29 May 2026

India Economic Outlook: Policy Shifts from Cushioning to Adjustment as Middle East Conflict Prolongs; Progress in US-Iran Negotiations Offers Cautious Optimism

- Tentative progress in US-Iran negotiations has improved sentiment and pushed Brent crude oil price below US$100/bbl, though significant uncertainty remains around the durability and implementation of any potential agreement. The risk of no near-term deal also persists.
- The Middle East conflict and associated energy supply and trade disruptions continue to weigh on the global economy, with pockets of resilience. For India, the sharpest pressures are visible in the external account and exchange rate, while the impact on domestic economic activity is uneven across sectors.
- India's manufacturing activity has moderated amid rising input costs and supply disruptions, while the services sector remains relatively resilient, supported by domestic demand and robust services exports.
- Agricultural conditions remain mixed, with a strong pace of wheat procurement and adequate reservoir levels partly offsetting risks from heatwaves, rising input costs, fertiliser supply disruptions, and the risk of a below-normal monsoon.
- Private consumption continues to hold up despite early signs of moderation, with higher fuel prices and rising inflation expected to weigh on purchasing power going forward.
- Absent measures to enhance revenue collections and/or rationalise expenditure, the central government fiscal deficit could widen to around 4.8% of GDP in FY27, above the budgeted 4.3%, reflecting excise duty revenue losses, likely lower OMCs' dividends, and higher fertiliser subsidies.
- Given the prolongation of the Middle East conflict, policy is shifting from cushioning elevated energy prices toward calibrated pass-through to end-users. Retail petrol and diesel prices have been cumulatively raised by ~Rs 7.5 per litre in May so far, with further pass-through likely if the conflict persists.
- CPI inflation rose to a 13-month high of 3.48% YoY in April, driven largely by food inflation, while core inflation remained steady at around 3.4%. The sharp divergence between WPI inflation at a 42-month high of 8.3% in April and CPI inflation signals substantial pipeline cost pressures that have yet to be transmitted to retail prices.
- Given the possibility of a near-term US-Iran peace agreement, we are retaining our FY27 India's real GDP growth forecast of 6.7% and CPI inflation forecast of 4.7% pending greater clarity on negotiations. Downside risks to growth and upside risks to inflation have, however, increased. We expect Q4 FY26 real GDP growth to come in at ~6.8%, taking full-year FY26 growth to around 7.4%.
- The RBI faces a difficult trade-off between preserving inflation-management credibility amid rising risks of second-round effects and persistent rupee pressures while supporting economic growth.
- While a rate hike is not ruled out, we expect the RBI to keep the policy repo rate unchanged at 5.25% in June, maintaining a wait-and-watch approach to assess geopolitical developments, inflation pass-through, and exchange rate pressures. The possibility of monetary tightening in H2 FY27 or even sooner will rise if energy disruptions persist, inflation expectations shift, or rupee pressures intensify.
- The RBI has deployed a range of exchange rate support measures so far. Going forward, policymakers are likely to focus on measures to attract foreign capital inflows, including FCNR(B) deposit schemes, facilitation of foreign-currency borrowing, and debt-market tax reforms.

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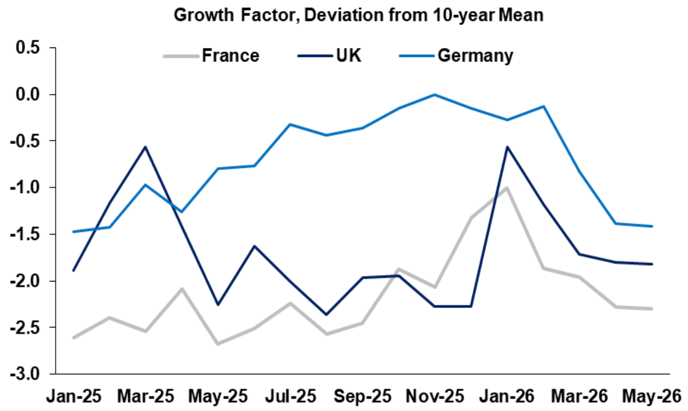
Supply Shock Emanating from the Middle East Conflict Continues to Weigh on the Global Economy, With Pockets of Resilience

The three-month-long geopolitical conflict centred on Iran is increasingly weighing on various parts of the global economy. To be sure, the global economy, writ large, has held up well even as energy costs have surged and consumers and businesses have fretted about future energy supplies and costs. But the more than 45% spike in average Brent crude prices since hostilities began, compared to the February average, and outsized increases in other energy products such as LNG, are slowing the pace of economic activity in a broad array of countries. Select countries are also experiencing a spillover from higher energy prices into non-energy prices, which has stiffened central bank rhetoric on the importance of low inflation and sent market interest rates notably higher, with bond yields in certain economies rising to the highest in 10- to 15-year periods.

As discussed in prior reports, the economies most likely to suffer the most adverse economic consequences of the energy shock are those most reliant on energy imports from the Middle East. This includes much of the European Continent and the British Isles, given their respective limited domestic energy production and reliance upon nearby Asia, particularly the Middle East, for energy. Indeed, a proprietary metric (so-called growth factor) that systematically tracks the economic growth environment depicts a sharp softening in the pace of European economic activity in recent months (see chart below). This weakening directly corresponds to the Iran-related energy shock.

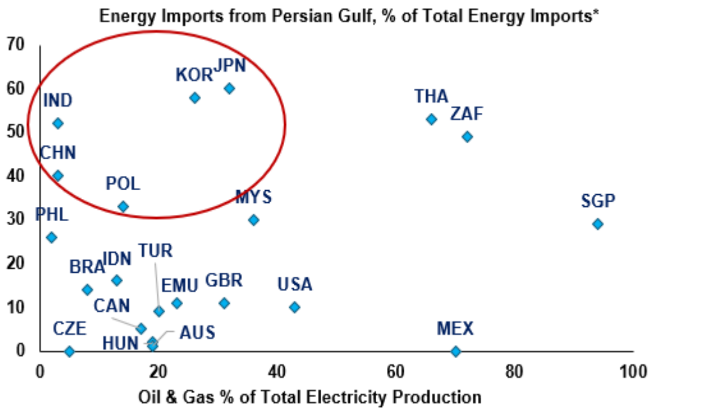
Economic Activity in France, Germany, and the UK Moderating Due to Iran-Related Energy Shock



Source: DeepMacro, Inc. Note: The "growth factor" is a systematic measure of a country's economic growth derived from a mix of traditional macroeconomic data and 'big data.' Printed with permission of DeepMacro, Inc.

Multiple large Asian economies are also quite exposed to the energy shock (see RHS chart). Economies such as China, India, Japan and South Korea all import a substantial portion of their oil and gas for domestic electricity generation from the Middle East. However, unlike European economies, these countries have yet to encounter the full effects of the energy price shock, as domestic policy measures have heretofore cushioned the pass-through to consumers and businesses. The longer the energy shock persists, the more likely consumers and businesses in economies such as these ultimately will experience the full brunt of the energy price shock.

Major Countries Exposure to Energy Shock



Sources: World Bank. * Denotes imports of crude, refined oil and LNG.

Energy costs remain high despite what has effectively been a two-month ceasefire in kinetic action. Elevated prices are a by-product of the ongoing closure of the Strait of Hormuz and dwindling oil and gas stockpiles around the world. As of this writing, the United States and Iran are engaged in a new round of peace talks to try to resolve the standoff in the Strait and to lay out a mutually agreeable framework for the two countries to discuss Iran's nuclear program. Should such an agreement be reached, energy prices – at least in futures markets – likely would fall, providing some economic relief.

However, there have been multiple false dawns on the agreement front in the past 60 days, so time will tell what happens with these latest negotiations. If a framework agreement is announced by both countries, implementation risks will nonetheless be high. And even if such an agreement results in a swift reopening of the Strait, local energy production will take time to ramp back up, and the distribution network has been fractured during these past few months. Accordingly, a return to normal Middle East energy production levels and distribution will likely take multiple months following a durable agreement among the US, Iran, and other key countries in the region.

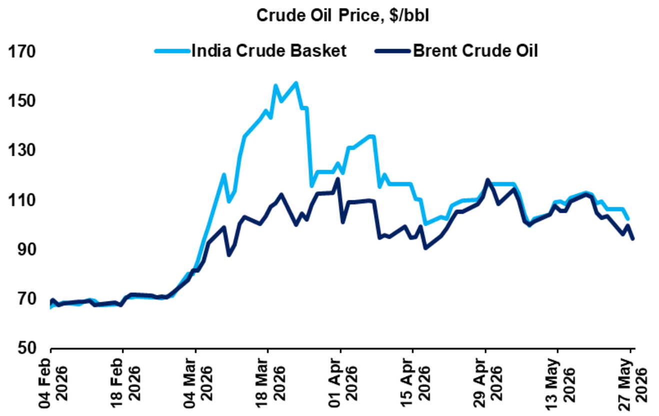
India Economic Outlook: Policy is Beginning to Shift from Cushioning the Energy Shock Toward Adjustment; US-Iran Negotiations Remain the Key Variable

The persistence of the Middle East conflict and the associated disruptions to energy supply and trade routes continue to weigh on the Indian economy. The spillover from the supply shock to the economy has risen, although the transmission to different economic segments has been uneven. So far, the sharpest pressures have emerged in the external account and the exchange rate. Domestic economic activity indicators present a more mixed picture, with several indicators continuing to display resilience while others show an adverse impact.

With the Middle East conflict and associated disruptions lasting longer than initially anticipated, India has now started to transition from the shock-absorption phase into a gradual adjustment phase, consistent with the standard policy approach of financing/absorbing temporary shocks while adjusting to those that prove more persistent. The initial fiscal cushion, through the excise duty cut on petrol and diesel announced in late March, reflected the assessment that the supply shock would be temporary. With the prolongation of the conflict, policy is now gradually shifting toward a calibrated pass-through of higher energy prices to end-users. Even so, the adjustment so far has been partial relative to the scale of the underlying cost shock. If a credible US-Iran peace agreement does not materialise within the next few weeks, or if the conflict re-escalates, further pass-through of elevated fuel and energy costs appears likely.

On a positive note, there are tentative signs of progress toward a US-Iran peace framework. Last weekend, US President Trump described a peace deal with Iran as "largely negotiated" and suggested that a formal announcement could materialise in the coming days, including commitments related to reopening the Strait of Hormuz. Iran's Foreign Ministry, meanwhile, characterised the talks as "moving toward a convergence of views" without signalling an imminent breakthrough. Brent crude prices have eased to below US$100/bbl, reflecting improved market sentiment, though sporadic attacks have since resumed, reviving doubts about the prospects for a near-term peace agreement.

Crude Oil Prices Softened Amid Optimism Around US-Iran Negotiations



Source: Bloomberg

Even if a US-Iran peace deal framework is announced, the trust deficit between the two sides and the breadth of unresolved issues are likely to weigh on the pace of implementation. Given the fragile nature of prior agreements and quasi-agreements between the US and Iran, scepticism about the viability and durability of any new arrangement is likely to persist until visible, verifiable progress toward reopening the Strait is underway. While any formal US-Iran agreement would support sentiment and provide grounds for cautious optimism, the extent to which external headwinds facing the Indian economy moderate will ultimately depend on the pace and degree of normalisation in transit through the Strait of Hormuz and the resulting impact on global energy supply and prices. A confirmed, credible agreement that leads to a swift reopening of the Strait of Hormuz would materially reduce the external headwinds facing the Indian economy.

Given recent developments, we are retaining for now our FY27 India's real GDP growth forecast of 6.7% and CPI inflation forecast of 4.7%, pending greater clarity on the negotiation process and the details of any potential US-Iran agreement. Some revisions to economic growth and inflation projections may be needed, given that the conflict and associated disruptions have persisted longer than expected, and the scale of any adjustment will depend on the trajectory and outcome of the negotiations. We will await greater clarity on the terms and durability of any agreement before revisiting our projections for growth, inflation, and the broader policy outlook. For Q4 FY26, we expect real GDP growth to come in at around 6.8%, bringing the full-year figure to ~7.4% in FY26, aided by a healthy pace of economic activity during the quarter, partly offset by the impact of the Middle East conflict in the final month and a rise in the deflator.

Given the possibility of a near-term diplomatic breakthrough, we expect the RBI to maintain a wait-and-watch stance at the June policy meeting to assess geopolitical developments, inflation pass-through, and exchange rate pressures while signalling readiness to respond if pressures persist or intensify. While a rate hike is not ruled out, we expect the RBI to keep the policy repo rate unchanged at 5.25% in the June policy meeting and maintain a neutral policy stance. In the interim, we expect the RBI to focus on measures to attract foreign capital inflows and reduce pressure on the exchange rate. However, a further delay in conflict resolution, a re-escalation of geopolitical tensions, or a more severe monsoon rainfall shortfall could bring monetary policy tightening into consideration in H2 FY27 or even sooner. Any such tightening would likely aim to preserve the RBI's credibility in inflation management and maintain macroeconomic stability.

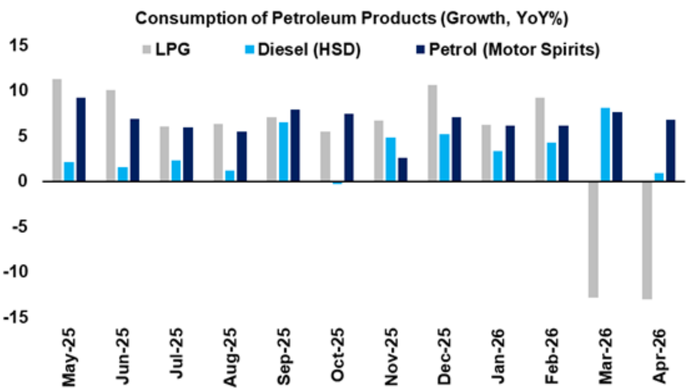
India Economic Activity: Pressure in Manufacturing, Services Resilient, Agriculture Facing Headwinds

Ongoing supply disruptions continue to weigh on India's economic activity, though pockets of resilience remain. IIP growth fell to a five-month low of 4.1% YoY in March, from 5.1% in February, reflecting rising input cost pressures and supply chain disruptions. Within the headline index, the mining sector provided support, with output growth accelerating to a three-month high of 5.5%. Manufacturing production growth, however, moderated to a five-month low of 4.3%, weighing on overall momentum. Electricity output growth also slowed to 0.8%, from 2.3% in February, though generation demand could improve in the coming months amid elevated temperatures.

April data presented a somewhat more constructive picture. Core sector output growth recovered moderately to 1.7% from 1.2% in March, supported by stronger electricity generation, firmer cement production, and a narrowing of the contraction in fertiliser output. Manufacturing PMI edged up to 54.7 in April from 53.9 in March, though the reading still signalled the second-slowest improvement in operating conditions in nearly four years. New orders and output growth showed a recovery, though the pace of expansion remained the second weakest since 2022. The flash PMI for May came in at 54.3, broadly steady relative to the final April reading.

Petrol and diesel consumption growth moderated in April, while LPG consumption continued to contract. In April, crude oil imports remained at ~85% of February levels, while LPG imports fell to nearly half of the pre-conflict average, with a rise in domestic production providing some offset, according to media reports.

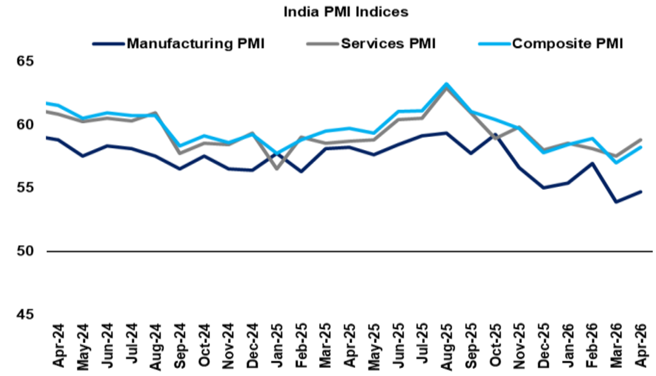
LPG Consumption Remained in Contraction, While Petrol and Diesel Consumption Moderated in April



Source: PPAC, CMIE

Service sector activity has shown relatively more resilience in April. The Services PMI rebounded to a five-month high of 58.8 in April from 57.5 in March, supported by stronger domestic demand, increased e-commerce activity, and a shift in demand from overseas markets toward domestic consumers amid geopolitical tensions. New business inflows increased at the fastest pace in five months, though growth in external sales moderated to a five-month low, weighed down by geopolitical tensions and softer tourism demand. The flash Services PMI for May held broadly steady at 58.9, marginally above the final April reading.

PMIs Showed Recovery in April, with Services PMI Posting a Sharper Pick-Up



Source: CMIE

Banking non-food credit growth also maintained a healthy pace in April. International air passenger traffic remained in contraction, reflecting disruption caused by the Middle East conflict, though the pace of contraction eased compared to March. Port cargo traffic similarly showed a moderate recovery in April. Services exports for March were revised up to show healthy growth, compared to the preliminary reading, which had indicated a contraction, and the April preliminary print points to a pick-up in export growth momentum.

Services Sector Activity Remained Broadly Resilient

Indicators (YoY%)	Jun-25	Jul-25	Aug-25	Sep-25	Oct-25	Nov-25	Dec-25	Jan-26	Feb-26	Mar-26	Apr-26
PMI Services	60.4	60.5	62.9	60.9	58.9	59.8	58.0	58.5	58.1	57.5	58.8
International Passenger Traffic	3.4	5.5	7.7	7.3	9.7	7.5	6.0	7.1	3.0	-18.5	-16.7
Port Cargo Traffic	5.6	4.0	2.5	11.5	11.9	14.5	12.7	7.6	5.1	0.6	2.4
GST E-way Bills	19.3	25.8	22.4	21.0	8.2	27.6	23.5	15.8	18.8	12.9	11.8
Services Exports	12.0	10.3	2.8	12.5	2.2	6.7	13.0	9.8	9.7	7.2	13.4
Banking Non-Food Credit	9.3	9.9	9.9	10.2	11.1	11.4	14.4	14.4	14.3	15.9	15.8

Source: CMIE and RBI. Banking Non-Food Credit for April 2026 is provisional as per the RBI Bulletin.

The government has approved the Emergency Credit Line Guarantee Scheme (ECLGS) 5.0 to help businesses manage short-term liquidity stress arising from the Middle East conflict. The scheme targets additional credit flow of Rs 2,55,000 crore, including Rs 5,000 crore earmarked for the airline sector, with the stated intent of maintaining business liquidity, protecting jobs, and sustaining critical supply chains. Eligible borrowers include MSMEs, non-MSMEs with existing working capital limits, and scheduled passenger airlines with standard accounts as of March 31, 2026. Guarantee coverage is 100% for MSMEs and 90% for non-MSMEs and the airline sector, with guarantee fees fully waived.

In the agriculture sector, government wheat procurement is on course to meet the full-season target of 34.5 million tonnes by the end of May or early June and sowing in the summer Zaid season has progressed well, with acreage under all major crops tracking above last year's levels except rice. Heatwaves and unseasonal rains could affect crop yields in certain parts of the country.

Looking ahead, the agricultural outlook faces headwinds in FY27 from higher input and fuel costs, disruptions to fertiliser supply, and the risk of a weaker monsoon. The IMD has projected below-normal rainfall for the southwest monsoon at 92% of the long-period average, with El Niño conditions likely to develop during the season. Deficient rainfall could weigh on agricultural output and rural demand, though adequate reservoir levels should provide some offset; total live storage across 165 key reservoirs stood at ~33% of total live storage capacity as of May 21, compared to the ten-year average of ~27%. Fertiliser availability reportedly remains adequate for the upcoming Kharif sowing season, and domestic prices of major fertilisers have been kept broadly stable despite a sharp increase in global prices. If the Middle East conflict persists, however, potential supply shortages could disrupt sowing, weigh on crop yields, and push food prices higher.

Private Consumption Holding Up; Investment Mixed; External Environment Challenging; Fiscal Pressures Rising

Private consumption showed some resilience, though early signs of moderation are emerging. Retail auto sales growth moderated in April for passenger vehicles and two-wheelers, though both segments maintained double-digit growth, indicating continued resilience. This may partly reflect pre-emptive purchases ahead of expected price hikes linked to rising input costs, alongside continued affordability gains from the GST 2.0 implementation. Banking sector retail credit growth maintained a robust pace in March, and UPI and credit card transactions also showed resilience in April. Domestic air passenger traffic, however, contracted further in April, weighed down by heatwaves and higher ATF prices. Looking ahead, the cumulative hike in retail petrol and diesel prices of around Rs 7.5 per litre so far in May, alongside the expected rise in inflation, is likely to weigh on purchasing power and could dampen consumption momentum.

In the labour market, overall unemployment edged up to 6.7% in April from 6.6% in March, as a rise in labour force participation outpaced the increase in employment levels, according to CMIE data. The increase in employment was, however, driven by a rise in small traders, wage labourers, and business-related jobs, offsetting a decline in salaried employment. This latter decline appears inconsistent with the pick-up in PMI manufacturing and services employment sub-indices and the continued healthy though moderating pace of formal sector hiring intent indicated by the Naukri JobSpeak index. We will monitor whether salaried jobs, which represent relatively better-quality employment compared to most other occupational categories, show any sustained moderation.

Private Consumption Indicators Continue to Show Resilience Amid Some Moderation

Indicators (YoY%)	Jun-25	Jul-25	Aug-25	Sep-25	Oct-25	Nov-25	Dec-25	Jan-26	Feb-26	Mar-26	Apr-26
Passenger Vehicle Sales	2.5	-0.8	0.9	5.8	10.7	20.4	26.6	7.2	26.1	21.5	16.4
Two-wheeler Sales	4.7	-6.5	2.2	6.5	51.8	-3.1	9.5	20.8	25.0	28.7	13.6
IIP- Consumer Durables	2.8	7.3	3.5	10.0	-1.3	11.2	12.4	7.2	7.1	5.3	
IIP- Consumer Non-durables	-0.9	0.5	-6.4	-0.3	-5.2	8.0	8.5	-2.3	-0.5	1.1	
Retail Credit Growth	12.1	11.9	11.8	11.7	14.0	12.8	14.4	14.9	15.2	16.2	
Domestic Air Passenger Traffic	3.7	-2.5	-0.5	-2.5	3.5	7.0	-4.9	3.1	-0.1	-1.3	-4.1
Unemployment Rate (%)	7.1	7.1	6.3	6.3	7.5	6.5	6.9	6.7	6.7	6.6	6.7
Rural	6.7	6.8	6.3	5.0	7.6	6.1	7.0	5.8	6.4	6.5	6.7
Urban	7.7	7.8	6.4	8.5	7.3	7.2	6.8	8.3	7.3	6.9	6.7
Naukri JobSpeak Index	10.5	6.8	3.4	10.1	-9.3	23.5	13.2	3.4	11.9	9.2	5.8

Source: CMIE and RBI. Numbers shown are YoY% except for unemployment rates, which are in percentage.

Investment proxy indicators presented a mixed picture. IIP capital goods production growth accelerated to a 29-month high of 14.6% YoY in March from 12.4% in the previous month, while infrastructure and construction goods output eased to 6.7% in March after four consecutive months of double-digit growth. The outlook for private investment remains clouded by elevated geopolitical risks and high energy prices. As noted in our previous report, private-sector new project announcements fell sharply in Q4 FY26 after a robust pace over the prior three quarters, amid geopolitical tensions and elevated uncertainty. We expect private investment momentum to moderate in the near term, with a gradual recovery contingent on the resolution of the conflict in the Middle East.

On the fiscal outlook, increased pressures in FY27 are expected to constrain the space for capital expenditure. A further calibrated pass-through of elevated energy prices would reduce the burden on oil marketing companies (OMCs) and eventually on the fiscal balance. However, absent a concerted effort to boost revenue or rationalise expenditure, the central government fiscal deficit is likely to rise to around 4.8% of GDP in FY27, against the budgeted 4.3% and an estimated 4.4% incorporating the recent GDP revision and an assumption of 11% nominal GDP growth in FY27. The key drags are revenue losses from excise duty cuts on petrol and diesel, likely lower dividend transfers from OMCs, and higher fertiliser subsidies, partly offset by export duty hike on petrol, diesel and ATF and buffers available in the Economic Stabilisation Fund. The RBI has approved a record-high dividend transfer of Rs 2.87 lakh crore to the central government, which should partly offset the possibility of lower dividends from some PSUs, thereby helping meet the budgeted estimate of Rs 3.16 lakh crore in combined dividends from the RBI and PSUs.

The external sector environment remains challenging despite a recovery in export growth in April. Goods exports rebounded to a five-month high of 13.8% YoY in April after contracting by 7.4% in March, supported by higher petroleum products exports amid elevated energy prices and a favourable base effect. By region, exports to the US returned to growth of 1.1% YoY after four months of contraction. Shipments to the UAE and Saudi Arabia remained in contraction, though the decline narrowed sharply in April compared to March, aided by the US-Iran ceasefire. Meanwhile, overall goods imports increased by 10% YoY in April after declining by 6.2% in March, led primarily by non-oil and gold imports. Petroleum crude & products imports continued to contract, declining by 10% YoY compared with a 36% contraction in March, reflecting supply disruptions linked to the Middle East conflict. Overall, India's goods trade deficit widened to a three-month high of US$ 28.4 billion in April.

Preliminary services trade data showed exports accelerating to a 13-month high of 13.4% YoY in April (vs revised 7.2% in March), while services imports declined by 1.5% YoY, resulting in a net services surplus of US$ 20.6 billion. Although this partly offset the widening merchandise trade deficit, the overall trade balance slipped to a deficit of US$ 7.8 billion from a marginal surplus of US$ 0.3 billion in March. Risks from the Middle East conflict, particularly through elevated crude prices, supply disruptions, and weaker GCC-linked trade flows, remain significant. We expect the current account deficit to be around 1% of GDP in FY26 before widening to ~1.7% of GDP in FY27, with upside risks.

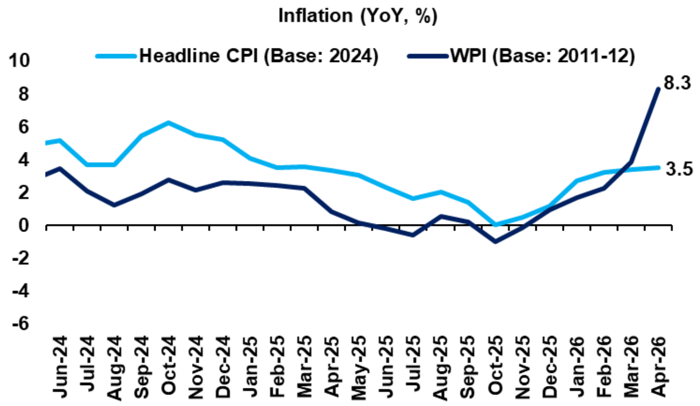
CPI Inflation Edges Up in April; Expected to Harden Further on Pass-Through of Elevated Energy Prices

The ongoing energy price shock emanating from the Middle East conflict and the possibility of below-normal rainfall due to El Niño conditions pose upside risks to CPI inflation in FY27. Inflation has so far remained subdued, but with OMCs beginning to pass on elevated prices to end-users from May, it is expected to pick up from May onwards.

CPI headline inflation edged up in April, rising to a 13-month high of 3.48% YoY from 3.40% in March as favourable base effects faded. The increase was driven mainly by food and beverages, paan, tobacco and intoxicants, and restaurants and accommodation. Food and beverage inflation rose to 4.0% in April from 3.7% in March, led by increases in vegetables, pulses, oils and fats, and fish and seafood prices. Restaurant and accommodation inflation also accelerated to 4.2% from 2.9% in the prior month, reflecting supply-side pressures, while fuel-related inflation remained relatively contained, suggesting only partial pass-through of elevated global energy prices through April. Core inflation excluding food and beverages and fuel remained steady at 3.4% in April for the fourth consecutive month, indicating benign underlying demand-side pressures. Core inflation excluding gold and silver remained muted at ~2.1% in April.

In contrast, WPI inflation surged to a 42-month high of 8.3% in April, up from 3.9% in March, driven by sharp increases in crude petroleum & natural gas and fuel & power inflation. The unusually wide divergence between CPI and WPI inflation suggests substantial pipeline cost pressures have yet to be transmitted to retail prices, increasing the risk of a broader pass-through into consumer inflation over the coming quarters, particularly if crude oil prices remain elevated and retail fuel price revisions continue. The cumulative ~Rs 7.5 per litre increase in retail petrol and diesel prices already announced is estimated to add around 30 to 40 basis points to headline CPI inflation. Despite this, the under-recovery on petrol and diesel for OMCs is estimated at around Rs 15-20 per litre on a blended basis, suggesting that scope for further pass-through remains.

CPI Inflation Continued to Edge Up; Acceleration in WPI Inflation Indicates Underlying Cost Pressures



Source: CMIE

Overall, we see upside risks to our FY27 CPI inflation forecast of 4.7%, reflecting ongoing and expected further pass-through of elevated energy costs, as well as the potential impact of a weaker monsoon.

Policy Outlook: Case for Monetary Policy Action Building; FX Toolkit to Broaden

The RBI held the policy repo rate unchanged at 5.25% in April 2026 meeting, with a neutral stance. Since then, the monetary policy and exchange rate outlook have become increasingly challenging as India's macro mix shifts toward higher inflation, weaker economic growth, and sustained external pressure. In this context, the policy dilemma facing the RBI can be framed through the lens of the economic concept of impossible trinity, which holds that a country cannot simultaneously maintain a managed exchange rate, free capital mobility, and an independent monetary policy; only two of the three are achievable at any time. With the RBI intervening in FX markets to support the rupee and the capital account remaining progressively open, it is monetary policy flexibility that comes under pressure when external shocks hit.

The current situation complicates this further because the shock is supply-side in origin. A supply-side inflation shock would ordinarily call for looking through the price rise rather than tightening demand, preserving economic growth at the cost of a temporary inflation overshoot. However, sustained rupee weakness and the risk of second-round inflationary effects could erode that option. Monetary policy tightening to anchor expectations and support the currency risks further compressing economic growth; remaining on hold risks a persistence of rupee depreciation and a more entrenched inflation cycle. The 2013 taper tantrum episode is instructive in this regard: initial attempts to defend the rupee through liquidity tightening and policy rate action proved insufficient to fully stabilise the currency. It was subsequently the introduction of the concessional FCNR(B) deposit scheme, alongside broader external adjustment measures, that helped attract large foreign capital inflows and stabilise the foreign exchange market. The episode underscores that a more durable resolution to the trilemma could be in measures that attract stable foreign capital inflows and compress the current account deficit, thereby reducing the burden on monetary policy.

Policy Response So Far: Intervention, Regulation, and Demand-Side Measures

The RBI has responded proactively to exchange rate pressure through direct intervention and regulatory action. In April, the central bank capped the authorised dealers' net open positions in the onshore deliverable market and limited their activities in the non-deliverable forward market. Since the start of the Middle East conflict, foreign exchange reserves have declined by ~US$40 billion to around US$689 billion (as of May 15), reflecting active spot market intervention. The RBI's net short forward book rose to ~US$103 billion by the end of March 2026, exceeding the previous peak of US$89 billion in February 2025. FX reserve buffers nevertheless remain relatively comfortable. Headline FX reserves of ~US$689 billion provide merchandise import cover of around 11 months, based on recent import trends, and are roughly 90% of the outstanding external debt.

On the trade and demand sides, import duties on gold and silver have been raised, alongside tighter import compliance measures to curb non-essential imports of precious metals and conserve foreign exchange. Prime Minister Shri Narendra Modi has also appealed to citizens to reduce fuel consumption through work-from-home practices, greater use of public transport, and adoption of electric vehicles, and has urged people to avoid non-essential foreign travel and defer discretionary gold purchases.

Balance of Risks Shifting Toward Tightening; Policy Rate Expected to Be Held in June to Assess Evolving Geopolitical Situation

At its June meeting, the RBI is expected to revise its FY27 economic growth projection down to around 6.5% from 6.9% and its CPI inflation projection up to around 5% from 4.6%. We will await clarity on the outcome of ongoing US and Iran negotiations before revisiting our own FY27 economic growth and CPI inflation projections.

With rising inflation risks and continued currency pressures, the balance of risks is shifting from supporting economic growth to preserving inflation-management credibility and macro-economic stability. Retail fuel price hikes will feed directly into inflation, and early evidence of second-round effects is emerging in announced and expected increases in milk prices, FMCG pricing, freight charges, logistics costs, and quick-commerce delivery fees. India's crude oil basket price averaged US$ 114.5 per barrel in April and US$ 107.5 per barrel in May through the 26th, keeping upward pressure on imported inflation and the current account.

A widening current account deficit, alongside persistent FPI outflows and weak net FDI inflows, could produce a large balance of payments deficit, weighing on FX reserves and, if sustained, raising concerns about external sector vulnerability. These dynamics increase the likelihood of some degree of monetary tightening to support currency stability and reduce the risk of a more abrupt adjustment cycle later. However, given the possibility of a near-term diplomatic breakthrough, we expect the RBI to maintain a wait-and-watch stance at the June policy meeting while signalling readiness to respond if pressures persist or intensify. That said, a rate increase cannot be ruled out if the RBI judges that inflation and macro-stability risks require a monetary policy response at the June meeting.

Broadening the Toolkit: Capital Inflow Measures and Structural Reforms

In our view, the more likely near-term avenue for policy support is measures aimed at attracting foreign capital inflows to reduce pressure on the exchange rate. These could include a scheme to incentivise inflows through foreign-currency non-resident deposits, like the 2013 FCNR(B) arrangement, under which the RBI offered banks concessional swap rates on dollars raised via such deposits, alongside encouragement for domestic institutions to raise foreign-currency borrowings. A reduction or removal of withholding tax on foreign investors in Indian government bonds could improve post-tax returns and support foreign portfolio inflows into the debt market, making India's bond market more competitive relative to peer emerging markets and potentially laying the groundwork for a future reassessment of Bloomberg Global Aggregate Index inclusion, which has thus far been deferred.

Additional measures reportedly under consideration include tightening rules under the Liberalised Remittance Scheme to moderate outward dollar demand, easing external commercial borrowing norms, and allowing PSUs or oil marketing companies to raise foreign currency loans to shift part of oil-related FX demand away from the spot market. Collectively, these measures are broadly consistent with the multi-pronged response deployed during the Russia-Ukraine shock, when a combination of easing of FPI investment norms, relaxation of external commercial borrowing norms, and FX intervention helped stabilise the currency.

Market Update

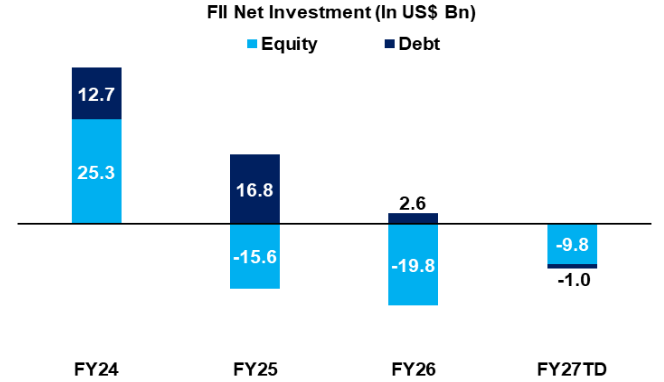
Bond Market: Banking system surplus liquidity rebounded sharply in April, with the surplus rising to an average of ~Rs 3.9 lakh crore from an average of ~Rs 1.6 lakh crore in March, supported by government spending and G-Sec redemptions. Liquidity conditions tightened somewhat in May, with the average liquidity surplus moderating to around Rs 1.8 lakh crore (data till May 26), driven by FX intervention and a rise in currency in circulation. Reflecting this, the WACR, which had traded in the lower half of the LAF corridor during the early part of May, moved above the policy repo rate of 5.25% after May 21. In response, the RBI conducted variable-rate repo operations and US$5 billion USD/INR buy-sell swap auction to inject liquidity into the banking system.

The 10-year G-Sec yield rose to a high of ~7.13% in early April, driven by concerns around fiscal slippage and a repricing of near-term policy rate expectations amid elevated crude oil prices and rising inflation risks. It eased later in the month, following the US extension of the ceasefire, before hardening again through May as elevated energy prices and rupee weakness continued to weigh on sentiment. The 10-year G-Sec yield traded in a broad range of ~6.92% to ~7.13% in May, reflecting high volatility. In recent days, it has eased back toward ~7%, reflecting cautious optimism around a potential US-Iran peace agreement and some moderation in crude oil prices.

Going ahead, the near-term direction of bond yields will depend on the trajectory of US-Iran negotiations and crude oil prices, the RBI's liquidity management measures, the evolution of inflation expectations, and any measures to boost FPI flows into the domestic debt market.

Equity Market: India's equity markets recovered in April after coming under sharp pressure in March amid escalating tensions in the Middle East, which had led to four consecutive months of losses. The Nifty 50 index rebounded 7.5% MoM in April, supported by the US-Iran ceasefire announcement, continued DII buying, and value buying following the sharp March correction. FPIs, however, remained net sellers, recording US$6.2 billion in outflows in April amid persistent concerns over broader macro risks and potential supply disruptions.

FPI Outflows Persist Amidst Elevated Uncertainty



Source: CMIE. FY27TD is till May 27, 2026.

Volatility resurfaced in early May as geopolitical developments, elevated crude oil prices, and continued pressure on the rupee weighed on sentiment. FPIs also remained net sellers in May, with net outflows of US$ 3.6 billion through May 27, although sustained DII support helped limit the downside. Sentiment improved somewhat after US President Trump's announcement of a potential near-term peace deal, with the Nifty 50 gaining 1.3% on May 25. Even so, the index remained broadly flat through May 27, down 0.4% from end-April levels, reflecting a cautious market stance amid an uncertain external environment. Going ahead, market direction is likely to remain closely linked to geopolitical developments and crude oil price movements.

Foreign Exchange Market: Since the onset of the Middle East conflict, the rupee has depreciated by 5.2% against the US dollar, as higher crude oil prices and trade route disruptions have raised concerns about a wider current account deficit and intensified FPI outflows. In April, the rupee recovered in the early part of the month to ~Rs 92.58 per US dollar, aided by the US-Iran ceasefire announcement and RBI regulatory measures, before weakening subsequently to end the month 0.1% weaker MoM at ~Rs 94.92 per US dollar, amid elevated energy prices, geopolitical developments, and FPI outflows. Pressure on the rupee persisted into May, with the currency closing at a record low of ~Rs 96.83 per US dollar on May 20. The rupee subsequently recovered, supported by active RBI intervention, the US$ 5 billion USD/INR buy-sell swap auction, and improving risk sentiment following US President Trump's announcement of a potential peace deal, closing at ~Rs 95.7 per US dollar on May 27.

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