supply chain reconfiguration and present select sectoral exemptions. Some sectors (particularly pharmaceuticals and smartphones) have received temporary exemptions. However, these exemptions are currently under review, and there is uncertainty about their continuation. Select industries, notably textiles, gems & jewellery, leather, and seafood, face significant headwinds due to US tariffs, given their high reliance on US markets.

Select Industries Highly Vulnerable to US Tariffs

Goods Category	Share in India's exports to US in FY25 %	Share of US in Total Industry Exports in FY25 %
Electronics	18.4	36.1
Gems & Jewellery	11.5	33.3
Pharmaceuticals	11.3	39.8
Textiles*	11.3	39.5
Machinery, Parts etc.	7.7	20.0
Agricultural & Allied Products*	6.5	11.2
Refined Petroleum Products	4.9	6.3
Iron & Steel and Articles thereby*	4.3	19.1
Organic Chemicals	3.1	13.2
Auto Components	3.0	11.4
Plastic Articles	1.9	20.5
Miscellaneous Chemical Products	1.4	17.3
Furniture & Accessories	1.3	44.8
Articles of Stone, Cement etc.	1.1	43.1
Optical Parts	1.1	18.3
Glass & Glassware	0.4	30.1

Source: Ministry of Commerce & Industry; USITC; **Note:** Textiles include HS Code 61, 62, 63, 57 & 59. Agriculture & Allied sectors include HS Code 01–20, 22, 23 & 24. Iron & Steel and articles thereof include HS Codes 72 & 73.

Given the current backdrop, the likelihood of concluding a trade deal by September–October now appears

increasingly low. A narrower interim agreement is still possible — though complicated by the renewed US focus on ending the Russia-Ukraine conflict — and would depend on mutual compromise. In the near term, Indian exporters face higher tariffs and policy uncertainty, with potential spillovers into market sentiment and investment flows. Export-oriented industries could face a sharp fall in orders and margin stress, though some relief could emerge in H2 FY26 if tariff risks reduce. Our baseline assumes US tariffs remain at 50% through Q3 FY26, followed by a partial rollback to 20–25% in Q4 under a possible interim agreement by then. Under this scenario, the GDP drag would be somewhat contained to 25–35 bps. Thus, the overall trade outlook is clouded by elevated US–India tensions and global demand softness, posing downside risks to trade and overall economic growth.

Government Front-Loaded Spending Supports Near-Term Recovery; Constrains Space for the Rest of FY26

The government's emphasis on fiscal consolidation, coupled with efforts to improve the quality of expenditure, has finally been rewarded with a sovereign rating upgrade by S&P from BBB-/Positive to BBB/Stable (see box for details on page 7). This is a significant and positive development for India's ongoing economic transformation. We expect the authorities to remain committed to fiscal discipline, even as they provide targeted stimulus through income tax relief in the Budget and planned indirect tax cuts (GST cuts) around Diwali to support economic recovery and competitiveness.

In Q1 FY26, the government frontloaded expenditure to sustain economic momentum. Central spending rose 26% YoY, led by a 52% surge in capital expenditure as investment outlays were advanced early in the year. Revenue expenditure also firmed, rising 20% in Q1, partly due to higher interest payments. States mirrored this trend: for 18 states, capex rose ~22% in Q1, while revenue spending increased ~10%.

On the receipts side, non-debt inflows rose 12.9% YoY in Q1, short of the 13.6% budget estimate, despite a 33.2% surge in non-tax revenues driven by record high RBI's dividend. Larger devolution to states and weaker direct taxes growth weighed on net tax revenues, which fell 1.7% YoY even as gross tax revenue grew by a muted 4.6%. Consequently, the fiscal deficit widened sharply in Q1 and may face further strain with the proposed GST rationalisation.

While frontloading of fiscal spending has bolstered economic growth, it has also constrained fiscal space for the remainder of the year. Based on current trends, implied central government capex for July 2025–March 2026 could contract by ~2.9%, while revenue expenditure (excluding

subsidies and interest) is estimated to rise at a moderate pace of ~6%, posing risks to economic momentum.

Government Plans Major GST Reform to Support Recovery and Boost Competitiveness

The GST overhaul plan, unveiled in the Prime Minister's Independence Day address, is the most ambitious reform since its 2017 launch. It aims to ease the tax burden on households and MSMEs, boost demand, and cut compliance costs, with a potential rollout around Diwali. A task force to identify "next-generation reforms" will also review economic laws and procedures to align governance with the 2047 development vision.

Current GST Slab Structure		
Slab	Revenue Share	Key Goods/Services
5%	6-8%	Electric vehicles, Sugar, Edible Oil, Paneer, Tea, Coffee, Coal, LPG, Life-Saving Drugs, Goods transport services
12%	5-6%	Mobile Accessories, Building materials, Computers, Construction materials, Packaging materials, Butter, Ghee, Processed Foods, Readymade garments (above Rs1,000), Construction services (residential), Works contracts
18%	70-75%	Mobile Phones, Capital Goods, Printers, Computers, Televisions, Electronic items, Telecom services, Cosmetics, Steel products, Machinery, Furniture, Soaps, Financial services, IT services, Consulting, Legal services
28%	13-15%	High-end electronics, ACs, large TVs, Cars, High-end Bikes, Cement
Others	1-2%	

Source: CBIC, Lok Sabha, Media Reports; **Note:** Revenue Share corresponds to FY24.

The proposal seeks to replace the current four-tier GST structure (5%, 12%, 18%, 28% + cess) with two principal rates—5% and 18%—and a 40% rate for demerit goods, while retaining concessional rates for labour-intensive sectors. The reform aims to simplify classification, correct inverted duty structures, and enhance ease of doing business. In FY24, the 18% slab accounted for ~72.5% of GST collections, the 28% slab ~14%, the 12% slab ~5.5%, and the 5% slab ~7%. Media reports suggest ~99% of items currently taxed at 12% may shift to 5%, while ~90% of items in the 28% slab may move to 18%. The planned GST cut would lower prices of both essentials and aspirational goods, boosting household purchasing power, while reducing disputes and distortions.

The fiscal implications, however, are material. The annualised revenue loss is estimated at ~Rs 1.7 trillion (0.47% of GDP), with the Centre likely to absorb ~0.14% and states the remainder. If new GST rates are implemented from October 2025, the FY26 revenue loss would be ~0.23% of GDP, including ~0.07% for the Centre. Likely demand gains should partly offset some of the revenue shortfall. The planned GST revamp should provide a near-term boost to economic growth; using a GST multiplier of 1.08, GST cuts could provide a policy stimulus of ~0.25% of GDP in FY26. While higher-than-expected RBI dividends and savings from the GST compensation cess provide some buffer, slower tax revenue growth

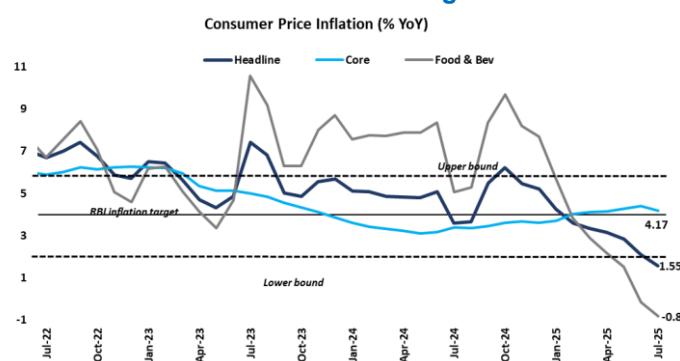
combined with likely lower nominal GDP (vs. the 10.1% assumed in the Budget) raises the risk of fiscal slippage by 10–20 bps (% of GDP) for the central government, without expenditure rationalisation.

Despite these near-term pressures, the GST revamp (together with other reforms to be identified by the task force) marks a decisive step in India's tax rationalisation journey. Over time, greater formalisation and predictability should broaden the tax base, cushion the fiscal impact, enhance ease of doing business, and reinforce India's standing in global trade negotiations where indirect tax regimes are increasingly on the agenda.

CPI Inflation Slumps to an Eight-Year Low, Core Inflation Also Moderates

Inflation remains firmly on a broad-based disinflation trajectory. Headline CPI inflation eased sharply to an eight-year low of ~1.6% in July from 2.1% in June. The deceleration was led by food inflation, which contracted for a second consecutive month. Core inflation also moderated to 4.17% in July from 4.41% in June, led by easing in services, while goods inflation was steady due to higher gold prices. Excluding gold, core inflation is closer to 3.2%, a level that should provide comfort to the RBI, which has been closely monitoring the core inflation trajectory. While led by food, the ongoing moderation in inflation is broad-based. In July 2025, 38% of items in the CPI basket recorded inflation below 2%, up from 21% two years ago and 35% in July 2024.

Headline CPI Inflation Falls to an Eight-Year Low



Source: CMIE

Looking ahead, the food inflation outlook remains favourable, supported by normal rainfall and strong kharif sowing. Healthy reservoir levels also bode well for the rabi crops. Meanwhile, easing WPI inflation is expected to keep core pressures contained, and crude oil prices are capped by slower global demand and higher OPEC output. Reflecting these factors, we revise our FY26 CPI inflation projection down to ~2.8% from 3.2%, with further possible decline due to the planned GST cut.

Focus Section: S&P Upgrades India's Sovereign Rating to 'BBB' with Stable Outlook

On August 14, S&P Global Ratings upgraded India's long-term sovereign credit rating from 'BBB-' to 'BBB' and raised the short-term rating to 'A-2' from 'A-3'. This is India's first S&P sovereign upgrade in 18 years. Moody's rates India at Baa3 and Fitch at BBB-. An enhanced sovereign rating reinforces India's global bond index inclusion story and improves India's attractiveness for FDI inflows.

Key Drivers of the Rating Upgrade:

1. Economic Resilience and Growth

S&P cited strong resilience and a robust post-pandemic recovery, with real GDP growth averaging 8.8% during FY22–FY24, the highest in Asia-Pacific. It projects economic growth to average 6.8% annually over the next three years, supported by consumption and public investment. This momentum should help gradually reduce the debt-to-GDP ratio despite still-high fiscal deficits. Structural strengths include favourable demographics, competitive labour costs, and improved corporate and banking sector balance sheets.

S&P also expects the impact of U.S. tariffs to be manageable. India's economy, driven primarily by domestic consumption (60% of GDP), is less exposed to trade shocks. Further, any potential shifts in crude sourcing from Russia could impose a small fiscal cost (if borne fully by the govt), as Russia's crude oil discount is presently moderate.

2. Fiscal Consolidation and Spending Quality

India's fiscal profile remains the weakest part of its credit story, but consolidation has gained traction. The general government deficit is projected to decline from 7.3% of GDP in FY26 to 6.6% by FY29. Spending quality has improved, with public capex on infrastructure at ~5.5% of GDP, comparable with/above sovereign peers. Subsidy compression has created space for capex. The FY26 Union Budget targets a 4.4% deficit (vs. 4.8% in FY25), supported by GST inflows, RBI dividends, and capex rationalisation.

India's debt trajectory improved from the pandemic-years changes in net general government debt of 9–13% of GDP to 7.8% presently, with net general government debt to GDP ratio projected to fall from 83% in FY25 to 78% by FY29. Favourable growth–interest differential supports debt sustainability. Nonetheless, fiscal challenges persist given state governments high deficits (~2.7% of GDP).

3. Stronger Monetary Policy Framework

S&P highlights notable improvements in monetary policy credibility. Since adopting inflation targeting, CPI inflation has stabilized compared to the double-digit levels seen on several occasions during the 2008–2014 period. Over the past three years, CPI averaged 5.5% despite global volatility. Anchored inflation expectations strengthen India's policy framework and macro stability.

Political stability and policy continuity were also cited as positives, alongside a robust external profile. The CAD is projected at 1.0–1.4% of GDP through FY26–FY29, cushioned by competitiveness gains from a weaker rupee. External buffers remain strong: reliance on foreign debt is limited, while the rupee now accounts for 1.6% of global FX market turnover, reflecting deeper liquidity and market participation.

The agency assigned a Stable outlook, reflecting its expectations of policy continuity, sustained public investment, and cautious fiscal and monetary management, which should gradually ease India's debt and interest burden. The agency may upgrade the rating if fiscal deficits narrow meaningfully and the net change in general government debt falls below 6% of GDP on a structural basis.

RBI in Wait-And-Watch Mode; Holds Status-Quo on Rates in August; Balance of Risks Favour Rate Cut

Following the front-loaded rate cut in June, the RBI's MPC kept the repo rate unchanged at 5.5% in August and maintained a neutral stance. The RBI noted that disinflation has been largely food-driven, while core remains steady around 4%. Minutes of the meeting showed some members noting space for policy easing but preferring caution amid ongoing transmission, evolving data, and global uncertainty from US tariffs. The Governor also emphasised a meeting-to-meeting approach, keeping the door open for future cuts if growth falters and inflation stays contained.

As anticipated, the RBI cut its FY26 inflation forecast to 3.1% (from 3.7%), noting a faster-than-expected decline in food prices, with major weather disruptions posing downside risks. As per RBI, inflation is projected to stay below 4% in Q2–Q3, before rising to 4.4% in Q4 and 4.9%

in Q1 FY27, driven by base effects. We expect inflation to undershoot even these revised numbers, given a favourable food inflation outlook, contained global crude prices, and the possible GST rate cut, which could further lower inflation in Q3–Q4 depending on passthrough.

On growth, the RBI retained its FY26 real GDP forecast at 6.5% and projected 6.6% for Q1 FY27. While headline real GDP growth is likely holding up near 6.5% in Q1, the recovery remains uneven, heavily reliant on fiscal spending. The planned GST cut should provide some support, though its benefits could be offset by likely fiscal expenditure rationalisation and external headwinds. Overall, the improved inflation backdrop and rising downside risks to growth should nudge the RBI to ease further in FY26. We continue to expect a 25-bps rate cut in Q3 FY26.

Market Update

Equity Market: Indian equities came under pressure in July, with the NIFTY50 declining 2.9% MoM as persistent global market volatility and mixed corporate earnings dampened sentiment. The trend carried into early August, initially amplified by the US decision to impose a 50% tariff on Indian exports. However, sentiment improved more recently, aided by the government's GST rationalisation announcement, alongside the boost from S&P's sovereign rating upgrade and easing concerns of additional US sanctions linked to India's Russia oil imports. These factors helped stabilise markets, with the NIFTY50 tracking 0.4% above the previous month's close as of August 22.

Looking ahead, domestic drivers such as fiscal stimulus through tax cuts may continue to lend support to equities. However, global headwinds, especially a likely delay in a US-India trade agreement and uncertainty over tariff relief, pose risks to market sentiment.

Bond Market: Government bond yields have firmed across the curve since the last policy meeting, reflecting the RBI's continued pause and renewed fiscal concerns stemming from the proposed GST rationalisation. The brief rally that followed S&P's upgrade of India's sovereign rating to BBB quickly faded—the 10-year G-Sec, which had eased by ~8-bps on August 14, rose to ~6.55% by August 22nd. At the shorter end, rates remained relatively stable, anchored by system surplus liquidity, which averaged around Rs 3.1 lakh crore in August (till 22nd). The overnight WACR averaged ~5.47% (in the previous week), staying below the policy repo rate. Liquidity conditions are expected to remain accommodative in the coming months, supported by the phased implementation of a CRR cut.

In the near term, yield pressures may persist on account of fiscal concerns. However, the medium-term outlook appears more constructive, supported by index-related demand (FTSE bond inclusion from September) alongside a likely 25-bps policy rate cut in Q3 FY26 and possibly some term premium compression post-sovereign upgrade.

Currency Market: The rupee came under renewed depreciation pressures in July, weakening 2.2% to close at 87.6 per USD, a five-month low, after a marginal 0.2% decline in June. The weakness was largely driven by global factors, with the US Fed's decision to keep rates unchanged strengthening the dollar and pushing US Treasury yields higher.

The pressure persisted into early August, with the rupee touching a record intraday low of 87.8/USD on August 5. However, the rupee has since staged a moderate recovery, supported by a softer dollar index and positive sentiment around the government's GST rationalisation measures. By

August 22, the currency had strengthened about 0.3% from its early-month low, closing at 87.53 per USD. Near-term outlook for the rupee is likely to be influenced by the evolving US Fed policy outlook and developments around the US tariff policy.

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