

Policy Support Lifts Domestic Demand Outlook Amid Increased External Headwinds



- As anticipated, the US Federal Reserve cut its policy rate by 25 bps in September and signalled further reductions in 2025, potentially as early as October and December. Softer labour market data prompted the move, though US growth remains supported by corporate profits, consumption, and fiscal stimulus.
- India's real GDP growth rose to a five-quarter high of 7.8% YoY in Q1-FY26, driven by a favourable deflator and front-loaded government spending.
- High-frequency indicators in early Q2 suggest a pickup in economic momentum, with gains visible across industry, consumption, and services activity.
- The GST Council announced a landmark reform in September, consolidating tax slabs from four to two, and signalling a policy shift from government-led investment toward reviving private consumption demand.
- Government spending is likely to take a back seat in H2-FY26 after strong front-loading, with fiscal space further constrained by GST-related revenue losses and earlier income tax reductions.
- External conditions remain challenging, with the US imposing a 50% tariff on Indian merchandise exports from late August. Meanwhile, the US H-1B visa fee hike highlights that India's services exports are not insulated from US reshoring efforts.
- Economic momentum may moderate in H2-FY26 as the deflator effect fades, government spending slows, and US tariffs weigh on trade. However, GST and income tax cuts, along with RBI easing, are expected to boost private consumption and support a transition toward private-sector-led growth, broadening the growth base into FY27.
- Given these dynamics and a stronger-than-expected Q1 growth, we have revised our FY26 real GDP growth forecast upward from 6.2% to 6.8%.
- Headline CPI inflation remained subdued at ~2.1% in August, with core inflation easing to around 4.1%. GST rate cuts should further lower inflation, thereby widening the RBI's policy space for additional easing. We have revised our FY26 inflation projection from 2.8% to 2.5%, primarily due to the impact of the GST cut.
- Despite stronger Q1 GDP data and a GST stimulus, we expect the RBI to cut the policy rate by 25 bps in Q3-FY26 to nurture consumption recovery amid external headwinds, constrained fiscal space, and an improved inflation outlook. The policy repo rate cut in the October meeting is a close call, with some possibility of it being delayed, with a dovish tone, until December.
- In the near term, targeted policy support from the RBI and the government is also expected for sectors adversely affected by US tariff actions.

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US Fed Cuts the Policy Rate by 25 bps, Signals Additional Cuts in 2025

The US Federal Reserve this month resumed lowering interest rates and, more importantly, signalled that additional rate reductions were ahead. The Fed's 25 bps reduction in its main policy interest rate in September was widely expected following Fed Chairman Powell's Jackson Hole speech last month and recent weeks' soft labour market data. Mr. Powell's press conference, combined with the Monetary Policy Committee's forecasts for growth, inflation, and interest rates, suggests a high likelihood of additional easing, including as soon as the October Monetary Policy Committee meeting.

We remain confident in our assessment that the Fed will lower its policy rate by about 75 bps in the mini-easing campaign now underway. Whereas we were previously agnostic about whether the anticipated three 25 bps rate cuts would occur at consecutive meetings or be spread out a bit, it now seems highly likely – with a probability of 85% plus – that the next two 25 bps reductions will be in October and December.

A key pillar of our confidence in this judgment is Chairman Powell's – and seemingly most Fed policymakers' – changed assessment of the US labour market. Recent high-profile labour market data undoubtedly crystallised Fed officials' less upbeat assessment of the labour market. The past two monthly employment reports have shown scant increases in headcount and have extended the trend of downward revisions to prior months' data – typically a sign of budding weakness. Moreover, as part of the annual revisions to employment estimates, US government statisticians estimate that there were roughly 900,000 fewer jobs in the past year than initially estimated.¹ These developments led officials to cease characterising the labour market as "solid" in their official communique and, per Mr. Powell's press conference, have led the Fed to conclude it needs to take out some monetary insurance against further softening of employment conditions.

Our assessment of the US labour market has been more downbeat than the Fed's throughout this calendar year. We have not characterised the labour market as weak, but rather as brittle, and one that is sensitive to adverse economic developments. Since mid-2024, the hiring rate on the part of businesses has been extremely low; turnover in jobs – a sign of dynamism and health – has also been very low. Nominal wage growth has been moderating, consistent with easing labour market conditions, and advertised job openings have been falling. This year, business uncertainty

has climbed due to the Trump Administration's trade/tariff policies, and stricter immigration enforcement has adversely affected both labour supply and demand. Recently, the number of job openings fell below the number of unemployed individuals – signalling greater difficulty for those out of work to find reemployment. Consistent with these trends, a New York Fed survey reports that less than half of consumers are confident about their ability to find a job within the next 12 months should they become unemployed, marking the lowest such reading in the survey's 12-year history.

Despite these cooling labour market trends, economic growth remains moderate and underlying fundamentals remain consistent with continued expansion. Corporate profitability remains high, and aggregate consumer spending is holding up reasonably well, as highlighted by recent retail sales data. The fiscal package enacted earlier this summer is likely to help bolster both consumer and business demand later this year / H1-2026. The fiscal support, coupled with the ongoing monetary easing and still solid underlying macro fundamentals, should maintain modest economic growth, barring some sort of exogenous shock.

Easier US monetary policy – even if only modestly easier, as we anticipate – will provide benefits to the global economy. As suggested by the Dollar Smile framework and borne out in prior similar periods, modest US economic growth coupled with monetary easing is likely to be associated with a generalised downward pressure on the US Dollar. US fiscal expansionism via this summer's tax legislation strengthens further the case for USD weakness, given the US twin deficit (fiscal and current accounts) issues. A global financial market backdrop void of US Dollar strength, plus the prospect of a capped upside for US interest rates due to monetary easing, should provide policymakers around the world with freedom to set their respective domestic macro policy as they deem necessary.

India's Domestic Demand Outlook Gets a Boost from Policy Support Amidst Increased External Headwinds

India's economic growth surprised on the upside in Q1-FY26, although the underlying drivers remained broadly in line with our expectations. The key factor supporting growth was a lower GDP deflator (reflecting moderating inflation), combined with front-loaded government spending. We expect the lower deflator to continue supporting real GDP growth in Q2, further aided by a favourable base effect from the previous year.

¹ US employment estimates undergo multiple revisions, as more robust data are available to statistical agencies. This ~900,000 figure refers to the initial revised estimate of US employment;

another (more accurate, based on individual tax data) revision will be released in early 2026.

Economic momentum is likely to moderate in H2 FY26 as the favourable deflator effect fades, government spending slows, and US tariffs weigh on external trade. However, the outlook for private consumption has improved, primarily driven by policy measures, including GST rate cuts, income tax reductions, and the RBI's policy rate cuts. This recovery in consumption may also support a moderate revival in private investment, particularly in domestically oriented industries.

The landmark GST revamp announced in September signals a greater emphasis on reviving private consumption compared to the hitherto focus on government-led investment spending. GST rates have now been consolidated into two slabs: 5% and 18%. This consolidation eliminates the 12% and 28% slabs, with tax reductions across essential items, agriculture, healthcare, and consumer durables. These reforms aim to ease the burden on middle-class households, support MSMEs and farmers, and reinvigorate key growth drivers.

These GST revamp measures are estimated to boost economic growth by ~ 40 basis points (bps) and reduce headline CPI inflation by ~ 30–50 bps (depending on the pass-through) in FY26, with the impacts concentrated in H2 FY26. The GST reform complements income tax cuts announced in the budget, followed by RBI policy rate cuts, forming part of a broader stimulus package designed to boost domestic consumption and support the economy amid global trade uncertainties and the adverse impact of US tariffs.

The resultant transition from government-led to private sector-led growth (primarily driven by consumption with some support from private investment) is a critical shift. If sustained, it would help broaden the growth base, laying the foundation for a more stable and better economic performance in FY27 and, potentially, beyond.

While US tariffs and associated uncertainties will remain a drag in H2-FY26, we continue to expect an interim deal by Q4-FY26, with at least a partial rollback of elevated tariffs. A comprehensive bilateral trade agreement (BTA) may follow in FY27. Additionally, progress on FTAs with other countries (such as the recent trade agreement with the United Kingdom) could improve the outlook for external trade toward the end of FY26 and into FY27.

Given these dynamics and the stronger-than-expected Q1 growth, we have revised our FY26 real GDP growth forecast upward, from 6.2% to 6.8%. While better-than-expected Q1 data and fiscal stimulus through GST cuts may reduce the urgency of an RBI policy rate cut in Q3-FY26, such a move remains possible amid ongoing external headwinds and an improved inflation outlook. In the near

term, we also expect targeted policy support from the RBI and the government for sectors adversely affected by the US tariff actions.

Real GDP Growth Surges to a Five-Quarter High in Q1, Supported by Lower Deflator

Real GDP rose by a five-quarter high of 7.8% YoY in Q1 FY26, up from 7.4% in Q4 FY25, supported mainly by the lower deflator. Meanwhile, nominal GDP growth slowed to 8.8% (from 10.8% in Q4 FY25), indicating slower underlying momentum in Q1.

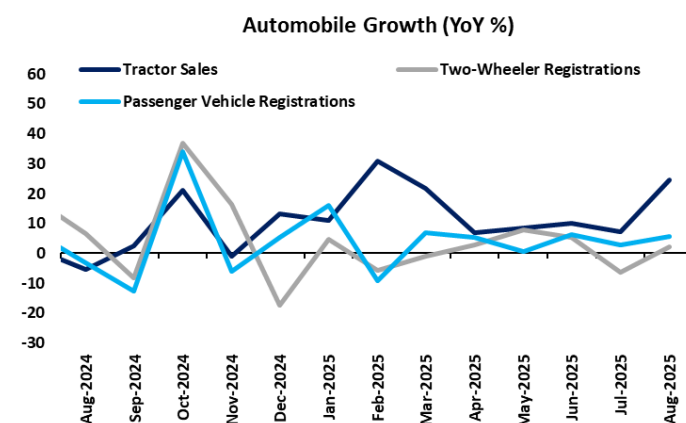
Economic growth in Q1 was supported by front-loaded government spending. Private consumption also recovered, likely driven by sustained rural demand and a moderate recovery in urban demand. Private investment likely remained muted. Meanwhile, the external sector was a drag on growth. From the supply side, real GVA grew by a six-quarter high of 7.6% (vs. 6.8% in Q4 FY25), supported by a resilient services sector and healthy agricultural performance despite some moderation. Industrial activity was mixed, with manufacturing recovering but offset by slowdowns in construction, mining, and electricity. Please refer to [Q1-FY26 GDP Review report](#) for more details.

In early Q2, most high-frequency indicators, with pockets of mixed trends and weakness, suggest that overall economic momentum picked up compared to the previous quarter. We discuss these in detail, along with the outlook for key segments, in the subsequent sections.

Consumption Rebounded in Q1; Outlook for Private Consumption Improved

Private consumption growth rebounded to 7.0% in Q1 FY26 (from 6.0% in Q4-FY25), likely supported by a stronger rural demand momentum. In early Q2, rural demand continues to lead the consumption revival, while urban consumption showed some tentative recovery but remained uneven.

Auto-mobile Growth Picks Up Momentum in early Q2



Source: CMIE

Tractor sales grew by 24.6% in August (compared to 7.1% in July and an average 8.5% in Q1 FY26), reflecting strong rural demand supported by agricultural performance. Two-wheeler registrations also rebounded in August, recovering from the contraction seen in the previous month. Meanwhile, passenger vehicle registrations rose by 5.5% in August, up from 2.7% in July and 4.1% in Q1 FY26, indicating some revival in urban spending. However, other indicators such as retail credit and air passenger traffic were muted, suggesting that urban demand remains uneven.

Labour market indicators showed significant improvement, with broad-based job gains leading to a decline in the unemployment rate to a seven-year low of 6.3% in August 2025, according to CMIE data. This decline was primarily driven by a sharp drop in urban unemployment from 7.8% in July to 6.4% in August, while rural unemployment also eased from 6.8% to 6.3%. Meanwhile, the Naukri Index growth slowed, with formal sector hiring softening for the second consecutive month in August, primarily due to weakness in select sectors such as IT Hardware & Networking, Telecom, Banking and Financial Services, and IT Software Services. The GST cut and festive demand may provide a boost to hiring in domestically oriented industries starting in September and October. However, potential job losses in the export sector, particularly those focused on the US, such as textiles, gems and jewellery, and leather products, remain a concern until a trade deal with the US materialises.

Looking ahead, private consumption is expected to emerge as the key driver of overall economic growth in H2 FY26. Rural demand is expected to continue leading consumption growth, while the outlook for urban demand has also improved. Policy support, in the form of recent GST cuts, prior income tax changes, and the pass-through of the RBI's policy rate cuts, coupled with lower inflation (supporting higher real disposable income), is expected to bolster the consumption outlook. Furthermore, recent positive developments in the labour market, if sustained, can potentially support the revival in consumption demand beyond policy-driven measures.

Government Spending Faces Constraints from Front-Loading and GST Revenue Loss

Government spending is likely to take a back seat in H2 FY26 after doing the heavy lifting in FYTD. Fiscal space will also be constrained by the tax revenue loss resulting from the recent GST rate cuts, as well as previous income tax reductions. This is expected to weigh on both government investment and revenue expenditure, both of which saw strong growth in Q1, contributing to overall economic expansion.

Central government revenue expenditure and capital expenditure grew by 17.1% (vs. the full-year target of 9.5%) and 32.8% (vs. the target of 6.6%), respectively, during April–July. To meet the fiscal targets, the implicit expenditure growth required in the remainder of FY26 is just 6.4% for revenue expenditure and for capital expenditure is -2.1% YoY, highlighting the likely drag on economic momentum going forward.

Additionally, the central government's net tax revenue contracted by 7.5% YoY in April–July, owing to muted gross tax revenue growth of just 0.8% YoY (partly impacted by the extended timeline for income tax filing this year) and a strong ~17% YoY increase in central tax devolution to states. However, this is expected to improve as tax filing accelerates ahead of the mid-September deadline. On the positive side, non-tax revenue grew by a robust 33.7% (aided by the RBI's record dividend transfer to the government), providing some buffer.

Crucially, the wide-ranging GST rate cuts will constrain fiscal space further in H2-FY26. According to government estimates, the revenue implications of the GST reform are projected to be ₹48,000 crore (based on FY24 consumption data), although granular details remain awaited. Factoring in the revenue loss in H2-FY26, the likely end of the GST compensation cess by December 2025, and potential second-round tax gains from stronger demand, we estimate a net fiscal revenue loss at ~30-bps of GDP in FY26, split between the Centre (~10-bps) and the states (~20-bps). Some of the shortfall could be offset through expenditure rationalisation, though this may dilute part of the growth impulse from the tax cuts. Any remaining surpluses in the GST compensation fund could also help mitigate the net fiscal impact.

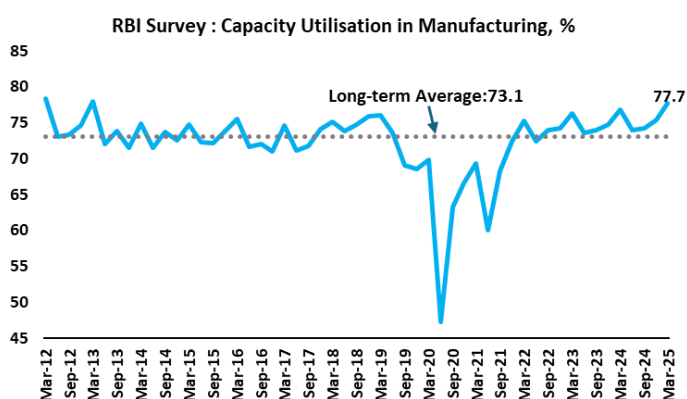
Overall, the central government's budget deficit target of 4.4% of GDP for FY26 faces rising risks of slippage, driven by front-loaded spending, slower revenue growth, and the fiscal impact of the GST cuts. Expenditure rationalisation may become necessary in the second half of FY26 to stay within the target. The expected slowdown in government spending for the remainder of FY26 is likely to weigh on overall economic momentum.

Private Investment Remains Subdued but Could See a Gradual Revival

Private investment is likely to remain subdued in the near term amid uncertainty related to US tariffs but may see some revival in domestically oriented industries. Average new project announcements in July–August are tracking at ₹1.3 trillion, significantly lower than ₹2.0 trillion in the previous quarter, as per CMIE data.

However, conditions are starting to improve, with an expected revival in consumption demand. Corporate balance sheets also remain healthy, and capacity utilisation in the manufacturing sector increased to an over-decade high of 77.7% in Q4-FY25, from 75.4% in the previous quarter, above its long-term average. As a result, we can expect a gradual increase in private investment in domestically oriented industries in H2-FY26 and beyond, given the anticipated boost to domestic consumption from policy measures. Meanwhile, export-oriented industries are likely to remain in a wait-and-see mode until a trade deal with the US materialises.

Capacity Utilisation in the Manufacturing Sector Rose to Over a Decade High



Source: CMIE. The capacity utilisation long-term average is based on values during June 2010 and March 2025

External Trade Environment Weakens Amid Escalating US Tariffs

The external trade environment has deteriorated following the implementation of the US's 50% tariff on India's goods exports. The US remains India's largest export destination, with its share rising to 21.9% in April–August FY26 from 19.2% in the same period last year. Early signs of the US tariffs' impact, coupled with the waning effect of front-loaded shipments, are already visible.

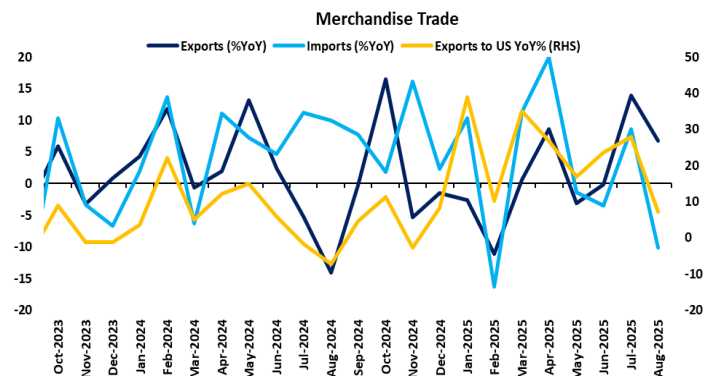
India's exports to the US sharply moderated in August, with growth falling to 7.2% YoY from around 28% YoY in July. Sequentially, exports to the US declined by ~14% MoM, reflecting the fading boost from earlier front-loading and the implementation of a 25% tariff from August 7.

Overall merchandise export growth also slowed significantly from 13.9% in July to 6.7% in August, as both petroleum exports and non-petroleum exports decelerated. The moderation in non-oil exports was broad-based. Sequentially, key sectors including readymade garments, marine products, leather goods, and gems & jewellery saw contractions, reflecting the impact of the 25% US tariff (which came into effect on 7th August). The full impact of the tariffs is expected to intensify from September, with an additional 25% duty coming into effect on August 27, raising

the total tariff burden to 50%. On the import side, India's inbound shipments contracted by 10.1% YoY in August, a sharp reversal from the 8.6% growth seen in July. This helped narrow the merchandise trade deficit to US\$26.5 billion in August, down from US\$27.4 billion in July.

Meanwhile, the services trade surplus remained strong at US\$16.6 billion in August (up from US\$16.4 billion in July), supported by robust services export growth of 12.2% (vs. a revised 10.3% in July), which continued to outpace services import growth that moderated to 6.0% (from 8.5% in July). As a result, the combined trade deficit (merchandise and services) narrowed to US\$9.9 billion in August, down from US\$10.9 billion in July.

Exports to the US Drop in August Amid Reciprocal Tariffs



Source: CMIE.

External sectors continued to face headwinds. The US has also recently announced a landmark change to its skilled migration regime, imposing a one-time fee of USD 100,000 on new H-1B petitions filed after September 21, 2025, with renewals and current holders exempt. This indicates that India's services exports are not insulated from the US onshoring efforts. The macroeconomic impact of the increased visa fee is estimated to be modest, with only a potential marginal drag on GDP via softer services exports and slower remittance growth. These effects could be partly offset by potentially stronger offshore delivery and expanded mandates for India-based Global Capability Centres over the medium term. Risks remain from parallel US legislative proposals such as the HIRE Act, which proposes a 25% tax on US companies' payments made to foreign firms for services used by American customers. If enacted, this would pose a more serious long-term challenge for India's IT and GCC delivery models. Please refer to the [report on the potential implications of the US H-1B visa fee hike for India](#) for more details.

On a positive note, India–US trade negotiations have resumed. While a narrower interim agreement remains possible, it is complicated by the renewed US focus on resolving the Russia-Ukraine conflict and will depend on mutual compromise. We are cautiously optimistic about an

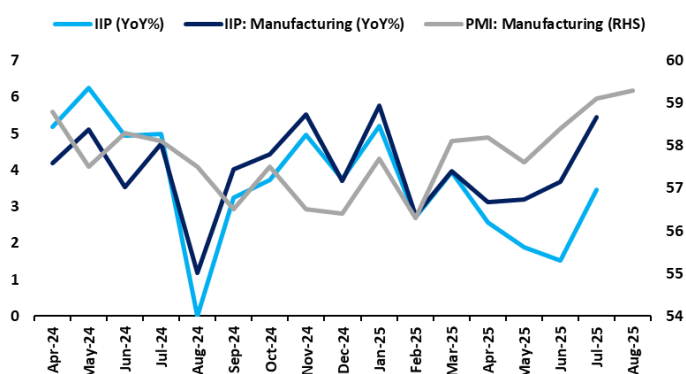
interim trade deal between the US and India by Q4 FY26 with possibility of a partial rollback of penal tariffs, potentially followed by a Comprehensive BTA in FY27.

Supply-Side Indicators Suggest Broad-Based Resilience in Industry, Services, and Agriculture

From the production side of the economy, high-frequency indicators suggest broad-based resilience in July and August compared to the previous quarter. Industrial activity showed signs of recovery in July 2025, with IIP growth rising to a four-month high of 3.5% YoY from 1.5% in June. This rebound was primarily driven by the manufacturing sector, which expanded by 5.4% (a six-month high), up from 3.7% the previous month. Electricity generation also returned to modest growth, increasing by 0.6% after two consecutive months of contraction. However, the mining sector continued to weigh on overall performance, contracting sharply by 7.2%, likely due to the impact of the monsoon. Among use-based categories, the recovery was broad-based (except for the primary sector, which continued to contract), led by infrastructure (at a 21-month high), capital goods, and consumer durables (at a seven-month high, aided by pre-festival stocking).

Looking ahead, the manufacturing PMI, a leading indicator, rose to 59.3 in August from 59.1 in July, marking the fastest pace of growth in the last seventeen years and six months. This, coupled with the expected easing of the seasonal drag on mining and electricity, is likely to allow industrial momentum to recover further in the coming months. Some volatility is expected, with export-oriented industries facing pressure from US tariffs, while domestically-oriented sectors may experience softness due to postponed purchases ahead of the GST rate cuts taking effect in late September. The recovery is likely to gain momentum from the festive season demand and a boost from the GST rate cut.

Manufacturing Sector Shows Signs of Turnaround



Source: CMIE and S&P Global.

The services sector remains robust, as reflected in strong PMI readings, double-digit growth in services exports, and improvements in air cargo traffic and international

passenger volumes. India's Services PMI rose to 62.9 in August from 60.5 in July, marking the strongest growth in 15 years. New orders increased for the 49th consecutive month at the highest rate in over 15 years. Growth in new export orders also picked up, reaching the third-strongest pace since 2014, supported by rising demand from clients across Asia, Europe, the Middle East, and the US. The growth in the banking sector credit and deposits has also started to show signs of a turnaround.

Services Sector Shows Signs of Resilient Growth

High-Frequency Indicators	Jan-25	Feb-25	Mar-25	Apr-25	May-25	Jun-25	Jul-25	Aug-25
PMI Services #	56.5	59.0	58.5	58.7	58.8	60.4	60.5	62.9
Domestic Air Passenger Traffic	14.1	12.1	9.9	9.7	2.6	3.7	-2.5	-1.1
Domestic Air Cargo	6.9	-2.5	4.9	16.6	2.3	2.6	4.8	
International Cargo Traffic	7.1	-6.3	3.3	8.6	6.8	-1.2	4.2	
International Passenger Traffic	11.1	7.7	6.8	13.0	5.0	3.4	5.5	7.4
Port Cargo Traffic	7.6	3.6	13.3	7.0	4.3	5.6	4.0	2.5
GST E-way Bills	23.1	14.7	20.2	23.4	18.9	19.3	25.8	22.4
Services Exports	12.1	11.7	18.7	8.8	9.6	12.0	10.3	12.2

Source: CMIE and RBI. #PMI Services is level, while the rest of the indicators are YoY%.

Agricultural activity has likely remained resilient, with Kharif sowing reaching to 1,115.9 lakh hectares (around 101.8 per cent of the normal area) as on September 19, 2025, and rainfall tracking 7.8% above the long-term average. However, unseasonal rains in Punjab, Haryana, and other parts of the country could weigh on crop yields. Meanwhile, prospects for the upcoming Rabi season (winter crops) appear favourable, supported by healthy reservoir levels. The central government has set a total foodgrain production target of 362.5 million tonnes for 2025–26, up from 353.96 million tonnes actual output in the previous year, representing a 2.4% increase. This follows a strong 6.5% rise in the previous year. Overall, agriculture is expected to provide stability to growth momentum in FY26, underpinning rural demand and supporting contained food prices.

Inflation Outlook Remains Favourable

The inflation outlook remains favourable, further supported by the recent GST rate cuts, which are expected to contribute to a softer inflation trajectory. This widens the policy space for the RBI to consider additional monetary easing. As long as inflation remains under control, the central bank is well-positioned to cushion the economy against potential shocks.

As anticipated, headline CPI inflation rose slightly to 2.07% YoY in August 2025, up from a revised 1.61% in July. Despite the uptick, CPI inflation in August remained the second-lowest reading in over six years. Sequential momentum also eased, rising by 0.46% in August, down from 0.98% in the previous month.

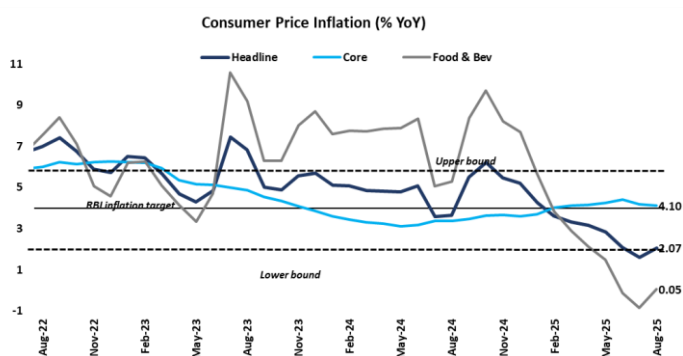
The rise in the headline CPI was primarily driven by the food and beverages segment, which was flat after registering

deflation in the previous two months. Within this category, five of twelve subcomponents, including vegetables (with reduced deflation), meat & fish, eggs, oils & fats, and sugar, saw upward price pressures.

Meanwhile, core inflation eased slightly to 4.1% in August from 4.17% in July, reflecting broad-based moderation across categories, except personal care and effects, where a sharp increase in gold and silver lifted prices. Excluding gold, core inflation remained subdued at ~3.08%. Notably, core services inflation eased to a 13-month low of 3.27%, while core goods inflation rose to a near two-year high of 4.94%.

Looking ahead, inflation is expected to decline during October and November as the GST rate cuts took effect in late September. Depending on the extent of pass-through by producers, headline CPI inflation could fall by 30–50 bps in FY26, with the bulk of the impact concentrated in the second half. Considering both the expected disinflationary effects of GST rate cuts and the offsetting weather-related risks, we revise our FY26 CPI inflation forecast down to 2.5%, from the earlier projection of 2.8%.

CPI Headline Inflation Rose Slightly in August 2025



Source: CMIE

Favourable Inflation Trajectory Expands Scope for Additional Monetary Easing

The ongoing disinflationary trend, reinforced by GST rate cuts, widens the space for further monetary easing. Additionally, the US Federal Reserve's recent 25 bps rate cut, along with guidance for two more rate cuts in 2025, enhances the RBI's policy flexibility to support growth. Despite stronger Q1 GDP data and stimulus from the GST revamp, we expect the RBI to cut the policy rate by 25 bps in Q3-FY26 to nurture consumption recovery amid external headwinds and an improved inflation outlook. The rate cut in October is a close call, with a possibility of delay to the December meeting (possibly with a dovish tone), if the central bank prefers a wait-and-watch approach. In the meantime, targeted support measures from the RBI and the government are also likely to be announced for sectors adversely affected by the US tariff policy.

We believe additional monetary easing could help nurture the transition in growth drivers from a public sector-led recovery to one likely to be driven by private consumption and also help revive the private investment cycle. Moreover, while fiscal space remains constrained due to GST-related revenue losses and front-loaded spending, the improved inflation outlook has expanded the available room for monetary policy support.

Although early signs of progress have emerged in US-India trade talks, uncertainty persists regarding the timing and scope of any interim deal or comprehensive agreement. In the meantime, Indian exporters (particularly those with high US exposure) face risks of order cancellations, job losses, and declining competitiveness. While the GST rate cuts are expected to boost consumption and aggregate demand, they do little to address the immediate pressures on the export sector. The government's Chief Economic Adviser has indicated that a policy support package for exporters is under consideration. This may draw on the COVID-era toolkit, possibly including regulatory forbearance, enhanced guarantees, and targeted liquidity support, many of which would require close coordination with the RBI.

Bond Market Dynamics and Policy Transmission Challenges

The RBI is also contending with a steepening G-Sec yield curve, which has complicated the transmission of monetary policy easing. The shift in policy stance from accommodative to neutral in June, combined with market concerns over higher government borrowing following the GST cuts, has driven up long-term yields.

While the government's estimate of ₹48,000 crore in revenue loss from GST cuts (based on FY24 data) offered some reassurance and led to partial easing of yields, long-term G-Sec yields remain elevated compared to May–June levels. In contrast, short-term rates remain well-anchored, supported by high system liquidity and the phased implementation of the 100-bps CRR cut, of which 25 bps became effective on September 6th. The average banking system surplus liquidity declined from ₹2.9 lakh crore in August to ₹1.6 lakh crore in September (data as of 25th). Surplus liquidity turned into a small deficit in the past few days, primarily due to tax outflows, with the WACR rising above the policy repo rate for the first time in FY26. Liquidity is expected to return to surplus within the next few weeks, driven by government spending and the ongoing phased implementation of the CRR cut through November, which should bring the WACR back below the policy repo rate.

As per the Central Government's released borrowing programme for H2-FY26, its gross market borrowing through dated securities is budgeted at Rs 6.77 lakh crore, compared to Rs 8.0 lakh crore in H1-FY26 and Rs 6.61 lakh

crore in H2-FY25. This brings the total gross borrowing for FY26 to Rs 14.77 lakh crore, marginally below the Budget Estimate of Rs 14.8 lakh crore, thereby easing concerns about higher post-GST reform borrowing.

A notable shift is observed in the maturity profile: the share of longer tenors (15 years and above) has decreased to 43.7% in H2-FY26, from 49% in H1-FY26 and 51.8% in H2-FY25. The reduction is led by lower issuances in the 30- and 40-year segments, partially offset by a modest increase in the 15-year tenor. Conversely, the share of tenors up to 10 years has risen to 56.4% in H2-FY26, up 8.1 percentage points (pp) from H2-FY25 and 5.4 pp from H1-FY26, with a relatively larger increase in 5- and 10-year securities. Given the redemption profile in these buckets, net borrowing is expected to be relatively lower. Overall, the H2 borrowing calendar is likely to be positively viewed by markets, with the marginal reduction in gross borrowing and lower reliance on ultra-long tenors expected to support demand and contribute to some flattening of the G-Sec curve.

Market Update

Bond Market: Since the RBI's June policy meeting, government bond yields have moved higher across maturities, reflecting the RBI's shift to a neutral policy stance and market concerns over increased government borrowing following GST rate reductions. That said, the 10-year G-Sec yield eased in September to ~6.52% (as of 26th Sept) from ~6.57% at the end of August, as government estimates suggested the revenue loss from GST rationalisation would be smaller than initially anticipated.

On the liquidity front, abundant system liquidity—despite temporary deficits around tax payment outflows—has kept short-term rates anchored, contributing to a steeper yield curve. Going ahead, the RBI may conduct Open Market Operations or Operation Twist Operations—simultaneously buying long-term G-Secs and selling short-term ones—to flatten the yield curve. Given that the liquidity impact of the CRR cut may limit the scope for outright OMOs (Open Market Operations) in the near term, Operation Twist appears to be a more viable strategy for managing yield dynamics.

Equity Market: Indian equities extended their decline in August amid persistent global market volatility and the imposition of US tariffs. The NIFTY50 Index fell by 1.4% month-on-month, following a sharper 2.9% drop in July. Global trade uncertainties and the announcement of a 50% US tariff on Indian exports weighed on the investors' sentiment, with a rise in FPI outflows during the month, even as domestic institutional investors continued to provide support.

Equity markets recovered in September, supported by the announcement of GST rationalisation, the US Fed's rate cut, and optimism around renewed US–India trade discussions. However, the recent hike in H-1B visa fees exerted pressure on the NIFTY IT Index. The benchmark NIFTY50 also gave up some gains last week, still managing to register a ~1% rise as of September 26 compared with the previous month's close. Looking ahead, while domestic policy measures and institutional support may underpin market recovery, the broader equity outlook remains vulnerable to evolving global trade dynamics and external shocks.

Currency Market: The Indian rupee remained under sustained pressure through August and September, weighed down by escalating US–India trade frictions, the 50% tariff on Indian merchandise exports, and the recent hike in H-1B visa fees. In August, the currency depreciated by 0.7% against the US dollar, driven primarily by equity outflows and the adverse impact of the tariff announcement. The weakness persisted into September, with the rupee closing at a historic low of ~88.76 per dollar on September 23. The announcement of the visa fee hike added to depreciation pressures, with the INR weakening by a further 0.6% through September 26 compared to end-August levels. These developments increase the likelihood of the RBI intervening to smooth volatility in the forex market. In the near term, the rupee's trajectory is expected to remain influenced mainly by US trade policy actions and the scale of the central bank's interventions.

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