29 July 2026

India's Domestic Resilience Faces Weather and Renewed External Headwinds; Rising Inflation Risks Strengthen the Case for Policy Tightening

- Resilient economic growth, near-full employment, and persistent above-target inflation have strengthened the case for monetary tightening in the United States and faster rate hikes in Japan, with the US Fed potentially front-loading a 50-bps increase and the Bank of Japan moving quickly to realign policy with prevailing macroeconomic conditions.
- Economic activity in India remained broadly resilient in early FY27, led by a pickup in industrial activity, while services held up, though softer forward-looking indicators suggest a potential loss of momentum ahead.
- The agricultural outlook remains challenging. The cumulative rainfall deficit so far remains sizeable despite narrowing from June levels. This, combined with lagging Kharif sowing and lower reservoir storage, poses risks to agricultural output, rural incomes, and inflation.
- Domestic demand indicators improved in June, supported by stronger retail auto sales, robust bank credit growth, and firmer investment indicators. However, rising inflation, mixed labour-market conditions, risks to rural incomes, and elevated geopolitical uncertainty could constrain the durability of the recovery.
- Fiscal slippage risks persist, reflecting weaker revenue mobilisation and a higher subsidy bill. Faster disinvestment, a sustained easing in fertiliser prices, and expenditure rationalisation could help contain the slippage.
- The external environment has deteriorated since our last update. The US–Iran interim peace agreement announced in mid-June has unravelled, and transit through the Strait of Hormuz has been disrupted anew, leading to sharp volatility in Brent crude oil prices.
- If sustained, renewed supply disruptions would push energy prices higher, with adverse implications for the current account, fiscal position, inflation outlook, and domestic economic activity, while also adding pressure on the rupee.
- We retain our FY27 real GDP growth forecast at 6.7%, and CPI inflation forecast at 5.1% for now. However, the balance of risks has shifted further in an unfavourable direction, with growth risks tilted to the downside and inflation risks increasingly tilted to the upside.
- Inflationary pressures are broadening, with headline CPI inflation crossing the 4% target for the first time since January 2025, rising to 4.4% in June, up from 3.9% in May. The WPI–CPI gap of more than 5 percentage points, deficient rainfall, and renewed energy-price pressures point to continued upside risks to retail inflation.
- The RBI's wait-and-watch stance is coming under increasing pressure, as all three key variables monitored by the MPC, namely geopolitical developments, second-round effects from the supply shock, and the monsoon rainfall, have moved unfavourably since the June meeting.
- We continue to expect 50–75 bps of cumulative policy repo rate hikes in H2 FY27, beginning in October or December, although an earlier move cannot be ruled out if geopolitical and inflationary pressures intensify materially.

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US and Japan Poised for Faster but Modest Monetary Tightening

Conditions are in place for a modest and abbreviated monetary tightening campaign by the US Federal Reserve and a quickening in the pace of tightening by the Bank of Japan (BOJ). The United States and Japan are the two strongest major economies in the world. Not only have both shrugged off the various headwinds of geopolitical conflict in the Middle East, but their economies have also strengthened according to key metrics. With both economies in the vicinity of full employment and inflation continuing to run above each central bank's respective target, odds are rising that one or both central banks will hike interest rates by more and/or faster than currently anticipated in the period ahead.

The case for monetary tightening in Japan is straightforward. The economy has been experiencing solidly above-trend economic growth, and Prime Minister Sanae Takaichi's fiscal and regulatory policies are unambiguously pro-economic growth. Recognising that some of her policy agenda is designed to boost Japan's supply side and potential output, the thrust of her policies, nonetheless, is buoying aggregate demand and likely will continue to do so for the foreseeable future. Above-trend economic growth is occurring at a time when inflation remains elevated. Indeed, the BOJ just hiked its policy rate in June by 25 bps to 1%. Nonetheless, at 1%, Japan's policy rate remains far below that implied by traditional monetary policy rules of thumb – even for Japan.

With both Japan's growth and inflation above target and monetary policy notably out of position for the macroeconomic setting, the case for continued tighter monetary policy is a textbook one. To be sure, rising longer-dated Japanese Government Bond (JGB) yields likely have helped to tap the brakes modestly on the economy beyond what otherwise would have been the case. But that is no substitute for a higher policy rate by the BOJ and the signalling and sentiment effects that would accompany such action.

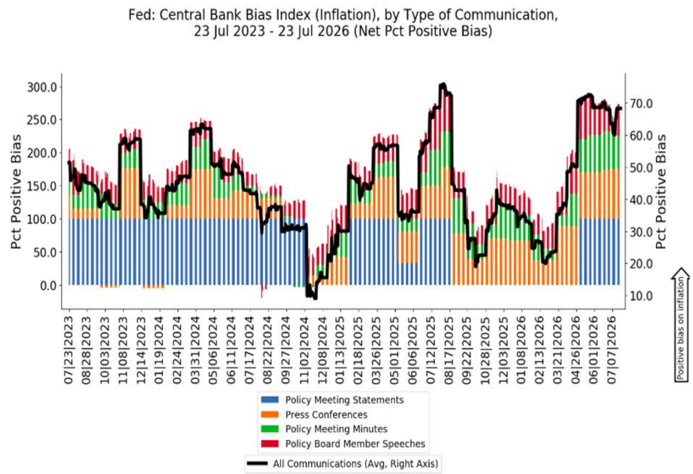
Given Japan's deflationary history and the popularity of the Takaichi government (and the nuanced nature of the BOJ / Japanese government's institutional relationship), the timing of the next monetary tightening is hard to predict. Such a move could come imminently – which would mark a stark departure from BOJ's gradualism. It also could take until late this calendar year. A monetary tightening at the next BOJ meeting or two would have a good chance of being followed by another at year-end, which would be a solid step toward closing the gap between prevailing macro conditions and monetary policy.

In the United States, inflation – however measured – also continues to run at an above-target pace. Consumer price inflation in the US has now been above target for more than five years. While tariffs, the surge in energy prices from the ongoing US–Iran conflict, and other idiosyncratic factors have contributed, inflation has remained sticky even after accounting for these dynamics. Despite weak household sentiment, a disjointed housing market, higher energy costs and geopolitical uncertainty, key parts of the economy have been strengthening in recent months. Case in point: Weekly unemployment claims have hit the lowest level since 1969 and, as a percentage of the labour market, are at the lowest reading on record.

The Fed's two mini-75 bps easing campaigns of 2024 and 2025 were questionable on the merits at the time given inflation's run-rate and the real economy's resilience – notwithstanding labour market concerns among some policymakers, particularly in 2025. With the benefit of hindsight, that prior policy easing has likely contributed to the continued above-target rate of inflation, and there is an argument to be made that those rate cuts may have been a policy error.

Under the prior leadership of Chairman Powell, the Fed likely would be examining incoming data for the next few months and – if policymakers ultimately concluded tighter monetary policy was merited – they likely would consider it in the final three months of the year or even early 2027. Any interest rate hikes likely would have been gradual – i.e. 25 bps – and couched in caution.

US Federal Reserve Central Bank Bias Index for Inflation



Note: The CBBI-I shows the net positive or negative bias of the central bank toward inflation. Index represents the net percentage of statements in central bank communications expressing views on inflation that are "positive" in a numerical sense, i.e., rising, accelerating, firming, etc., (not positive in a normative sense). The chart takes the net percent bias for each type of communication (the bars), and then averages together (the black line). Policy statements, press conferences, and policy meeting minutes are held constant until the next release of the same communication; for speeches, the index takes the 42 day moving average to approximate the policy board meeting interval.

Note: Reprinted with permission of DeepMacro, Inc. Source: DeepMacro, Inc.

With new Fed Chairman Kevin Warsh at the helm, it is our judgment that any such monetary tightening could (i) occur on a significantly faster timeline and (ii) unfold at a substantially faster pace. Indeed, it is our assessment that a

50-bps rate hike is a very real possibility at one of the Fed's next two policy meetings. Chairman Warsh consistently has made the case that the totality of the Fed's operations in recent years has contributed to the current above-trend inflation rate and –importantly – has been emphasising that the Federal Reserve under his leadership "will deliver price stability." That turn of phrase has been the cornerstone of every public statement he has made since becoming Chairman. Moreover, it is not just Chairman Warsh whose public comments are focused on inflation – an index gauging the Fed's public focus on inflation is at an extremely elevated reading (see chart above on page 2).

With roughly 50 bps of monetary tightening priced into forward US interest rate markets for the next six months, delivering that tightening in a single strike could have multiple benefits, recognising the capacity for (perhaps considerable) short-run market volatility. Frontloading the tightening priced into markets would have the potential – if properly framed by Mr. Warsh and his colleagues – of reducing policy uncertainty by getting monetary tightening done sooner rather than later. Doing more today reduces the likelihood of having to do considerably more later in the event inflation worsens, including potentially over-tightening, which historically has been a key contributor to the end of economic expansions. Once the initial shock of such decisive action wore off, it also likely would have favourable inflation expectation effects.

On this score, longer-term bond yields likely would have a good chance of steadying or even falling following such action, as the Fed flexing its price stability muscles would help to reduce market-based inflation premium. Given the influence that US interest rate markets have globally, stabilising or falling US long-term rates could beneficially spill over into other economies.

Hikes by the Fed and/or BOJ of 50 bps – or thereabouts – in the next couple of quarters are highly unlikely to restore the US or Japan's underlying inflation rate back to target. The resiliency of economic activity in these (and other) economies suggests that while higher rates will have the desired directional effect, they are unlikely to be sufficient to push inflation back down to target on their own. Ultimately, an economic contraction probably will be necessary for inflation to return to target or lower on a realised basis.

But effective price stability is not solely a number. Inflation targets are an important anchor for monetary policymaking and an avatar for the public. Effective price stability is the absence of inflation from everyday decision-making by households and businesses. To the extent the Fed and BOJ (and other central banks) can make progress in that direction while sustaining the expansion, it would be an unmitigated win for policymakers.

A frontloaded rate hike by the Fed will not necessarily accelerate the RBI's own monetary tightening timeline. India has become less sensitive – although not insensitive – to changes in US monetary policy, but the economy's cyclical and structural dynamics likely will allow the RBI to act on its own timeline.

India Economic Outlook: Early FY27 Economic Resilience Faces Weather and Renewed External Headwinds; RBI Policy Response in Focus

Economic activity in India has remained broadly resilient in early FY27, with industrial activity picking up and services activity holding up, even as the agricultural sector remains under pressure. Private consumption recovered in June after early signs of pressure in the previous month, while investment indicators strengthened. Although resilient domestic drivers continue to provide underlying support to economic activity, softer PMI readings point to an emerging moderation in economic momentum ahead. At the same time, the external environment has deteriorated since our last update. The US–Iran interim peace agreement announced in mid-June has unravelled, transit through the Strait of Hormuz has been disrupted anew, and Brent crude oil price has risen again, averaging ~US$90/bbl (from 13th July to 27th July) since the recent escalation up from around US$73/bbl at end-June. Renewed rupee weakness and intensifying upstream cost pressures have compounded the initial supply shock.

Against this backdrop, we retain our FY27 real GDP growth forecast at 6.7% and CPI inflation forecast at 5.1% for now, though the balance of risks has shifted further in an unfavourable direction: growth risks remain tilted to the downside amid prolonged geopolitical disruptions and monsoon uncertainty, while inflation risks are increasingly tilted to the upside, given the pipeline pass-through signalled by the high WPI–CPI gap, hardening household inflation expectations, and food-price risks from a deficient monsoon.

RBI Policy Outlook: August Policy Meeting a Fine Balance; 50-75 bps of Cumulative Hikes in H2 FY27 Remain Our Base Case

At its upcoming policy meeting in August, the RBI confronts a challenge to its current wait-and-watch approach in view of rising risks to the inflation outlook, alongside renewed pressures on the external account and the rupee. The Monetary Policy Committee (MPC) has held the policy repo rate unchanged in 2026 so far and retained a neutral stance, focusing on developments in the geopolitical situation, signs of second-round effects from the ongoing supply shock, and the evolution of the monsoon rainfall. With each of these three dimensions having deteriorated since the June meeting, the balance of considerations facing the MPC is shifting towards monetary policy action rather than continued wait-and-watch.

Measures announced by the RBI and the Government of India in June helped attract foreign capital inflows and ease pressure on the external account and the rupee through late June, with FPI debt inflows of ~US$7.8 billion since the June policy meeting and ~US$20.7 billion mobilised through fresh FCNR(B) Deposits, ECBs and Overseas Foreign Currency Borrowings providing meaningful near-term support. However, the renewed escalation in the Middle East conflict has driven a sharp jump in crude oil prices, adding pressure on the exchange rate and increasing upside risks to inflation. The rupee has consequently weakened again, likely prompting RBI intervention in the foreign-exchange market to contain volatility. The capital-inflow measures announced so far, while structurally supportive, are unlikely on their own to fully offset an energy-driven trade shock if it persists longer than presently anticipated. This could incrementally narrow the RBI's space to maintain a wait-and-watch approach and may influence its policy thinking going forward.

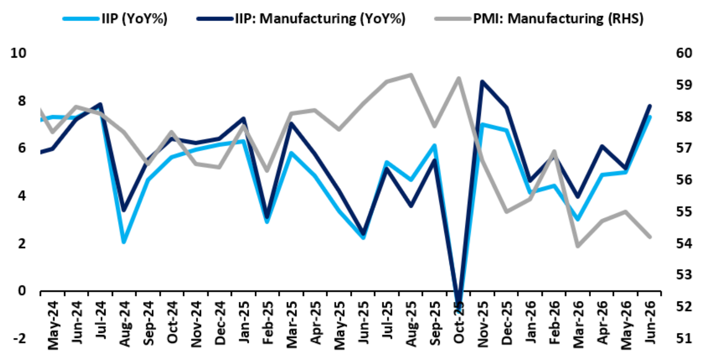
We believe that the build-up of inflationary pressures, with further upside risks, should carry more weight in the RBI's policy reaction function, given its inflation-targeting mandate. Three considerations reinforce this view. First, at its June meeting, the MPC noted that cost pressures were becoming increasingly visible but judged it prudent to await greater clarity on the duration of supply disruptions and the extent of their pass-through to inflation; that clarity is now arriving, and in an unfavourable direction. The US–Iran interim peace agreement has since unravelled, and renewed energy-supply disruptions have again pushed up crude oil prices. Second, headline CPI inflation has now crossed the 4% target for the first time since January 2025, and the persistent WPI–CPI gap of over 5 percentage points signals substantial pipeline pressures still to transmit, implying that the retail inflation trajectory from here is likely to be higher, not lower, even absent further escalation in geopolitical tensions. Third, the RBI's own household inflation expectations survey has shown a sequential hardening, raising the risk of second-round effects of the supply shock becoming self-reinforcing if left unaddressed.

Under a temporary supply shock, monetary policy would typically look through the short-lived rise in inflationary pressures rather than respond immediately with tighter policy, since raising rates cannot ease an exogenous supply constraint and risks compounding growth costs. In the current environment, however, the case for looking through the supply shock is weakening on multiple fronts: a deficient monsoon that could layer a food-inflation shock on top of the existing fuel price shock, energy prices remaining elevated, the rising risk of second-round effects already visible in hardening inflation expectations and the ongoing WPI-to-CPI pass-through. Together, these could broaden inflationary pressures beyond the initial shock, strengthening the case for monetary tightening. We therefore continue to expect 50–75 bps of cumulative policy repo rate hikes in H2 FY27, as persistent cost pressures and hardening inflation expectations eventually necessitate policy action. While not our base case, we do not rule out a policy rate hike at the August meeting itself, particularly if the current escalation trajectory deteriorates significantly in the run-up. Conversely, a significant easing of geopolitical tensions, leading to a faster and more durable normalisation in global energy markets, coupled with easing external pressures, contained second-round inflation effects, and better-than-expected monsoon rainfall, could reduce the need for monetary tightening.

India Economic Activity in Early FY27: Industrial Output Resilient, Services Softening at the Margin, Agriculture Faces Rainfall Risks

Industrial output continued to show resilience despite external shocks. The Index of Industrial Production (IIP) expanded at a near two-year high of 7.3% YoY in June, up from 5.0% in May 2026. The acceleration was broad-based, led primarily by Manufacturing and Electricity & Gas Supply. Growth in Water Supply, Sewerage & Waste Management also remained healthy, while Mining & Quarrying returned to positive territory after five consecutive months of contraction, further supporting overall industrial activity.

Industrial Activity Picks-up Even as PMI Continues to Trend Lower



Source: CMIE

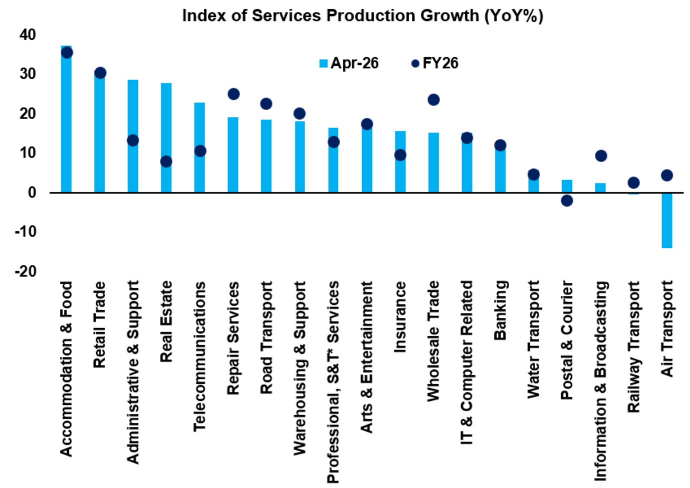
Forward-looking indicators presented a mixed picture, with the Manufacturing PMI signalling some loss of momentum. The Manufacturing PMI moderated to 54.2 in June from 55.0 in May, marking the second-weakest improvement in manufacturing conditions since mid-2022, although it remained above its long-run average. July's Flash Manufacturing PMI indicates that the moderation continued, with the index easing further to 53.9 as renewed Middle East tensions weighed on business sentiment.

Fuel (Petrol and Diesel) consumption data for June showed early signs of a recovery in demand and an easing of supply constraints, while LPG consumption remained in double-digit contraction albeit narrowing from the previous month. India's crude oil import volumes remained broadly stable at around 4.9–5.0 mb/d in June, as higher shipments from Russia and other alternative suppliers helped offset constrained supplies from the Middle East. Russian crude oil accounted for more than half of India's total crude oil imports in June, while higher shipments from Venezuela and Brazil provided further support, underscoring the benefits of continued supply diversification.

Gas imports, meanwhile, presented a mixed picture. LPG imports remained well below the FY26 monthly average, although increased domestic production provided an important buffer for household availability. LNG imports, in contrast, rebounded strongly, exceeding the average monthly level recorded before the conflict in FY26.

Services sector activity remained resilient through April and May, though early indicators for June presented a more mixed picture. MoSPI released the first trial Index of Services Production (ISP), with FY25 as the base year, marking India's first monthly high-frequency indicator of formal services activity. The initial release covers 19 sub-sectors, accounting for around 60% of services-sector GVA. An official aggregate ISP will be introduced once MoSPI has assessed the stability and robustness of the sub-sectoral indices and broadened coverage further.

Index of Services Production Indicated Resilient Services Activity in April, Supported by Broad-Based Sectoral Expansion



Source: CMIE, MOSPI. Note: *S&T in Professional, S&T Services stand for Professional, Scientific & Technical services including R&D. Dots represent growth in the sub-sectors for FY26.

Based on a weighted aggregation of the available sub-sectoral indices of the ISP, services activity expanded by a robust 20.5% YoY in April 2026. Although growth moderated from the fiscal year-end surge in March, it remained above the estimated FY26 average of around 18%, pointing to continued resilience in formal services activity. Growth was broad-based, with 14 of the 19 sub-sectors recording double-digit expansion, and all remaining in positive territory except Rail Transport and Air Transport

Bank non-food credit growth and e-way bill generation maintained robust double-digit expansion in May and June, with credit growth accelerating to over a two-year high in June. Port cargo traffic recovered in May following weakness in the previous two months, while early indicators suggest that the improvement continued through June. International air passenger traffic, however, remained in contraction amid disruptions related to the Middle East conflict, although the pace of decline eased sharply in June compared with March–May. Renewed geopolitical tensions in the Middle East could weigh on port cargo traffic and international air travel in July.

Services Sector Activity Remained Resilient, Though Softer PMI Signals Potential Moderation Ahead

Indicators (YoY%)	Oct-25	Nov-25	Dec-25	Jan-26	Feb-26	Mar-26	Apr-26	May-26	Jun-26
PMI Services	58.9	59.8	58.0	58.5	58.1	57.5	58.8	59.8	57.4
International Passenger Traffic	9.7	7.5	6.0	7.1	3.0	-18.5	-16.1	-9.1	-5.2
Port Cargo Traffic	11.9	14.5	12.7	7.6	5.1	0.6	2.4	6.6	
GST E-way Bills	8.2	27.6	23.5	15.8	18.8	12.9	11.8	10.9	14.5
Services Exports	2.2	6.7	13.0	9.8	9.6	7.2	12.7	2.8	2.9
Banking Non-Food Credit	11.1	11.4	14.4	14.4	14.3	15.9	15.8	17.4	18.3

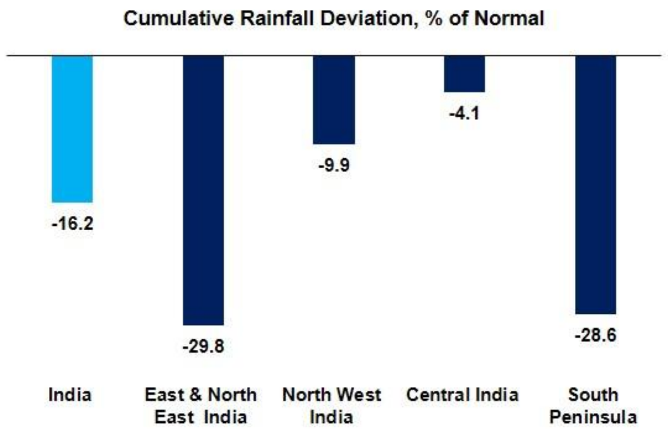
Source: CMIE and RBI. Banking Non-Food Credit for June 2026 is provisional as per the RBI Bulletin.

Forward-looking indicators, however, point to emerging pressure on services-sector momentum. The Services PMI Business Activity Index declined to 57.4 in June from 59.8 in May, marking the weakest upturn in 17 months, though it remained above its long-term average. The moderation was driven primarily by softer domestic demand and slower growth in new orders, partly offset by new export business rising at its fastest pace in three months. The pick-up in export orders is a tentative bright spot, as preliminary data suggest services export growth was muted in May and June compared with April. July's Flash Services PMI indicates that activity moderated further, with the index falling to 53.1, its weakest reading in 53 months, amid slower growth in new orders and output, alongside weaker business sentiment.

The agricultural outlook remains challenging. Following exceptionally weak monsoon rainfall in June, when precipitation was around 40% below normal, the cumulative rainfall deficit narrowed to ~16% below normal as of July 27. The increase in the gross irrigated area to around 60% of the gross cropped area, from about 48% a decade ago, should provide some structural support. However, reservoir storage remained weak at ~38.4% of live storage at Full Reservoir

Level (FRL) as of July 23, around 36% below the previous year and 7% below the historical 10-year average.

Cumulative Rainfall Deficit Persists, Posing Risk to Agricultural Output



Source: CMIE. Data till 27 July 2026.

Reflecting the improvement in rainfall, the contraction in total Kharif crops area sown narrowed to 4.7% YoY as of July 24, from around -16% two weeks earlier, with roughly 71% of the season's normal sowing completed so far. Sowing of pulses, rice, and coarse cereals continued to lag the corresponding period last year. The quantum, timing, and spatial distribution of rainfall through August will remain the key swing factors for agricultural output, rural demand, and food inflation in the months ahead.

Private Consumption Recovered in June, but Headwinds to the Outlook Persist

Private consumption recovered in June after showing early signs of pressure in the previous month. The outlook, however, remains subject to headwinds from the erosion of household purchasing power amid rising inflation and risks to rural incomes from a potentially deficient southwest monsoon rainfall.

Consumption Indicators Showed Signs of Recovery

Indicators (YoY%)	Oct-25	Nov-25	Dec-25	Jan-26	Feb-26	Mar-26	Apr-26	May-26	Jun-26
Passenger Vehicle Sales	10.7	20.4	26.6	7.2	26.1	21.5	18.1	23.2	28.6
Two-wheeler Sales	51.8	-3.1	9.5	20.8	25.0	28.7	17.2	7.5	21.2
IIP- Consumer Durables	-6.0	13.0	7.4	-0.2	4.2	2.4	5.6	8.0	7.7
IIP- Consumer Non-durables	-9.4	3.9	5.9	-1.2	1.6	-0.6	0.2	-0.4	4.9
Retail Credit Growth	14.0	12.8	14.4	14.9	15.2	16.2	16.0	15.4	
Domestic Air Passenger Traffic	3.5	7.0	-4.9	3.1	-0.1	-1.3	-2.8	7.7	-1.0
Unemployment Rate (%)	7.5	6.5	6.9	6.7	6.7	6.6	6.7	6.9	6.6
Rural	7.6	6.1	7.0	5.8	6.4	6.5	6.7	6.2	6.3
Urban	7.3	7.2	6.8	8.3	7.3	6.9	6.7	8.0	7.2
Naukri JobSpeak Index	-9.3	23.5	13.2	3.4	11.9	9.2	5.8	1.0	6.1

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

Urban and rural demand indicators strengthened in June. Retail passenger vehicle sales, a proxy for urban demand, recorded double-digit growth for the fifth consecutive month, accelerating to 28.6% YoY in June, supported by the continued shift toward EVs and fuel-efficient models. Two-wheeler sales, a proxy for rural demand, also improved significantly, with growth rising to 21.2% YoY in June from 7.5% in May, aided by strong entry-level demand and increasing EV adoption. Attractive financing conditions, reflected in robust vehicle loan growth across banks and NBFCs, provided further support, in line with the broader strength in retail credit across both lender categories. Domestic air passenger traffic contracted marginally in June, largely reflecting lower airline capacity deployment amid elevated fuel prices rather than any material weakening in underlying demand.

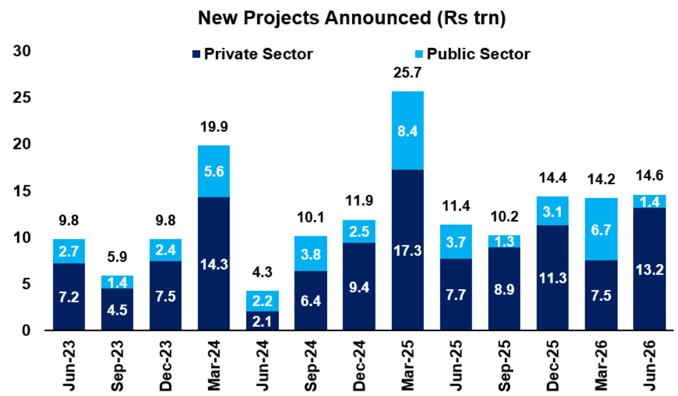
Evolving labour market conditions will remain a key determinant of whether the recent improvement in private consumption can be sustained, given the twin headwinds of monsoon-related risks to rural incomes and the erosion of purchasing power from higher inflation. As per CMIE data, labour market conditions were broadly steady in June: the unemployment rate declined to 6.6% from 6.9% in May, although this reflected a contraction in the labour force rather than an improvement in employment, which remained broadly unchanged. Formal-sector labour indicators were mixed. Hiring intent, as captured by the Naukri JobSpeak Index, improved during the month, while the employment components of the Manufacturing and Services PMIs pointed to an easing in hiring momentum.

Investment Activity Strengthened, Though Broader Revival Remains Contingent on Geopolitics

Investment indicators strengthened in early FY27, though fiscal pressures could weigh on government capital expenditure, while renewed geopolitical tensions and associated uncertainty may delay a broader revival in private investment.

IIP infrastructure and construction goods output growth improved to 7.5% YoY in June from 6.6% in May, while capital goods production maintained a robust pace, expanding 14.2% YoY in June compared to 15.5% in May.

Private Sector New Project Announcements Surge in Q1, Driven by Nuclear and Data Centre Projects



Source: CMIE

As per CMIE data, private-sector new project announcements, a key forward-looking indicator of private capital expenditure, rebounded sharply in Q1 FY27, reversing the slowdown recorded in the previous quarter. Total private new project announcements rose by 76% QoQ and 71% YoY in the June 2026 quarter, lifting the private sector's share of total project announcements to 90%, from 53% in the preceding quarter. The recovery, however, was concentrated in the electricity sector, led by nuclear projects, and in IT-enabled services, supported by data-centre investment. Together, these two sectors accounted for around 80% of total new projects announced in Q1 FY27, up from 35% in the previous quarter.

Going forward, investment activity is likely to see traction in select domestically oriented sectors, though renewed geopolitical tensions and the risk of further energy-supply disruptions could weigh on business sentiment and delay a broader-based revival in private capital expenditure. Further, rising fiscal pressures are also likely to constrain the pace of government capex.

Rising Subsidy Burden and Muted Revenue Growth Point to Fiscal Slippage Risk

Fiscal developments in the first two months of FY27 point to emerging pressures, amid higher commodity prices and the government's efforts to cushion the domestic economy through fuel tax cuts and increased subsidy outlays. The central government's fiscal deficit widened to around 9.6% of the Budget Estimate (BE) during April–May, compared with just 0.9% in the same period last year. The increase reflected front-loaded expenditure, which rose by 18.1% YoY in April-May, alongside weaker revenue receipts.

The rise in expenditure was driven primarily by higher revenue spending, led by a sharp increase in food and fertiliser subsidy payouts and higher interest payments. Capital expenditure recorded growth broadly in line with the full-year growth target during April–May, although momentum weakened in May relative to April. Revenue mobilisation, meanwhile, remained muted. Direct tax collections were supported by strong corporate tax receipts, while personal income tax growth stayed relatively moderate. Indirect tax collections, by contrast, weakened, reflecting a contraction in Union excise duties following retail fuel duty cuts and a marginal decline in GST collections. Higher customs duty collections, likely supported partly by stronger imports and the increase in gold import duties, provided some partial offset. Non-tax revenues fell by 1.7% YoY in April–May amid a sharp contraction in other non-tax revenue, partly offset by growth in dividends and profits (aided by the RBI's record Rs 2.87 trillion dividend transfer) and interest receipts.

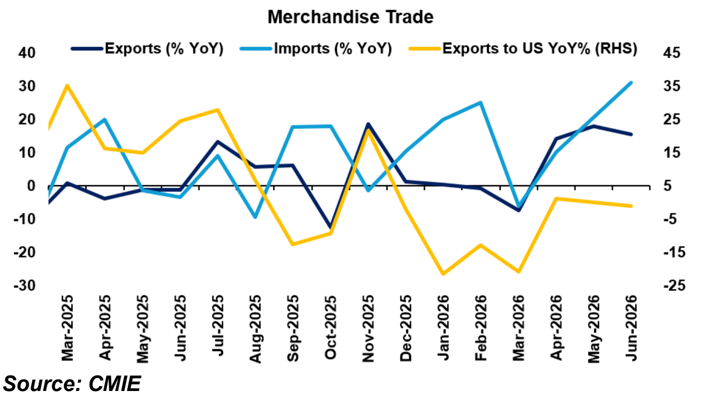
Looking ahead, the risk of fiscal slippage of around 0.4–0.5 percentage points relative to the FY27 budgeted deficit target of 4.3% of GDP persists. The key pressures include revenue losses from excise duty cuts on petrol and diesel, potentially lower dividend transfers from oil marketing companies, and higher fertiliser subsidies, partly offset by higher export duties on petroleum products, increased import duties on gold and silver, and drawdowns from the Economic Stabilisation Fund. A pickup in the disinvestment programme and correction in fertiliser prices, if sustained, could help contain these pressures.

External Sector: Trade Deficit Widens in June; Current Account Returns to Deficit in May

The external environment continues to remain challenging despite signs of momentum in goods exports. India's goods trade deficit widened to a five-month high of US$30.4 billion in June 2026, as a sharp sequential moderation in imports of petroleum crude & products (POL) and gold imports was offset by a sequential moderation in exports, driven by a fall in POL exports.

In terms of growth, merchandise exports continued to recover in early FY27, although the growing divergence between export and import growth will put pressure on the trade balance. Goods export growth moderated to 15.5% YoY in June from 18.0% in May, partly reflecting base effects. The expansion was supported by acceleration in non-oil exports, even as growth in petroleum and crude-product exports slowed sharply. By destination, exports to the US contracted further, declining by 1.2% YoY, while shipments to GCC countries, excluding Bahrain, recovered. Export diversification also broadened across markets including China, Hong Kong, Singapore, South Africa, and Tanzania.

Goods Exports Growth Remained on a Recovery Path; Imports Growth Accelerated Further Led by POL



Source: CMIE

Goods imports surged by 31.0% YoY in June, up from 20.6% in May, driven by a higher oil import bill and resilient domestic demand. Petroleum and crude-product imports rose by 40.1% YoY, although growth moderated from 53.8% in May, with the rise increasingly reflecting a recovery in import volumes alongside elevated prices. Non-oil, non-gold and silver imports also increased sharply, rising by around 29% YoY in June, led by electronics, fertilisers, chemicals, non-ferrous metals, and machinery.

Preliminary services trade data showed muted export growth of 2.9% in June, broadly unchanged from 2.8% in May but sharply below 12.7% in April. Services import growth, by contrast, picked up, narrowing the services trade surplus to US$15.1 billion in June from US$15.7 billion in May. Nevertheless, the services account surplus continued to partially offset the widening merchandise trade deficit.

India's current account returned to a deficit of US$2.0 billion in May 2026, from a surplus of US$4.7 billion in April, driven by lower net transfers and net services receipts, while the merchandise trade deficit remained broadly unchanged. This was in line with our expectation that the April surplus was unlikely to be sustained. We maintain our FY27 current account deficit forecast at ~1.7% of GDP, up from 0.6% in FY26, reflecting the ongoing recovery in import volumes and renewed upward pressure on global energy prices.

On US–India trade, negotiations have advanced, with both sides indicating that an agreement could be concluded in the coming months. In the interim, the US Trade Representative has imposed additional Section 301 tariffs of 10% or 12.5% on imports from 60 economies, including India, effective from July 24, effectively replacing the temporary 10% duty imposed under Section 122 that lapsed on the same date. The move follows the conclusion of a USTR investigation into the alleged failure of these countries to impose or effectively enforce prohibitions on imports of goods produced using forced labour. India is among 17 economies, including the United Kingdom, Canada, and Mexico, subjected to an additional 10% ad valorem duty (on top of the MFN rate), while 38 economies, including China, Brazil, Vietnam, and Russia, face the 12.5% rate (on top of the MFN rate). Among the remaining countries and regions, the European Union and Taiwan face a 10% rate applied net of a product's MFN duty, while Japan, South Korea, and Switzerland receive the same net-of-MFN treatment at the 12.5% rate.

India qualified for the lower rate, compared to the 12.5% initially proposed in June, following its adoption of a prohibition on imports linked to forced labour. According to the government, an estimated 45% of India’s exports to the United States remain outside the scope of the additional 10% duty. These include currently zero additional duty categories, such as generic pharmaceuticals, smartphones, and certain other specified products, as well as goods already covered under Section 232 measures, including steel, aluminium, and auto parts. The remaining 55% will attract the additional 10% duty. However, India’s overall tariff incidence remains lower than that faced by most other economies covered by the investigation, providing a modest relative advantage over some peers.

Separately, US President Trump announced a phased tariff regime intended to reshore generic-drug production to the US. Imported generics would face zero-tariff rate for two years from August 1, 2026, before facing a 100% tariff for one year and 200% thereafter. The measure was framed as a penalty for manufacturers that do not establish US production capacity.

India is particularly exposed, with the US accounting for ~35% of India's pharmaceutical exports in FY26. However, the dependence is mutual: India supplies around 40% of generic drugs prescribed in the US, strengthening India's negotiating position but also raising potential risks to US medicine costs and availability.

The two-year transition period limits the immediate impact but creates significant medium-term risks for Indian exports and manufacturers' margins. It could also pressure drugmakers to expand their US manufacturing footprint, although reshoring generic production would be commercially challenging given higher operating costs and substantial capital requirements. Nevertheless, the treatment of Indian exports remains uncertain: the February US–India framework provides for "negotiated outcomes" on generic pharmaceuticals and ingredients following the US Section 232 investigation, leaving scope for exemptions or a separate arrangement without guaranteeing preferential treatment.

CPI Inflation Crosses 4% for the First Time Since January 2025; WPI–CPI Gap Signals Continued Pipeline Pressures

Inflationary pressures continue to build, with risks to the outlook remaining tilted to the upside. A broadening pickup in food inflation, coupled with the risk of persistent deficient monsoon rainfall, is likely to exert further pressure on consumer prices. Supply-chain disruptions linked to the Middle East conflict may also take longer to normalise, keeping input costs elevated. The moderation in global energy prices following the US–Iran peace agreement in June provided only temporary respite. Brent crude oil prices have risen to an average of ~US$90/bbl in July since the renewed escalation of US–Iran tensions, up from around US$73/bbl at end-June, with transit through the Strait of Hormuz nearing a standstill and Houthi threats to Saudi Arabia's energy exports through the Bab el-Mandeb adding to inflation risks.

Headline CPI inflation rose to an 18-month high of 4.4% in June 2026 from 3.9% in May, crossing the 4% mark for the first time since January 2025 as favourable base effects continued to fade. The increase was driven primarily by a further acceleration in Food & Beverages inflation and sharp increases in Transport and Electricity, Gas & Other Fuels, reflecting the continued pass-through of higher fuel and energy costs. Inflation in Restaurants & Accommodation also increased further. Together, these pressures more than offset the moderation in Personal Care & Miscellaneous.

Food & Beverages inflation rose to 5.1% in June from 4.5% in May, reflecting a broader pick-up in price pressures led by milk, cereals, and prepared food. Food inflation is likely to remain on an upward trajectory in the near term amid rising input costs, with a deficient monsoon posing an additional upside risk.

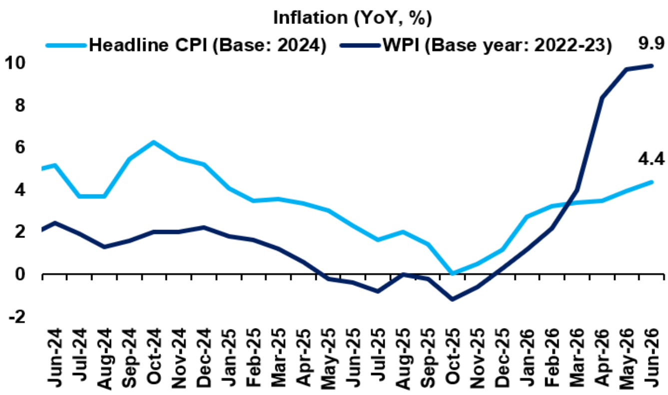
Inflation Pressures Broadening, Led by Food- and Fuel-Related Categories

Inflation Basket (Base=2024)	Weights (%)	CPI (% YoY)					
		Jan-26	Feb-26	Mar-26	Apr-26	May-26	Jun-26
Food and Beverages	36.8	2.1	3.4	3.7	4.0	4.5	5.1
Paan, Tobacco and Intoxicants	3.0	2.9	3.5	4.2	4.8	4.8	4.8
Clothing and Footwear	6.4	3.0	2.8	2.7	2.8	3.0	3.2
Housing, Water, Electricity	17.7	1.5	1.5	2.0	1.7	1.7	2.0
Electricity, Gas and Other Fuels	5.4	0.2	0.1	1.6	0.7	0.8	1.8
Furnishings and Maintenance	4.5	1.4	1.4	1.4	1.6	1.9	2.2
Health	6.1	2.2	1.9	1.8	1.6	1.5	1.4
Transport	8.8	0.09	-0.05	0.00	-0.01	1.75	4.31
Information and Communication	3.6	0.2	0.2	0.3	0.5	0.3	0.4
Recreation, Sport and Culture	1.5	2.3	2.2	2.5	2.1	2.0	1.7
Education Services	3.3	3.3	3.3	3.3	3.1	3.0	3.3
Restaurants and Accommodation	3.3	2.9	2.7	2.9	4.2	5.7	6.9
Personal Care and Misc.	5.0	19.1	19.7	18.6	17.7	18.5	16.7
Core CPI	**53.0**	3.7	3.7	3.7	3.7	3.9	3.9
Core (excl. Gold)	52.4	3.1	3.1	3.1	3.2	3.4	3.4
Core (excl. Gold & Silver)	52.1	2.1	2.1	2.1	2.2	2.4	2.5
Headline CPI	**100**	**2.7**	**3.2**	**3.4**	**3.5**	**3.9**	**4.4**

Source: CMIE

Core inflation, excluding Food & Beverages and fuel, remained stable at ~3.9% in June, as moderation in precious-metal prices offset a continued gradual pick-up in underlying core inflation excluding precious metals.

Wide WPI-CPI Gap Indicates Continued Pipeline Pressures Yet to Pass Through to Retail Prices



Source: CMIE

WPI inflation, based on the revised FY23-base series, rose further to 9.9% in June from an already elevated 9.7% in May, led by the Fuel & Power segment. The unusually wide divergence between WPI and CPI inflation in recent months reflects the faster pass-through of higher crude and energy prices to wholesale prices than to retail prices, pointing to continued upside risks to CPI inflation as elevated pipeline input-cost pressures gradually transmit to consumers.

The renewed escalation in the Middle East conflict and associated disruptions to energy supplies have further increased the upside risks to our FY27 CPI inflation forecast of 5.1%. The continued rainfall deficit, although narrower than in June, also poses risks to the food inflation outlook. A de-escalation in geopolitical tensions and faster normalisation of transit through the Strait of Hormuz and the Red Sea could shift the balance of risks favourably, although this appears unlikely under the current escalation trajectory. A sustained improvement in the quantum and spatial distribution of rainfall could also help contain food-price pressures and moderate the broader inflation outlook.

Market Update

Bond Market: Banking system liquidity tightened in June, with the average surplus declining to around Rs 0.8 lakh crore from Rs 1.7 lakh crore in May. Conditions improved in July from the deficit recorded in late June, with the average surplus rising to Rs 1.1 lakh crore through July 27, supported by government spending, VRR operations, G-Sec redemptions, and fresh FCNR(B) deposits. Continued FX intervention to support the rupee and the persistent gap between credit and deposit growth, however, remain underlying sources of pressure on liquidity. The weighted average call rate (WACR) averaged 5.23% in July, compared with 5.25% in June, remaining close to the repo rate but occasionally moving above it as liquidity tightened. The RBI also conducted a Rs 20,000 crore government securities buyback auction on July 28 to improve cash management and provide support to the short-term money market.

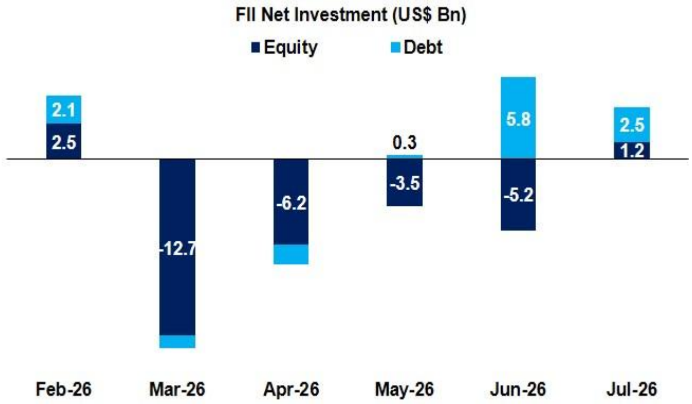
India's 10-year G-Sec yield eased to 6.75% by end-June from a high of 7.13% in mid-May. The decline was supported by tax exemptions for eligible FPI investments in government securities and the expansion of longer-tenor securities under the Fully Accessible Route, resulting in around US$7.8 billion of FPI debt inflows since the June policy meeting, and lower crude prices following the interim US–Iran peace agreement. Renewed Middle East tensions subsequently pushed crude prices higher and weighed on sentiment, driving the 10-year G-Sec yield higher to 6.84% by July 23, before easing to ~6.77% as of July 27 following early signs of a pause in US and Iran fighting.

Going forward, market conditions will depend on crude oil prices, the durability of RBI liquidity support, Bloomberg's review of India's inclusion in the Global Aggregate Bond Index, and FPI debt flows. A favourable Bloomberg decision could attract around US$20–30 billion of phased inflows in a staggered manner, assuming a 0.7%–1.0% index weight, partly offsetting the adverse external backdrop.

Equity Market: After falling in May, Indian equities recovered in June with the Nifty 50 Index rising by ~1.4% MoM, supported by optimism around an interim US–Iran peace agreement, and measures announced by the RBI and the Government to attract foreign capital.

Markets extended their recovery in early July before the re-escalation of the Middle East conflict reintroduced caution. The domestic equity market remained resilient despite the increase in crude oil prices, with the Nifty 50 Index gaining 0.5% through July 27 from end-June levels. FPIs also turned net equity buyers in the equity segment for the first time since February 2026, recording inflows of US$1.2 billion through July 27. The outlook remains sensitive to geopolitical developments, crude oil price movements, and the durability of foreign capital flows.

FPIs Turn Net Buyers in India's Equity and Debt Markets



Source: CMIE. July data is till July 27, 2026.

Foreign-Exchange Market: Pressure on the rupee eased in June following the announcement of an interim US–Iran agreement, with the currency appreciating 0.4% MoM to close at around Rs 94.67 per US dollar, recovering from its record low of Rs 96.83 at the close of May 20. Lower crude oil prices and targeted measures to attract foreign capital inflows supported the recovery.

However, re-escalation of the Middle East conflict subsequently pushed the rupee around Rs 96.57, before recovering to close at Rs 95.90 as of July 27, around 1.3% weaker than the end-June level.

Geopolitical developments, crude oil prices, US Fed Policy Actions/outlook, and RBI's intervention will determine the rupee trajectory in the near future.

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