

# Domestic Demand Anchors Growth; FY27 Budget Expected to Reinforce Reform Momentum



- Despite heightened geopolitical and financial market volatility early in 2026, the global economy remains resilient, supported by solid macro fundamentals. Modestly improving growth momentum across major economies, and a cooling in underlying inflation across most G10 economies, pointing to steady, if unspectacular, global growth ahead.
- The Indian economy entered a “Goldilocks” phase in H1 FY26, marked by sharp disinflation alongside accelerating economic growth, with fiscal measures and cumulative monetary easing helping domestic demand offset an adverse external environment.
- Following a strong growth in H1 FY26, economic momentum is expected to moderate in H2 FY26, reflecting the normalisation of base effects and deflators, a pullback in government spending, and subdued external demand.
- However, steady private consumption and a recovery in private investment are likely to sustain economic growth at around 6.8% in H2 FY26, implying a slower but still healthy expansion.
- High-frequency indicators corroborate this outlook. In Q3 FY26, private consumption and private investment activity improved, while the central government’s CAPEX moderated sharply, and goods exports were subdued.
- While uncertainty around the US–India trade talks persists, India and the EU have concluded negotiations on a landmark FTA, which could provide a meaningful boost to trade, investment, and export diversification over the medium term.
- In the FY27 Union Budget, we expect a renewed push for structural reforms to boost investment, job creation, and exports, alongside continued adherence to the fiscal consolidation path.
- The central government is likely to meet the FY26 budget deficit target of 4.4% of GDP, with expenditure rationalisation offsetting revenue shortfalls.
- FY27 marks a transition towards a debt-anchored fiscal framework, with central government debt targeted to decline from ~56.1% of GDP in FY26 to 50±1% by March 2031, implying a gradual consolidation path. We expect the budget deficit to be around 4.3% of GDP in FY27.
- Benign inflation dynamics continue to provide the RBI with space to keep policy rates lower for longer.
- We expect the RBI to keep the policy repo rate unchanged at its February meeting, while announcing additional liquidity measures to support policy transmission and easier funding conditions.

## Christopher Wiegand

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

## Pramod Chowdhary

Chief Economist  
pramod.chowdhary1@dmifinance.in

## Bhawna Sachdeva

Economist  
bhawna.sachdeva@dmifinance.in

## Shantanu Sharma

Economist  
shantanu.sharma@dmifinance.in



[www.dmifinance.in](http://www.dmifinance.in)



+91 11 4120 4444



## DMI Finance Private Limited

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

## Global Economy Resilient Amidst Geopolitical and Financial Market Developments; Inflation Cooling

Less than a full month into 2026, the global economy has been buffeted with a dizzying array of developments and events. On the geopolitical front, there has been United States military action in Venezuela, US rhetoric and threats about the strategic significance of Greenland, and some renewed negotiating efforts at resolving the now multi-year conflict in Ukraine. On the economic policy front, there has been the Trump Administration's pressure on Federal Reserve Chair Powell, public musings by Mr. Trump regarding the next Fed Chair, and Japanese Prime Minister Takaichi announcing plans for a multi-year consumption tax cut alongside her snap election announcement. On the financial markets front, there has been a steady escalation in the prices of precious metals, a multi-standard deviation move in long-dated Japanese Government Bonds (JGBs) and a possible resumption of the so-called "Sell America" trade given rising US bond yields and non-US equity market outperformance.

Nonetheless, abstracting from these myriad headlines, the key macroeconomic fundamentals underpinning the global economy and most major individual economies remain solid. Those fundamentals joined with the spate of macro policy action taken by various central banks and governments in 2025H2 are likely to keep fostering solid, if unspectacular, economic performance throughout much of the world in the period ahead.

Solid underlying fundamentals are an essential component of the global economy's ongoing resiliency. We discussed that resiliency last month, and two aspects are worth underscoring again. **First**, the global economy's ability – in aggregate – to be relatively less affected than initially feared by the newly introduced US tariff regime is especially notable. At roughly 15%, the prevailing effective tariff rate on goods sent to the US is the highest in the past 75 plus years and is six times the rate that prevailed at the start of 2025.

**Second**, consumer demand – and, in turn, aggregate demand – in most countries has withstood so-called affordability challenges, owing to the 2021H2 to 2023 inflation surge. During that roughly 18-month period, price increases massively outstripped households' nominal income gains, reducing real purchasing power and catapulting the price level, which remains elevated today. Yet, households in aggregate have been able to smooth through those challenges, sustaining solid economic growth. Various fiscal and monetary policy measures taken around the world have assisted on this front. But those policy cushions have been small to modest in comparison to the real purchasing power squeeze.

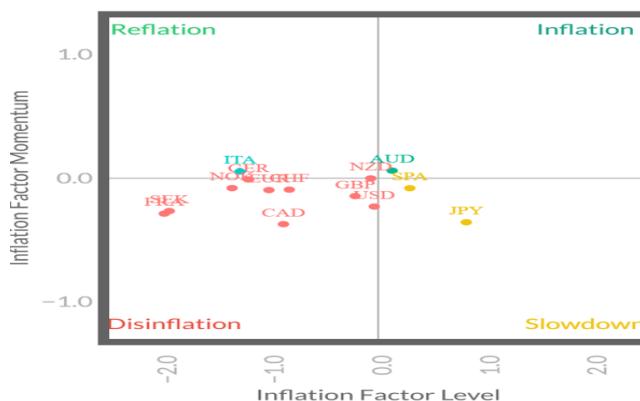
Our analysis suggests that the global economy has been picking up some modest, but broadly based, momentum in recent months. The pace of economic growth in Australia, New Zealand, and the northern part of Europe has been trending modestly upward. Growth in the US, which has been close to but slightly below trend, has been steady but has a large pending boost to household income from last summer's fiscal package ahead of it in the coming months. In Japan, where growth has been and remains above trend, the rate of growth may be cooling slightly. But here, too, there is now the possibility of policy action (PM Takaichi's proposed consumption tax break) that could buoy household income ahead.

Inflation developments are also turning in a favourable direction in many economies. Underlying inflation rates in the majority of G20 countries have been cooling; moreover, upside surprises to underlying (i.e. core) inflation data – that is, monthly readings that come in higher than consensus expectations – have fallen sharply in recent months. A systematic distillation of this dynamic is highlighted in the charts below, which show a shift from inflationary to disinflationary trends across many economies over the past three months.

### G10 Inflation Factor States: 25 Oct 2025



### G10 Inflation Factor States: 25 Jan 2026



**Note:** A positive level (horizontal axis) or momentum (vertical axis) reading indicates above target and accelerating momentum, respectively, for inflation. The reverse also holds. Source: DeepMacro, Inc. Printed with permission of DeepMacro, Inc.

## India's Economic Activity Remains Resilient on Domestic Drivers; FY27 Budget to Push Reforms

The Indian economy entered a **"Goldilocks"** phase in H1 FY26, marked by sharp disinflation alongside accelerating economic growth, even as external headwinds intensified. A pickup in domestic demand, supported by fiscal measures and monetary policy easing, helped offset the drag from an adverse external environment.

We continue to expect FY26 real GDP growth of around 7.4%, underpinned by strong growth in the first half and followed by a moderation in momentum in H2 FY26. The expected slower pace of economic growth in H2 reflects normalisation of base effects and deflators, a pullback in government spending after front-loading in H1, and the impact of US tariffs and heightened global uncertainty on external demand. That said, a recovery in private consumption and a gradual improvement in private investment are likely to sustain H2 FY26 economic growth at around 6.8%, implying a slower but still healthy pace compared to the ~8% growth recorded in H1.

Against this backdrop, attention is now turning to the upcoming Union Budget. In the budget, we expect renewed impetus to economic reforms aimed at boosting investment, job creation, and exports, while maintaining adherence to the fiscal consolidation path. Meanwhile, the RBI is expected to keep a status quo on the policy repo rate in its February 2026 policy meeting but put a greater emphasis on liquidity management and policy transmission.

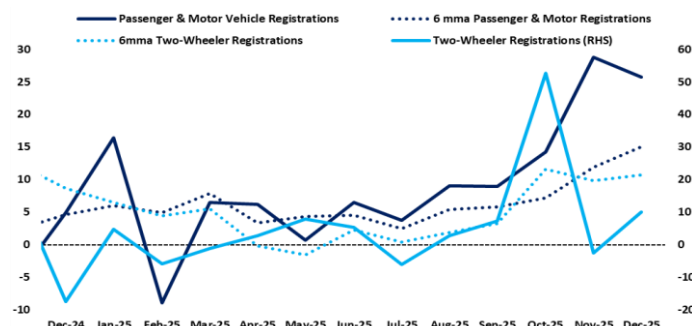
## Private Consumption and Private Investment Activity Improving as Government Spending Moderates and Goods Exports Remain Subdued

In line with our projections, the National Statistics Office's (NSO) first advance estimate (FAE) pegs FY26 real GDP growth at 7.4%, accelerating from 6.5% in FY25, with strong growth in H1 followed by moderation in H2. Growth is estimated to be driven by resilient private consumption and investment, while government consumption grows moderately and net exports remain a drag.

High-frequency indicators broadly corroborate this outlook. In Q3 FY26, private consumption demand improved, reflected in a pickup in personal vehicle and two-wheeler registrations, consumer durables and non-durable goods production, and air passenger traffic, while retail tractor sales were relatively steady. At the same time, retail credit growth showed improvement in October-November compared to Q2. CMIE data point to continued solid employment generation in Q3 FY26, even as the unemployment rate edged up marginally due to higher labour force participation. The Naukri JobSpeak Index

reported an acceleration in formal job creation during Q3, with broad-based gains across industries.

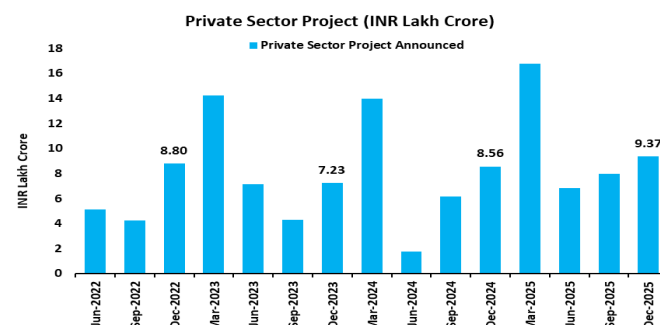
## Auto Registrations Suggest Momentum in Rural and Urban Demand



Source: CMIE

Meanwhile, private-sector investment activity continues to improve. CMIE data show that new private investment project announcements (a key forward-looking indicator of capex) maintained an upward trajectory in FY26. New project announcements rose ~9% YoY in Q3 FY26, while cumulative private-sector project announcements during April–December 2025 grew by a robust ~47% YoY, signalling a tentative revival in private investment. However, private investment activity remains concentrated in manufacturing (with concentration in metals, chemicals, and machinery) and electricity, underscoring the still selective nature of the capex recovery.

## Private Sector's New Projects Announcement Accelerates in Q3, Indicating an Improving Investment Outlook



Source: CMIE

While private investment activity is showing improvement, the capital expenditure of the central government remained in contraction for the second consecutive month in November. This is due to front-loading of the CAPEX in H1-FY26. On the revenue side, the expenditure recovered in November and is tracking better in October-November compared to Q2. We expect rationalisation of revenue expenditure, with CAPEX broadly meeting the budgeted target in FY26. That said, this would still imply YoY% contraction in the Central government's CAPEX over the remainder of FY26, given the front-loading earlier in the year.

On the external front, merchandise export growth slowed to 1.9% in Q3, from 8.4% in Q2, with exports averaging 2.7% growth in the first three quarters of FY26, highlighting a clear loss of momentum. Exports to the US contracted by 1.8% YoY in December, bringing the average contraction during the post-tariff period (September–December) to around 0.2%, following robust ~18% growth during April–August driven by front-loading ahead of the 50% tariffs. Exports to non-US markets grew only 2.7% YoY in December, down sharply from 18.6% in November, underscoring the challenges in export-market diversification.

Meanwhile, goods imports growth accelerated to 7.9% in Q3 from 5.0% in Q2, aided by non-oil imports and elevated gold and silver imports, leading to a widening of the merchandise trade deficit. As a result, the trade deficit widened to USD 38.6 bn in Q3 from USD 37.1 bn in the previous quarter, as the improvement in the services trade surplus was offset by a wider merchandise trade gap, as per the preliminary data.

Uncertainty around the timing and scope of the US–India trade deal persists. Markets are also watching a potential US Supreme Court ruling on the legality of the administration’s use of the International Emergency Economic Powers Act (IEEPA), 1977, to impose broad-based reciprocal tariffs. In contrast, the EU and India announced a landmark trade deal that could unlock significant opportunities for India’s trade diversification, labour-intensive exports, services, and a medium-term investment cycle (**please see the box on page 8 for details on the India-EU trade deal**).

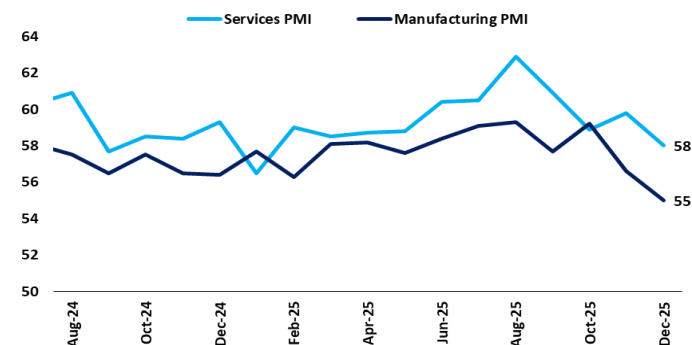
### Industrial and Services Activity Firm, but Forward Indicators Point to Moderation

Industrial activity remained strong in December, with IIP growth accelerating to a 26-month high of 7.8% YoY, up from 7.2% growth in November. This was led by manufacturing, which posted a second straight month of over 8% growth, while mining and electricity output also showed a healthy recovery. In Q3, IIP momentum improved, with IIP growth accelerating to a six-quarter high of 5.2%. However, forward-looking indicators point to some moderation. The manufacturing PMI eased to 55.0 in December from 56.6, marking the weakest expansion in two years, driven by slower growth in new orders, output, and export orders.

Service indicators remain largely resilient, supported by trends in air traffic, cargo movements, and banking sector credit. However, the Services PMI Business Activity Index moderated to 58.0 in December, the slowest expansion since January, suggesting some loss of momentum. Meanwhile, agricultural prospects remain favourable, supported by robust Rabi sowing (up 3.3% YoY, covering 102.3% of the normal sown area as of 16<sup>th</sup> January),

supporting expectations of healthy farm output and rural demand.

### Manufacturing and Service PMIs Indicate Some Moderation Ahead



Source: CMIE

### Preview of the Union Budget FY27

#### Central Government Likely to Meet FY26 Fiscal Deficit Target of 4.4% of GDP

In the upcoming FY27 Budget, we expect the central government to push ahead with its broader reform agenda while maintaining a strong focus on capital expenditure and a continued commitment to fiscal consolidation.

FY26 has been characterised by structural tax reforms, including income tax cuts and a GST revamp, alongside significant front-loading of capital expenditure to support domestic demand amid external headwinds. Despite these measures, we expect the central government to meet the FY26 fiscal deficit target of 4.4% of GDP, underscoring its continued commitment to fiscal consolidation. A sizeable shortfall in tax revenues is likely to be offset by higher-than-budgeted non-tax receipts and rationalisation of revenue expenditure, while CAPEX is expected to be in line with the budgeted target.

Gross tax collections have decelerated sharply in FY26, growing just 3.3% YoY during April–November, compared to 10.7% in the corresponding period last year. We estimate gross tax collections to undershoot Budget Estimates (BE) by around Rs 1.8 lakh crore, nearly equally split between direct and indirect taxes. On the indirect tax side, the combined impact of GST rationalisation and the removal of the compensation cess is estimated to result in a shortfall of about Rs 1.0 lakh crore in FY26, while customs duty collections are also likely to miss the target marginally. This is partly offset by higher excise duty collections, following the Rs 2 per litre duty hike on petrol and diesel in FY26 and imposition of additional excise duty on taboo products and pan masala effective February 2026.



**Government to Meet FY26 Deficit Target Despite Revenue Shortfall, CAPEX to Remain in Focus in FY27**

Fiscal Metrics	INR Lakh Crore				% of GDP				% YoY			
	FY25 P	FY26 BE	FY26 E	FY27 E	FY25 P	FY26 BE	FY26 E	FY27 E	FY25 P over FY24 A	FY26 BE over FY25 P	FY26 E over FY25 P	FY27 E over FY26 E
<b>Revenue Receipts</b>	<b>30.4</b>	<b>34.2</b>	<b>33.5</b>	<b>35.6</b>	<b>9.2</b>	<b>9.6</b>	<b>9.4</b>	<b>9.0</b>	<b>11.3</b>	<b>12.6</b>	<b>10.2</b>	<b>6.3</b>
<b>Net Tax Revenues</b>	<b>25.0</b>	<b>28.4</b>	<b>27.2</b>	<b>28.8</b>	<b>7.6</b>	<b>7.9</b>	<b>7.6</b>	<b>7.3</b>	<b>7.4</b>	<b>13.5</b>	<b>8.8</b>	<b>5.8</b>
<b>Gross Tax Revenues</b>	<b>38.0</b>	<b>42.7</b>	<b>40.9</b>	<b>43.4</b>	<b>11.5</b>	<b>12.0</b>	<b>11.4</b>	<b>11.0</b>	<b>9.5</b>	<b>12.5</b>	<b>7.7</b>	<b>6.1</b>
Direct Tax	21.7	25.2	24.3	26.7	6.6	7.1	6.8	6.8	10.9	16.1	11.8	10.0
Corporate Tax	9.9	10.8	10.8	11.9	3.0	3.0	3.0	3.0	8.3	9.7	9.5	9.7
Income Tax	11.8	14.4	13.4	14.8	3.6	4.0	3.8	3.8	13.2	21.6	13.7	10.2
Indirect Tax	16.3	17.5	16.6	16.7	4.9	4.9	4.7	4.2	7.7	7.7	2.2	0.5
Customs	2.3	2.4	2.3	2.3	0.7	0.7	0.6	0.6	-0.1	3.1	-3.0	2.7
Union Excise Duty	3.0	3.2	3.5	4.0	0.9	0.9	1.0	1.0	-1.7	5.6	15.6	14.9
CGST+ Compensation Cess	10.6	11.8	10.7	10.4	3.2	3.3	3.0	2.6	10.7	11.2	1.3	-3.1
<b>Non-Tax Revenues</b>	<b>5.4</b>	<b>5.8</b>	<b>6.3</b>	<b>6.8</b>	<b>1.6</b>	<b>1.6</b>	<b>1.8</b>	<b>1.7</b>	<b>33.8</b>	<b>8.5</b>	<b>16.8</b>	<b>8.5</b>
<b>Total Receipts</b>	<b>30.8</b>	<b>35.0</b>	<b>34.0</b>	<b>36.6</b>	<b>9.3</b>	<b>9.8</b>	<b>9.5</b>	<b>9.3</b>	<b>10.4</b>	<b>13.6</b>	<b>10.3</b>	<b>7.7</b>
<b>Total Expenditure</b>	<b>46.6</b>	<b>50.7</b>	<b>49.7</b>	<b>53.4</b>	<b>14.1</b>	<b>14.2</b>	<b>13.9</b>	<b>13.6</b>	<b>4.8</b>	<b>8.8</b>	<b>6.7</b>	<b>7.5</b>
<b>Revenue Expenditure</b>	<b>36.0</b>	<b>39.4</b>	<b>38.4</b>	<b>40.9</b>	<b>10.9</b>	<b>11.0</b>	<b>10.8</b>	<b>10.4</b>	<b>3.1</b>	<b>9.5</b>	<b>6.6</b>	<b>6.5</b>
<b>Capital Expenditure</b>	<b>10.5</b>	<b>11.2</b>	<b>11.3</b>	<b>12.5</b>	<b>3.2</b>	<b>3.1</b>	<b>3.2</b>	<b>3.2</b>	<b>10.8</b>	<b>6.6</b>	<b>7.0</b>	<b>11.0</b>
<b>Fiscal Deficit</b>	<b>15.8</b>	<b>15.7</b>	<b>15.7</b>	<b>16.9</b>	<b>4.8</b>	<b>4.4</b>	<b>4.4</b>	<b>4.3</b>				

Source: Note: BE refers to budget estimates, P: refers to Provisional based on Monthly data, E refers to DMI Estimates

Part of the sizeable shortfall in gross tax revenue is expected to be offset by higher non-tax revenues, largely driven by a stronger-than-budgeted dividend transfer from the RBI. Non-debt capital receipts, however, are likely to fall modestly short of BE, reflecting subdued divestment proceeds. Overall, total receipts are estimated to undershoot BE by ~ Rs 1.0 lakh crore, after accounting for the gross revenue shortfall and lower-than-budgeted transfers to states.

To bridge the revenue gap, the government is expected to rely primarily on expenditure rationalisation, led by savings in revenue expenditure, while maintaining capital spending. Revenue expenditure growth has been muted at 1.8% YoY (April–November) versus a budgeted growth of 9.5% (over FY25 actuals), driven by a contraction in core revenue expenditure (excluding interest and subsidies). Several ministries have underspent so far, indicating potential savings from under-utilisation of allocations. While supplementary demands imply additional cash outgo of around Rs 0.42 lakh crore (largely due to subsidies and LPG compensation to OMCs), we still estimate net expenditure savings of about Rs 1.0 lakh crore for FY26 due to underspending by multiple ministries.

Capital expenditure has remained robust, with spending during April–November FY26 growing 28.2% YoY, reflecting front-loading. This has been led by railways, roads, defence, and transfers to states and UTs via interest-free loans for capex. We expect the government to broadly adhere to the budgeted capex target to support growth.

Overall, we estimate the fiscal deficit at around Rs 15.72 lakh crore, marginally above the budgeted Rs 15.69 lakh crore, with the revenue shortfall largely offset by higher non-tax revenues and expenditure savings. With nominal GDP (as per the NSO's first advance estimate) slightly higher than budgeted, the budget deficit ratio is estimated at around 4.4% of GDP, in line with the budget target.

## FY27 Budget Outlook: Consolidation with Reform Momentum

**Looking ahead to FY27, the Union Budget is expected to balance a continued commitment to fiscal consolidation with a stronger push on structural reforms to support medium-term growth.** FY27 marks a transition towards a debt-anchored fiscal framework, moving beyond annual deficit targets, with the government targeting a reduction in central government debt from 57.1% in FY25 and estimated ~56.1% of GDP in FY26 to 50±1% by March 2031. This implies a gradual consolidation path, with the FY27 fiscal deficit likely to moderate to around 4.3% of GDP, down from 4.4% in FY26.

The FY27 Budget is expected to incorporate the 16th Finance Commission's recommendations on states' tax devolution for FY27–FY31, while salary and pension revisions (to be effective January 2026) linked to the 8th Pay Commission, are likely to have a larger fiscal impact in FY28 due to phased/delayed implementation. In addition, the new GDP series (base year revised to 2022–23), due by end-February 2026, may lead to revisions in estimated and projected fiscal ratios. Accordingly, the FY27 outlook discussed in a subsequent section is based on current information, assuming FY27 nominal GDP growth of around 10.2%, broadly stable trends in states' share of the divisible tax pool, and limited pay-revision spillovers into FY27.

In FY27, we expect tax revenue growth to improve, led by direct taxes. Indirect tax collections should recover gradually as the GST revamp and possible customs-duty rationalisation weigh on collections, while excise duties are expected to grow in double digits, supported by levies on products such as tobacco and pan masala. Non-tax revenues are likely to normalise after the exceptionally high RBI's dividend in FY26, though they may remain elevated, aided partly by central bank's earnings linked to FX

operations. Higher dividend payouts from public sector banks (subject to finalisation of changes in dividend frameworks by the RBI) could also provide support. Divestment and asset monetisation are also expected to see a renewed push.

On the expenditure front, **the government is likely to maintain a strong emphasis on public capital expenditure, with capex expected to remain around 3.2% of GDP, implying growth of roughly 11% YoY over the FY26 estimated outturn.** Spending priorities are likely to remain centred on roads, railways, and defence. The allocation of interest-free loans to states for capex is likely to be enhanced from Rs 1.5 lakh crore in FY26 to Rs 1.8–2.0 lakh crore. Revenue expenditure growth is expected to remain moderate, consistent with the broader consolidation agenda.

**We expect the budget deficit to be around Rs 16.9 Lakh crore in FY27, that is around 4.3% of GDP.** In terms of financing, net market borrowings through G-Secs in FY27 are estimated at around Rs 11.8 lakh crore (up from around Rs 11.5 Lakh crore in FY26). At the same time, the government's reliance on small savings schemes and T-bill issuance for financing is expected to increase, to limit dated bond supply pressures amid elevated G-Sec yields. However, with large debt redemptions of around Rs 5.5 lakh crore (partly managed through switches), gross market borrowings could rise to about Rs 16.7 lakh crore from an estimated Rs 14.72 Lakh crore in FY26. Given this, the RBI's greater support via OMOs will be needed to manage bond supply pressures and help anchor government bond yields.

Beyond fiscal arithmetic, we expect **a renewed policy thrust toward structural reforms to improve the ease of doing business and competitiveness, boosting investment and exports. The government's emphasis on job creation, skill development, and rural development is likely to continue, reinforcing inclusive and productivity-led growth.**

Manufacturing-led growth is expected to receive renewed emphasis through sharper execution of the National Manufacturing Mission, potentially via targeted industrial infrastructure, broader ecosystem enablers through SEZ reforms, and calibrated expansion of PLI coverage. Policy focus is also likely to intensify on capability building in emerging areas such as artificial intelligence and data-centre infrastructure.

At the same time, critical minerals are emerging as a core strategic pillar of industrial and energy policy. Import-dependence reduction is being advanced through the National Critical Mineral Mission, and given the importance of these materials for EVs, electronics, aerospace, and

defence, the Budget is likely to place greater emphasis on scaling domestic capabilities, securing supply chains, and crowding in private capital across the critical-minerals value chain.

In parallel, the Budget is expected to outline a revamp of the customs-duty framework, including simpler duty slabs, lower duties on intermediate goods, and measures to address inverted duty structures, supporting exports and domestic value addition. Amid continued pressures from US tariffs, targeted interventions for MSMEs and export-oriented sectors are also likely, including relief measures, improved access to finance, and support for export-market diversification.

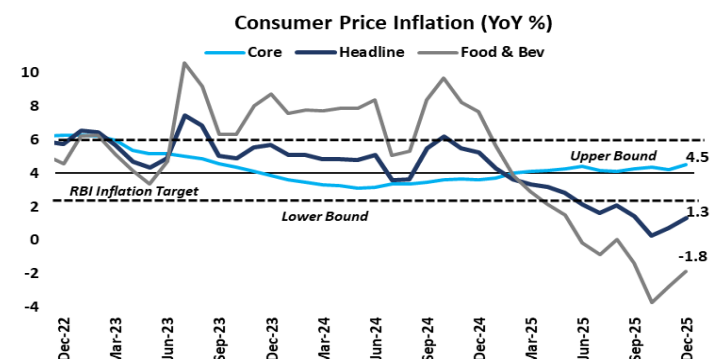
Industry bodies have also called for targeted financial-sector measures to sustain credit flows, particularly to MSMEs, through refinance support to NBFCs, expanded credit guarantees, regulatory and tax rationalisation, and steps to attract long-term foreign capital. Real estate stakeholders have sought affordability-focused measures, including updated definitions of affordable housing, enhanced tax incentives, faster approvals, continued support for project completion, and stronger policy backing for rental housing.

**Overall, the FY27 Budget is likely to prioritise measures that support investment, job creation, and exports, while remaining firmly anchored to the path of fiscal consolidation.**

### Preview of RBI's Monetary Policy Meeting: Pause on Rates, Measures Expected to Aid Transmission

Inflation pressures remain benign, allowing the RBI to keep **policy rates lower for longer**, while placing greater near-term emphasis on liquidity and currency management.

### Inflation Remains Benign Despite Slight Uptick



Source: CMIE

Headline CPI inflation edged up to 1.33% YoY in December, from 0.7% in November, but remained well below the RBI's lower tolerance band of 2%. The uptick primarily reflected unfavourable base effects and a moderation in food and beverages price deflation. Meanwhile, core inflation firmed modestly, rising to 4.5% YoY in December from 4.2% in

November, driven largely by a sharp increase in the personal care and effects category reflective of elevated gold prices. However, excluding gold, core inflation remained benign at 2.55% YoY, indicating contained underlying pressures.

At the quarterly level, Q3 FY26 average CPI inflation came in at ~0.8%, the lowest reading in the current CPI series, in line with expectations and down from 1.7% in Q2 FY26, underscoring persistently muted price pressures. Looking ahead, inflation is expected to normalise towards ~3% in Q4 FY26, with FY26 CPI inflation averaging around 2.1%.

Against this backdrop, the RBI delivered a 25-bps policy rate cut at the December MPC meeting, taking cumulative easing to 125 bps since February 2025. In our assessment, **the bar for a further rate cut is now high, and we do not expect additional easing in FY26 unless economic growth outcomes surprise materially on the downside or the macroeconomic outlook deteriorates meaningfully.** FY27 policy calibration is likely to be reassessed after the release of the new GDP and CPI inflation series in February 2026, which could influence the RBI's reaction function and forward guidance.

**In the interim, the RBI is expected to place greater emphasis on policy-rate transmission.** Banking-system liquidity improved in November but tightened sharply in the second half of December and remained under pressure into early January. Liquidity pressures have been driven by FX interventions, tax outflows, seasonal demand around the Q3-end and fiscal year-end, and the government's elevated borrowings. Reflecting this tightening, the weighted average call rate (WACR) has been trading above the policy repo rate in recent weeks on several occasions, signalling tighter money-market conditions and uneven transmission.

In response, the RBI has taken proactive liquidity measures, injecting around Rs 4.35 lakh crore durable liquidity through OMOs and USD/INR buy-sell swaps since the December policy meeting. As pressures persisted, the RBI announced additional liquidity infusion of around Rs 2 lakh crore in January, including 90-day VRR operations of Rs 25,000 crore, a 3-year USD/INR buy-sell swap auction of USD 10 billion, and OMO purchases of Rs 1,00,000 crore, with operations staggered during January-February. Looking ahead, we expect the RBI to manage system liquidity at around 1% of NDTL, with further liquidity operations in Q4 FY26 and into FY27 likely to support smoother transmission of monetary policy.

## Market Update

**Bond Market:** G-Sec yields have remained elevated despite the policy rate cut and liquidity injections. Yields rose after the December MPC meeting, with the benchmark 10-year

G-Sec climbing to a high of ~6.67% from 6.51% at the end of November. Market sentiment turned cautious amid expectations that the easing cycle may be nearing its end, a lower-than-anticipated OMOs announcement in the policy meeting, and the government's elevated borrowing.

After a brief reprieve in late December due to the RBI's additional OMOs purchases, sentiment weakened again in early January (with the 10-year G-Sec at 6.72% as on 27<sup>th</sup> Jan) amid caution ahead of the Union budget, the state governments' heavy borrowing programme for Q4 FY26, and the deferral of India's G-Sec inclusion in the Bloomberg Global Aggregate Bond Index. Elevated global bond yields also likely spilled over into the domestic bond market. Near-term bond market direction will be guided by the Union Budget (particularly FY27 borrowing estimates), RBI liquidity operations (especially OMOs), and movements in global bond yields.

**Equity Market:** India's equity markets came under pressure in December (-0.3%) and January (-3.7% up to 27<sup>th</sup> January) following strong gains in October-November. Risk appetite weakened amid mixed global cues, delays in US-India trade-deal finalisation, and FPI outflows. Sentiment deteriorated further in January due to disappointing early corporate earnings results, FPI outflows, renewed uncertainty around US tariff actions, and a rise in geopolitical tensions, leading to a more cautious near-term outlook.

**Currency Market:** The Indian rupee has remained under pressure, weakening to a low of ~91.96 per USD in Jan-2026 before recovering to 91.72 by 27<sup>th</sup> Jan, with RBI FX interventions continuing to provide an important anchor. Renewed depreciation pressures in January were driven by fresh FPI outflows, global risk aversion, and heightened geopolitical tensions.

Sentiment has also been affected by delays in the US-India trade deal and the postponement of India's G-Sec inclusion in the Bloomberg bond index. Currency near-term movement is likely to be guided by developments around the US Supreme Court ruling on reciprocal tariffs, progress on US-India trade negotiations, and the RBI's FX interventions.

**(Please see box on the India-EU trade deal on the next page)**

## EU-India FTA: A Strategic Boost to Trade Diversification

India and the European Union have announced the successful conclusion of negotiations on a Free Trade Agreement (FTA), closing an almost 18-year-long process that began in 2007. While legal finalisation and ratification are still pending, the agreement marks a major milestone in India-EU economic relations.

Once implemented, the FTA is expected to unlock meaningful trade, investment and technology-transfer opportunities, reflecting the scale of the two partners. India and the EU are respectively the 4th and 2nd largest economies globally, together accounting for about 25% of global GDP and nearly one-third of global trade. Strategically, the agreement reinforces India's trade-diversification agenda at a time of elevated uncertainty around US trade policy, including the US' 50% tariffs on India's goods exports. Over the past year, India has also concluded or announced trade deals with the UK, Oman and New Zealand, underscoring this diversification push.

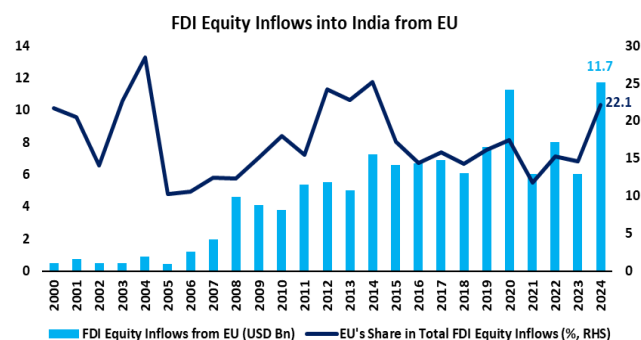
### Labour-Intensive Sectors and Services Likely Key Beneficiaries

Bilateral merchandise trade between India and the EU stood at around USD 137 billion in FY25, with India exporting ~USD 76 billion (about 17.3% of total merchandise exports) and importing ~USD 61 billion (around 8.4% of total goods imports). India's key exports to the EU include petroleum products, electrical machinery, pharmaceuticals, iron & steel, auto components, chemicals, textiles, and gems & jewellery.

Under the FTA, India will receive preferential market access for nearly 99% of its exports to the EU by trade value. Notably, the agreement could lower tariffs to zero from currently up to 10% on nearly USD 33 billion of India's labour-intensive exports, giving a boost to textiles, apparel, leather, footwear, marine products, gems and jewellery, handicrafts, engineering goods, and automotive exports. Agriculture and dairy appear to be largely kept outside the core of the agreement, with selective concessions.

On the import side, India is expected to eliminate or reduce tariffs on about 96.6% of EU goods by value over time, including machinery, chemicals, and pharmaceuticals. Automobile tariff reduction by India will be phased, quota-based and calibrated, balancing domestic industry protection with reciprocal market access for Indian auto and auto-component exports into the EU.

India's Top 10 Export Commodities to EU	USD bn		% YoY		% Share in India's Total Exports to EU	
	FY25	Apr-Nov'25	FY25	Apr-Nov'25	FY25	Apr-Nov'25
MINERAL FUELS & OILS	15.0	8.8	-21.8	-24.2	19.8	17.9
ELECTRIC MACHINERY AND EQUIPMENT	11.3	5.6	41.2	-24.4	14.8	11.5
MACHINERY AND MECHANICAL APPLIANCES	5.0	3.8	-3.9	14.2	6.6	7.7
IRON AND STEEL & ARTICLES THEREOF	4.9	3.7	-26.8	0.0	6.4	7.6
ORGANIC CHEMICALS	5.1	3.3	1.2	3.7	6.7	6.7
APPARELS	4.6	2.8	11.6	0.0	6.0	5.7
PHARMACEUTICAL PRODUCTS	3.0	2.2	2.5	12.9	3.9	4.4
AUTOMOBILES AND PARTS THEREOF	2.2	2.0	-3.6	34.3	2.9	4.0
GEMS, PRECIOUS STONES AND JEWELLERY	2.5	1.7	-15.1	0.5	3.3	3.5
RUBBER AND ARTICLES THEREOF	1.3	0.9	5.3	10.4	1.7	1.9



Source: CMIE, DGCIS, DPIIT; Note: Apparel consists of HS-2 codes 61 and 62.

### Services, Investment and Strategic Cooperation

India's services exports to the EU rose from ~USD 22 billion in 2019 to USD 37 billion in 2023, while bilateral services trade reached USD 83 billion in 2024. The FTA includes commercially meaningful commitments in services, covering IT & ITES, professional services, education, financial services, tourism, construction and other business services. Further, a comprehensive mobility framework is expected to facilitate temporary movement of professionals, including intra-corporate transferees, business visitors, contractual service suppliers and independent professionals, aligned with India's services export strengths.

Beyond trade, the agreement strengthens cooperation in innovation, clean technologies, artificial intelligence, regulatory alignment and digital payments, and is expected to support higher FDI inflows. EU's cumulative FDI equity investment into India stood at about USD 119 billion during 2000-2024, accounting for ~16.6% of total FDI, led by services, software and automobiles. Strong IP protection under the FTA should further bolster EU investor confidence.

The EU's Carbon Border Adjustment Mechanism (CBAM), effective from January 2026, remains a risk for India's carbon-intensive exports, particularly steel and aluminium. Meanwhile, the EU has committed €500 million over two years under a climate cooperation framework to support India's low-carbon industrial transition.



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