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Indian Economy Remains Resilient in Q1; Inflation Risks Strengthen the Case for Monetary Policy Tightening

DMI FINANCE

- Government bond yields in advanced economies are likely to stay near post-GFC highs, as resilient nominal growth and above-target inflation keep yields aligned with macro fundamentals. Without further monetary policy tightening and credible fiscal consolidation, yields are likely to remain sticky, with risks skewed upward.
- The Indian economy appears to have weathered the global supply shock better than feared, with Q1 FY27 real GDP growth expected at ~7.4%, down from 7.8% in the previous quarter. This creates an upside bias to our FY27 real GDP growth forecast of 6.7%, though geopolitical risks and elevated energy prices remain key headwinds.
- India's industrial output growth remained robust at 6.7% YoY in July, though it moderated from a more than two-year high of 8.8% in June, while services indicators showed mixed signals. PMI readings for both manufacturing and services point to some loss of momentum ahead.
- Downside risks to the agricultural outlook have eased as the rainfall deficit and shortfall in kharif sowing have narrowed, but the outlook remains vulnerable. Uneven rainfall, below-normal reservoir levels and lagging crop sowing continue to pose risks to rural incomes and food inflation.
- Private consumption held up in July, supported by both rural and urban demand indicators. However, weaker underlying labour-market dynamics, rising inflation and monsoon-related risks to rural incomes remain constraints to a durable recovery.
- Merchandise exports maintained double-digit growth in July, but continued strength in imports widened the trade deficit. We expect the current account deficit at 1.4% of GDP in FY27, cushioned by the services account surplus, resilient remittances and a better-than-expected recovery in merchandise exports.
- The Centre's Q1 FY27 fiscal position remained manageable, with the fiscal deficit at 18.2% of BE, broadly in line with the Q1 FY26 trajectory, despite higher subsidies and strong capex.
- We expect the fiscal deficit at 4.5–4.6% of GDP in FY27, above the 4.3% BE, as excise-duty cuts and higher subsidy spending are partly offset by the recent correction in fertiliser prices, increased duties on petroleum-product exports and gold/silver imports, and stronger disinvestment receipts. Some expenditure rationalisation is likely to be needed to meet the budget target.
- CPI inflation rose to 4.45% in July and stayed above the RBI's 4% target for a second consecutive month. Retail food-price pressures, elevated WPI inflation, broader inflation diffusion and sticky household inflation expectations keep risks tilted upward; we retain our FY27 CPI inflation forecast at 5.1%.
- In August, the RBI held the repo rate at 5.25% and retained its neutral policy stance, but the hawkish undertone in the MPC minutes suggested a tightening bias. We continue to expect cumulative policy repo rate hikes of 50–75 bps over the upcoming tightening cycle, likely beginning in December 2026 or February 2027 and potentially extending into FY28, while not ruling out policy action as early as October if inflation pressures broaden more quickly.

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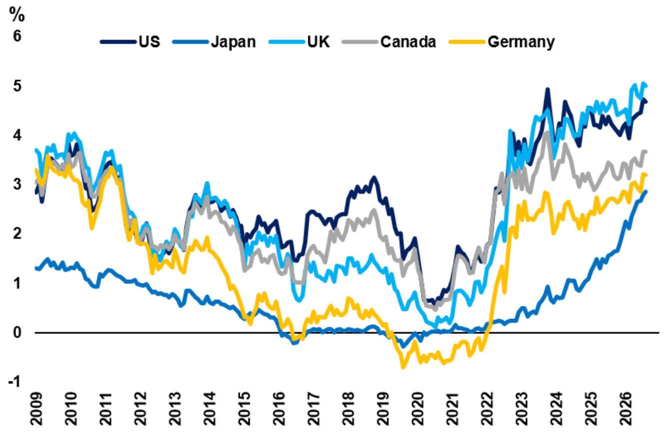
Advanced Economies' Sovereign Bond Yields Post-GFC Highs Reflect Resilient Growth, Sticky Inflation and Fiscal Strains

Barring shifts in macroeconomic policy, benchmark bond yields across many advanced economies are likely to continue to hover near post-Global Financial Crisis (GFC) highs. Following an inflation-driven adjustment higher post-COVID, sovereign bond yields have continued a steady upward drift, reaching, in many economies, their highest levels in nearly two decades (see chart below). To date, prevailing yield levels have generated significant commentary among analysts and the financial press but have had a limited adverse effect on macroeconomic performance.

10-year Sovereign Bond Yields in Select Economies

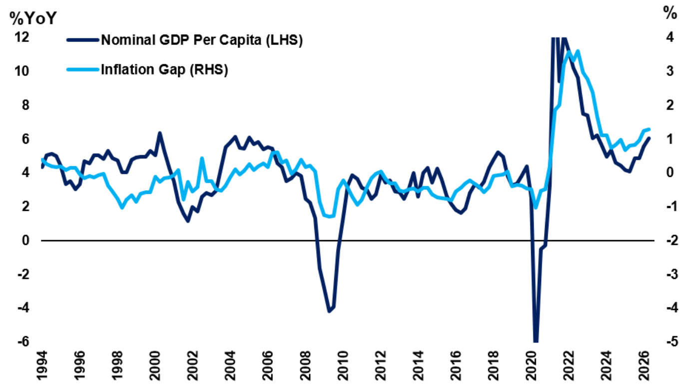


Source: Bloomberg. August 10-year bond yield readings are month-to-date averages based on available daily data.

The rise in yields – and their relative stickiness in recent months near prevailing levels – is a function of various factors. A key component underpinning current market interest rate levels is the ongoing resilience in economic activity. Despite myriad geopolitically induced headwinds this year, the pace of global economic activity continues to advance at a healthy pace and, in many countries, has outstripped consensus and policymakers' expectations. As outlined in prior Economic Monthly reports, economic conditions in large countries such as the United States have strengthened over the past six months despite geopolitical and macroeconomic policy uncertainty, higher energy costs, and continued downbeat consumer sentiment. Meanwhile, inflation has cooled considerably from its breakneck pace of 2022-23, but it remains solidly above desired levels in many large economies. Post-COVID monetary tightening failed to return underlying inflation rates to target, and economic resilience plus supply shocks have sustained broad-based above-trend inflation dynamics in many large economies.

Trends in nominal income/GDP highlight this dynamic. The rate of nominal GDP growth in low-productivity economies such as the Euro Area is running above the level that prevailed from the GFC to the onset of COVID. In a country such as Japan where the government's official position is that deflation has not yet been defeated, nominal GDP, likewise, is expanding at a pace substantively in excess of the GFC-to-COVID period. Importantly, prevailing income/growth trends imply that inflation rates will be hard pressed to cool materially in the period immediately ahead. Consider, for instance, current conditions in the United States: Economic growth per capita currently is on par with the peak of the boom years of the 1990s expansion – the most robust US economic expansion in the post-WWII era. However, unlike that period when core inflation was running below 2%, it now is running at roughly 3¼%. The historical relationship between per capita economic growth and underlying inflation points to a continued above-target inflation in the period ahead (see chart).

Change in US Nominal GDP per Capita and Core PCE Inflation Gap



Note: Core PCE Inflation Gap is the year-to-year percent change in core PCE inflation less the Fed's 2% inflation target; a zero-inflation gap reading is equivalent to inflation being at target and is broadly consistent with the economy growing at its potential rate, estimated by DMI to be 4% in nominal terms.

Sources: US Census Bureau, BEA, DMI Estimates

While not a hand-in-glove relationship, nominal (real) market interest rates generally track nominal (real) intermediate- to longer-dated sovereign bond yields in advanced economies given the (general) absence of credit risk in such securities. On this score, nominal benchmark market bond yields are not unusually high, as they are aligned with trends in nominal economic growth. To be sure, nominal market interest rates are high relative to the rates that prevailed for much of the post-GFC period. But nominal economic growth also was relatively low in the world's largest economies during much of the post-GFC period. Accordingly, sovereign bond yields in advanced economies currently tend to be broadly in sync with underlying macroeconomic conditions.

Two dynamics present upside risks to bond yields in many large economies. First, with many such economies at or near full employment and inflation above target, an insufficiently tight monetary policy has the potential to extend the uptrend in yields. Second, many large economies are running outsized fiscal deficits at a time when their respective public sector debt stocks, as a share of GDP, are extremely elevated. Moreover, despite economic resiliency, fiscal deficits in a variety of cases are not improving, sowing the seeds of a possible marked deterioration in public-sector debt dynamics that feed on itself.

The former dynamic can be addressed quickly by determined central banks. Indeed, as outlined in last month's report, it is our judgment that in countries such as the United States and Japan, chances are good that the Federal Reserve will embark on a modest, abbreviated tightening cycle and the Bank of Japan will quicken its pace of monetary tightening. To the extent such an outcome materializes, it likely would help to stabilize longer-dated bond yields and help to provide breathing room for the latter dynamic to be addressed – recognizing the incredibly difficult fiscal policy choices that would be involved and that something approaching a crisis may be necessary to catalyse fiscal policymakers into action.

Indian Economy Has Withstood the Global Supply Shock Reasonably Well So Far, but Geopolitical Risks Continue to Pose Headwinds to the Outlook

Despite a significant energy-supply shock, the Indian economy appears to have remained broadly resilient in Q1 FY27, aided by the impact of last year's policy support, including tax relief and earlier monetary easing, and by FY27 measures such as excise-duty cuts on petrol and diesel and limited pass-through of higher energy prices. Efforts to diversify energy sourcing since the onset of the Middle East conflict also appear to have cushioned the shock, as have the economy's favourable underlying fundamentals.

High-frequency indicators broadly point to resilience, with economic activity likely slowing much less than initially feared. In Q1 FY27, private consumption indicators held up, although real private consumption growth may be somewhat lower than in the previous quarter due to a higher deflator. Investment is likely to remain resilient, with a modest pickup compared to the previous quarter, supported by healthy high-frequency indicators and stronger government capex. Government consumption is also expected to pick up compared with the previous quarter. Net exports, however, are likely to be a drag, after making a modest positive contribution in the previous quarter.

We estimate real GDP growth at around 7.4% in Q1 FY27, compared with 7.8% in the previous quarter, creating an upside bias to our FY27 real GDP growth projection of 6.7%. However, risks to both economic growth and inflation persist from ongoing supply disruptions and elevated energy prices. With economic activity showing resilience and inflation pressures rising, we continue to expect the RBI to begin tightening monetary policy in FY27, with the cumulative cycle potentially extending into FY28.

RBI Holds Policy Repo Rate at 5.25% in August Meeting; MPC Minutes Point to Tightening Ahead in FY27

At its August policy meeting, the RBI's Monetary Policy Committee (MPC) unanimously kept the policy repo rate unchanged at 5.25% and retained the neutral stance, preserving flexibility to respond to evolving macroeconomic conditions. The policy statement was cautious and balanced, signalling a continuation of the wait-and-watch approach as the MPC seeks greater clarity on the inflation trajectory and its composition before taking policy action.

The RBI raised its FY27 real GDP growth projection by 10 bps to 6.7%. It lowered its FY27 CPI inflation projection by 10 bps to 5.0%, with inflation projected to peak at 5.9% in Q3, and cut its core CPI inflation projection by 40 bps to 4.3%. However, it expects core CPI excluding precious metals to converge towards overall core inflation by the end of the financial year, indicating a gradual broadening of underlying price pressures. The balanced policy tone and lower inflation forecast prompted us to push back our expected start of the rate-hike cycle to December 2026 or February 2027, from our earlier expectation of October or December 2026.

However, the minutes released a fortnight after the MPC meeting offered firmer guidance on the policy outlook. Some committee members highlighted inflation risks and conditions that could warrant monetary tightening. MPC member Indranil Bhattacharyya noted that "a pause preserves flexibility on timing; it does not necessarily imply an extended pause". Governor Sanjay Malhotra noted that "there are signs of a normalisation of inflation from its benign levels seen hitherto", but he preferred to wait for more certainty on the inflation trajectory "for any recalibration of the policy rate", while Deputy Governor Dr Poonam Gupta noted that "a case for a hike may emerge during the course of the year", given the projected inflation trajectory.

Taken together, these comments suggest that MPC members are increasingly focused on the timing of future rate action, while remaining data-dependent and attentive to geopolitical developments. In our view, the combination of resilient economic growth, estimated real policy rate turning negative from Q3 FY27 (based on the RBI's inflation projections and the current repo rate) and persistent upside risks to inflation continues to warrant policy tightening. Household inflation expectations also remain elevated and sticky, reinforcing the risk of second-round effects. Accordingly, we continue to expect cumulative policy-rate hikes of 50–75 bps in the upcoming tightening cycle, likely beginning in December 2026 or February 2027 and potentially extending into FY28, though we do not rule out policy action as early as the October meeting if inflation pressures broaden more quickly.

Separately, banking-system surplus liquidity widened sharply, averaging Rs 3.4 lakh crore through August 27, up from Rs 1.1 lakh crore in July. This was driven by a significant rise in fresh FCNR(B) deposit mobilisation, a drawdown in government cash balances and G-Sec buybacks. Easier liquidity conditions kept the weighted average call rate below the repo rate, averaging 5.13% through August 27, down from 5.23% in July, while the large systemic liquidity overhang prompted the RBI to conduct variable rate reverse repo operations to absorb surplus liquidity and anchor the weighted average call rate closer to the policy repo rate. A large liquidity surplus amid rising inflation risks and persistent currency pressure complicates liquidity management.

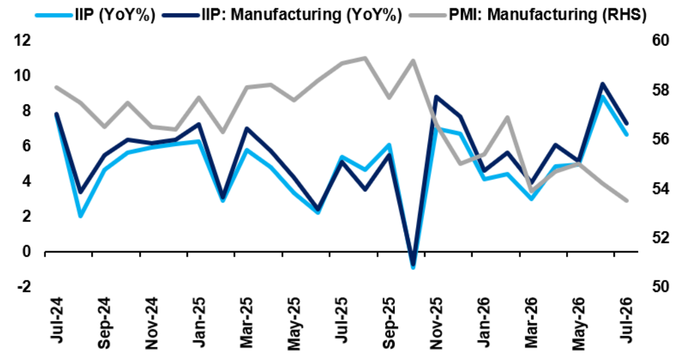
Given the large liquidity surplus and strong response to the June policy measures, the RBI decided to close the FCNR(B) swap facility ahead of schedule, with the window ending on August 31 instead of the earlier September-end deadline, indicating that the scheme has largely served its FX reserve-building objectives. Total inflows under the broader scheme covering FCNR(B) deposits, external commercial borrowings (ECBs) and overseas foreign-currency borrowings (OFCBs) reached around US$72.8 billion by August 21, of which around US$65.4 billion came through FCNR(B) deposits. These inflows supported banking-system liquidity and helped lift FX reserves to a record high of ~US$729.3 billion as of August 21. With total mobilisation through the broader schemes (including FCNR(B) deposits, ECBs and OFCBs) potentially reaching around US$80–100 billion in FY27, liquidity management is likely to remain challenging in the near term and may require additional absorption measures beyond routine short-term fine-tuning operations.

Industrial Activity Strengthens; Services Momentum Moderates and Agriculture Remains Vulnerable Despite Easing Downside Risks

India's industrial output growth remained robust in July at 6.7% YoY, though it moderated from a 27-month high of 8.8% (revised) recorded in June. This performance was driven by strong growth in the Manufacturing and Electricity & Gas Supply sectors, alongside a pickup in Water Supply, Sewerage and Waste Management, which helped offset a marginal contraction in Mining and Quarrying.

On a quarterly basis, IIP growth rose to an eight-quarter high of 6.2% in Q1 FY27, led by Manufacturing and Electricity and Gas Supply, with support from Water Supply, Sewerage and Waste Management, while the contraction in Mining and Quarrying narrowed marginally. Industrial activity therefore remained resilient in Q1 FY27 despite energy-supply disruptions and elevated input costs, with momentum sustaining in July. The pickup suggests that domestic demand remained supportive, export recovery aided manufacturing, and some pre-stocking amid uncertainty over energy-supply disruptions may also have contributed. The deficient monsoon rainfall may also have mechanically supported industrial output by limiting rainfall-related disruptions and boosting electricity demand.

Industrial Activity Remains Robust; PMI Suggests Loss of Momentum Ahead



Source: CMIE

Forward-looking indicators, however, point to an emerging loss of momentum. The Manufacturing PMI declined to 53.5 in July from 54.2 in June, falling below its long-term average. New order growth slowed, partly offset by faster growth in new export orders. Post-production inventories rose at their fastest pace in over 11 years, indicating precautionary stocking amid Middle East-related supply risks and raising the possibility of softer production in the coming months if inventories are not absorbed. The August flash Manufacturing PMI also suggests that moderation continued, with the index easing further to 52.9, the softest improvement in five years.

Total fuel consumption showed signs of demand recovery, expanding by 2.9% YoY, up from a contraction of 3.5% in the previous month, aided by higher petrol and diesel consumption. This points to stronger mobility, freight movement and economic activity. Domestic LPG consumption, however, contracted at a double-digit pace for a fifth consecutive month. Renewed Middle East tensions and disruptions around the Strait of Hormuz have pushed energy prices higher, with India's crude oil basket price rising to around US$90/bbl in August (till 27th), from US$82–83/bbl during the brief June–July relief period. Domestic buffers and diversified sourcing offer some cushion, but LPG supply remains constrained. The government has reportedly specified maximum LPG production targets for refineries and upstream companies, with a combined production potential of 63,810 tonnes per day, to be activated during periods of supply constraints. This could help limit shortages if vessel transit through the Strait of Hormuz is disrupted for a sustained period.

Services activity showed mixed signals, with moderation in formal services indicators but resilience in select high-frequency proxies. Our weighted average estimate based on MoSPI's trial sub-sectoral Index of Services Production suggests that formal services activity expanded by 9.5% YoY in May, down from 20.5% in April. Part of the moderation appears to reflect an unfavourable base rather than a sharp sequential loss of activity. Most sub-sectors recorded slower momentum, with only eight registering double-digit growth in May, compared with 14 in April. During April–May, formal services activity expanded by an estimated 14.8% YoY, below the FY26 average of 18.0%, but still consistent with resilience after a strong base period.

Other high-frequency services indicators were uneven. Bank non-food credit growth remained robust, accelerating to a more than two-year high of 19.1% in July. Port cargo traffic maintained momentum following a strong recovery in May and June. In contrast, GST e-way bill generation slowed sharply to single-digit growth in July, partly due to a base effect, after several months of double-digit expansion. International air passenger traffic remained in contraction amid Middle East-related disruptions, although the pace of decline eased in July compared with the sharper declines during March–May.

Services Sector Activity Was Mixed in July; Softer PMI Signals Potential Moderation Ahead

Indicators (YoY%)	Q4FY26	Q1FY27	Mar-26	Apr-26	May-26	Jun-26	Jul-26
PMI Services	58.0	58.7	57.5	58.8	59.8	57.4	53.3
International Passenger Traffic	-2.8	-10.0	-18.5	-16.1	-9.1	-4.6	-4.0
Port Cargo Traffic	4.4	6.1	0.6	2.4	6.6	9.4	8.8
GST E-way Bills	15.8	12.4	12.9	11.8	10.9	14.5	6.0
Services Exports	8.9	9.6	7.2	12.7	2.8	13.3	6.4
Banking Non-Food Credit	15.9	18.3	15.9	15.8	17.4	18.3	19.1

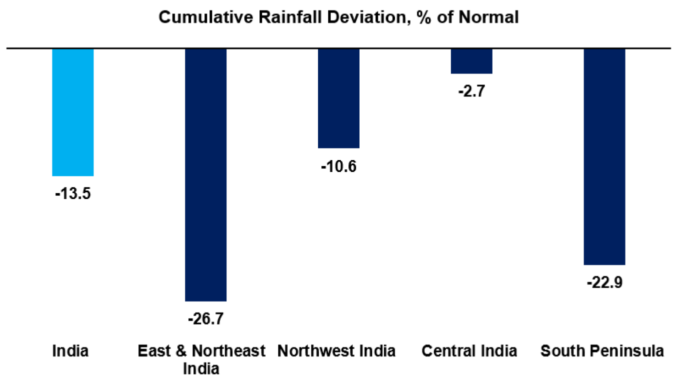
Source: CMIE and RBI. Banking non-food credit for July 2026 is provisional as per the RBI Bulletin. FY26 and quarterly numbers are based on monthly averages. Credit growth numbers are as of end-period.

Forward-looking indicators continue to point to pressure on services-sector momentum. The Services PMI Business Activity Index declined to 53.3 in July from 57.4 in June, marking the weakest expansion in 53 months. Growth remained positive but slowed visibly, weighed down by softer demand, competitive pressures and fewer enquiries. New business inflows moderated, while external demand was a relative bright spot. August's flash Services PMI suggests a modest recovery, with the index rising to 54.5 from July's low, aided by stronger job creation and improved business expectations.

Downside risks to agricultural activity have eased, but the outlook remains vulnerable. Monsoon progress through July and most of August narrowed the cumulative rainfall deficit from around 40% below normal at the end of June to 13.5% below normal by August 28. However, the recovery masks significant variability, with prolonged dry spells interspersed with short bouts of intense rainfall, posing risks to crop yields. Reservoir storage has also improved but remains around 17% below last year's level and slightly below the 10-year average as of August 20, limiting the comfort provided by the rainfall recovery.

Kharif sowing has also improved, with the contraction in overall acreage easing to 1.7% YoY as of August 28, from a double-digit decline in early July. Even so, sowing across most major crop categories continues to trail last year's pace, with rice and coarse cereals seeing more shortfalls. Continued rainfall normalisation through the remainder of the monsoon will be critical for crop outcomes, rural incomes and food inflation.

Cumulative Rainfall Deficit Persists, Posing Risks to Agricultural Output



Source: CMIE. Data till 28 August 2026.

Private Consumption Held Up in July, but Headwinds to the Outlook Persist

Private consumption indicators showed resilience in July, although the outlook remains exposed to headwinds from rising inflation, potential erosion of household purchasing power and risks to rural incomes from a deficient and uneven southwest monsoon rainfall.

Urban and rural demand indicators held up in July. Retail passenger vehicle sales, a proxy for urban demand, recorded double-digit growth for the sixth consecutive month, although growth moderated from June levels. Momentum was supported by broad-based demand ahead of the festive season and a continued shift towards electric vehicles and fuel-efficient models. Retail two-wheeler sales, a proxy for rural demand, improved to a four-month high of 28.3% YoY, aided by entry-level demand, improving monsoon sentiment and rising EV adoption. Supportive financing conditions, reflected in robust vehicle-loan growth across banks and NBFCs, continued to provide support, consistent with broader strength in retail credit. Domestic air passenger traffic remained weak in July, appearing to reflect lower airline capacity deployment amid elevated fuel prices rather than a material weakening in underlying travel demand.

Consumption Indicators Showed Signs of Resilience

Indicators (YoY%)	Q4FY26	Q1FY27	Mar-26	Apr-26	May-26	Jun-26	Jul-26
Passenger Vehicle Sales	18.3	24.6	21.5	18.1	23.2	32.6	19.1
Two-wheeler Sales	24.8	15.6	28.7	17.2	7.5	22.1	28.3
IIP- Consumer Durables	2.1	8.0	2.4	5.6	8.0	10.3	10.5
IIP- Consumer Non-durables	-0.1	1.8	-0.6	0.2	-0.4	5.6	-1.0
Retail Credit Growth	16.2	15.8	16.2	16.0	15.4	15.8	
Domestic Air Passenger Traffic	0.6	1.2	-1.3	-2.8	7.7	-1.2	-4.8
Unemployment Rate (%)	6.7	6.7	6.6	6.7	6.9	6.6	6.2
Rural	6.2	6.4	6.5	6.7	6.2	6.3	6.4
Urban	7.5	7.3	6.9	6.7	8.0	7.2	5.9
Naukri JobSpeak Index	8.1	4.3	9.2	5.8	1.0	6.1	5.0

Source: CMIE and RBI. Numbers shown are YoY% except for unemployment rates, which are in percentages. FY26 and quarterly numbers are based on monthly averages. Credit growth numbers are as of end-period.

Labour-market conditions, however, point to a qualitative deterioration. According to CMIE data, the headline unemployment rate fell to an eight-year low of 6.2% in July, but the decline was statistical rather than employment-led. It was driven by discouraged jobseekers exiting the labour force, resulting in a fall in the labour-force participation rate rather than stronger job creation.

Formal-sector hiring intent remained positive but moderate. The Naukri Index rose by 5.0% YoY in July, slightly below 6.1% in June. Hiring gains remained uneven, with most industries continuing to grow at rates below their FY26 average pace. PMI survey data also pointed to divergent employment trends: manufacturing job creation continued to ease, while a narrow-based recovery in services hiring lifted employment growth at the composite level. August's flash PMI suggests that this divergence became more pronounced.

On the positive side, urban wage-income momentum in the formal sector remained resilient in Q1 FY27, as proxied by quarterly results data available so far for listed non-financial corporate employee-cost growth deflated by urban CPI inflation. Overall, the non-financial corporate sector's real employee-cost growth rose to an average of 5.5% YoY from 5.0% in FY26, indicating continued income support in the urban segment employed in the formal sector. However, the expected pickup in inflation could erode real purchasing power over the remainder of FY27. Urban demand therefore remains resilient for now, but not immune to the gradual broadening of retail price pressures.

Overall, sustained improvement in labour-market conditions will be critical to a durable recovery in private consumption. Near-term demand is being supported by vehicle sales, credit availability and formal-sector wage resilience, but softer labour-market conditions, inflationary pressures and monsoon-related risks to rural incomes remain key constraints.

Investment Activity Strengthens, Though Broader Revival Remains Contingent on Geopolitical and Energy Risks

Investment indicators strengthened in early FY27, supported by a strong pickup in central government capex and firm IIP-linked investment indicators. IIP capital goods output grew by 15.2% in Q1 FY27, up from 12.0% in the previous quarter, while infrastructure and construction goods output maintained a healthy pace of 7.2%, slightly slower than 9.3% in Q4 FY26. This momentum extended into July, with capital goods output expanding by 16.1% YoY and infrastructure and construction goods output growing by 6.9% YoY.

Listed non-financial corporates' Q1 FY27 results also point to stronger nominal sales momentum, although pockets of margin pressure remain. This should support private-sector capex activity. The RBI's survey showed manufacturing capacity utilisation rising to 77.4% in Q4 FY26 from 75.6% in Q3 FY26, holding above its long-term average and signalling a supportive environment for investment.

Near-term caution persists amid renewed geopolitical uncertainty and elevated energy-supply risks. A sustained easing of these risks would be important for strengthening corporate confidence, protecting margins and supporting a broader recovery in private investment.

Fiscal Deficit Remains on Track in Q1 FY27, but Slippage Risks Persist

The Centre's fiscal deficit remained manageable at 18.2% of the Budget Estimate in Q1 FY27, broadly in line with the Q1 FY26 trajectory. Total expenditure grew by ~11.0% YoY, driven by a strong 23.7% expansion in capital expenditure. Revenue expenditure grew at a more measured pace of 7.4%, as elevated core revenue spending and a 37.4% rise in major subsidies were partly offset by lower interest payments. The recent sharp correction in urea prices should reduce the extent of the expected overshoot in fertiliser subsidies relative to the budget allocation.

On the revenue side, direct taxes provided support, backed by strong corporate tax receipts despite more moderate growth in personal income-tax collections. Indirect tax growth remained subdued at 2.3% YoY, weighed down by a steep contraction in excise collections following fuel-duty cuts and muted GST collections, even as robust customs-duty revenue provided a buffer. Net tax revenue appeared strong, but part of the gain was optical, as June 2026 did not include an additional advance devolution tranche to states, unlike June 2025.

Non-tax receipts were muted, with weaker general receipts offset by higher RBI dividend transfers and interest receipts. Renewed momentum in disinvestment could support revenue mobilisation and help reduce fiscal pressure.

Looking ahead, revenue losses from excise-duty cut, potentially lower OMC dividends and still-elevated fertiliser subsidies continue to pose fiscal-slippage risks. These could be 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 disinvestment and a sustained correction in fertiliser prices would also help contain slippage. The government had achieved nearly four-fifths of the Rs 800 bn FY27 disinvestment and asset-monetisation target by late August, strengthening the revenue-offset cushion.

Based on our revised estimates, the central government fiscal deficit is likely to settle at around 4.5–4.6% of GDP in FY27, below our earlier estimate of 4.8% but above the Budget Estimate of 4.3%. This assumes sustained easing in fertiliser-subsidy pressures and potential overachievement on disinvestment receipts. Meeting the budgeted target would likely require some expenditure rationalisation, which may be back-ended.

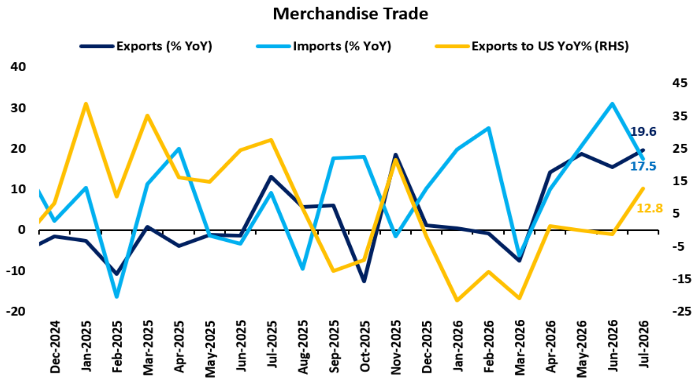
Merchandise Trade Deficit Widens in July; Current Account Deficit Edges Up Marginally in Q1 FY27

Merchandise exports continued to recover in early FY27, though continued strength in imports kept pressure on the goods trade deficit, which widened to a six-month high of ~US$32.0 billion in July.

Goods exports maintained double-digit growth for the fourth consecutive month, rising to an over four-year high of 19.6% YoY in July. Growth was supported by a sharp rebound in petroleum shipments and sustained momentum in non-oil exports. Destination-wise, exports to the US recovered strongly, registering double-digit growth in July after contracting in May–June, while shipments to GCC countries, excluding Bahrain, maintained healthy growth. Goods imports grew by 17.5% YoY, despite sequential moderation in oil imports, indicating resilient domestic demand alongside price effects from oil, gold and fertiliser imports.

In the first four months of FY27, merchandise exports grew by 17.0% YoY, with petroleum crude and products, engineering goods and electronic goods accounting for around 83% of the absolute YoY increase in shipments. Merchandise imports rose faster, by 19.2% YoY, led by petroleum crude and products, gold, fertilisers and electronic goods, which together accounted for around 77% of the absolute YoY increase. This indicates that both export and import growth remain relatively concentrated and partly price-driven, rather than fully broad-based.

Goods Export Growth Remained Robust; Exports to the US Rebounded Sharply in July



Source: CMIE

Preliminary services trade data for July showed moderate export growth alongside a faster pickup in services imports. This narrowed the services account surplus marginally in July, though it continued to provide a substantial cushion against the widening merchandise trade deficit.

Despite higher energy prices and disruptions to trade routes, the current account deficit widened only marginally to US$3.1 billion in Q1 FY27 from US$2.9 billion in Q1 FY26. A wider merchandise trade deficit more than offset gains in the services trade surplus, higher remittances and a narrower primary income-account deficit. We now expect the FY27 current account deficit to be around 1.4% of GDP, below our earlier estimate of 1.7% but still wider than 0.6% in FY26. The revision reflects stronger exports, healthy remittances and a resilient services surplus, which should partly cushion the pressure from elevated crude oil prices, higher gold imports and continued trade-route disruptions linked to Middle East tensions.

Broadening Price Pressures, Elevated WPI Inflation and Sticky Household Inflation Expectations Keep Inflation Risks Tilted Upward

Inflationary pressures continue to broaden, with elevated wholesale-price pressures, firmer retail food inflation and sticky household inflation expectations pointing to persistent upside risks to the inflation outlook. Headline CPI inflation rose to a 19-month high of 4.45% in July 2026, remaining above the 4% target for the second consecutive month. The increase was driven by firmer Food and Beverages inflation and continued pressure across Transport, Housing, Water and Electricity, and Restaurants and Accommodation, which more than offset moderation in Personal Care and Miscellaneous.

Food and Beverages inflation continued to edge up, rising to 5.2% in July from 5.1% in June. Food inflation is likely to remain an upside risk in the near term amid uneven monsoon rainfall and elevated input costs. Daily commodity prices through August 26 point to continued and broad-based food-price pressures, with key commodities such as edible oils, onion and sugar registering double-digit YoY increases, suggesting near-term upside to food inflation.

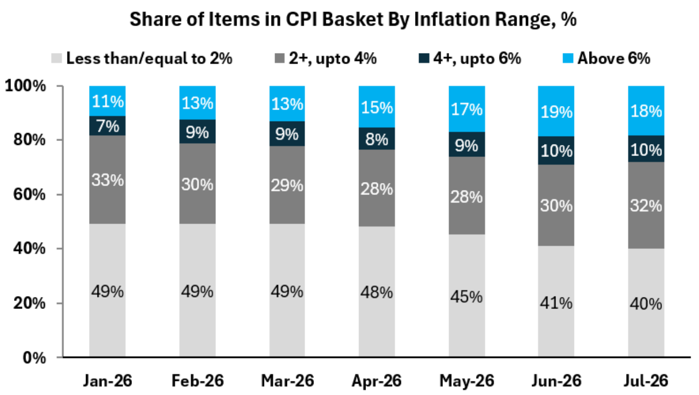
CPI Inflation Stays Above the RBI's 4% Target for the Second Straight Month

Inflation Basket (Base=2024)	Weights (%)	CPI (% YoY)				
		Mar-26	Apr-26	May-26	Jun-26	Jul-26
Food and Beverages	36.8	3.7	4.0	4.5	5.1	5.2
Paan, Tobacco and Intoxicants	3.0	4.2	4.8	4.8	4.8	4.8
Clothing and Footwear	6.4	2.7	2.8	3.0	3.2	3.4
Housing, Water, Electricity	17.7	2.0	1.7	1.7	2.0	2.2
Furnishings and Maintenance	4.5	1.4	1.6	1.9	2.2	2.4
Health	6.1	1.8	1.6	1.5	1.4	1.3
Transport	8.8	0.0	0.0	1.8	4.3	4.4
Information and Communication	3.6	0.3	0.5	0.3	0.4	0.6
Recreation, Sport and Culture	1.5	2.5	2.1	2.0	1.7	1.6
Education Services	3.3	3.3	3.1	3.0	3.4	3.6
Restaurants and Accommodation	3.3	2.9	4.2	5.7	6.9	7.7
Personal Care and Misc.	5.0	18.6	17.7	18.5	16.7	14.8
Core CPI	**53.0**	3.7	3.7	3.9	3.9	3.9
Core (excl. Gold)	52.4	3.1	3.2	3.4	3.4	3.4
Core (excl. Gold & Silver)	52.1	2.1	2.2	2.4	2.5	2.6
Headline CPI	**100**	**3.4**	**3.5**	**3.9**	**4.38**	**4.45**

Source: CMIE

Core CPI remained stable at 3.9%, although core inflation excluding precious metals increased to 2.6% from 2.5% in June, indicating a gradual firming in underlying price pressures. Personal Care and Miscellaneous inflation moderated to 14.8%, partly reflecting softer precious-metal prices. Beyond the headline print, inflation diffusion is also broadening. The share of CPI items recording inflation above 4% rose to 28% in July from 18% in January, while the share with inflation at or below 2% declined to 40% from around 49%. A similar broadening pattern is visible within core CPI items.

Broadening CPI Pressures and Sticky Inflation Expectations Reinforce Second-Round Risks



Source: CMIE

WPI inflation remained elevated at 9.8% in July, only marginally below 9.9% in June. The moderation in Fuel and Power inflation was partly offset by firmer non-food and manufactured-product inflation. The persistent WPI-CPI gap continues to signal pipeline cost pressures and the risk of broader pass-through to consumer prices. Household inflation expectations also remain sticky, with households' median inflation expectations for the next three months easing by 10 bps to 9.2%, while year-ahead expectations rose by 10 bps to 9.4%. We maintain our FY27 CPI inflation forecast at 5.1%, with risks tilted to the upside.

We expect CPI inflation to rise further in the coming months, driven by firmer food inflation, broader wholesale-to-retail pass-through of input-cost pressures and second-round effects from the fuel and supply shock. This continues to support our call for the RBI to begin monetary policy tightening in FY27, with the cumulative cycle potentially extending into FY28.

Market Update:

Bond market: India's 10-year G-Sec yield hardened to 6.84% by end-July from 6.75% at end-June, tracking higher crude oil prices and renewed Middle East tensions. Bloomberg's decision to defer India's G-Sec inclusion in its Global Aggregate Bond Index also weighed on sentiment. The 10-year G-Sec yield rose further to ~6.91% through August 28, as the RBI's decision to close the FCNR(B) swap facility ahead of schedule and the hawkish tone of the August MPC minutes weighed on market sentiment. Going forward, market conditions will depend on crude oil prices and evolving expectations of monetary policy tightening.

Equity market: Equity markets remained range-bound in August after extending gains in July, when the Nifty 50 Index rose by 2.2% amid easing geopolitical risks and supportive policy measures. In August, resilient Q1 FY27 corporate earnings and continued DII and FPI support were offset by renewed geopolitical tensions and higher crude oil prices. Consequently, the Nifty 50 declined by 0.9% through August 28, tracking geopolitical developments and movements in crude oil prices. FPIs, however, remained net buyers, recording equity inflows of around US$3.2 billion through August 28, providing some support.

Foreign-exchange market: The rupee remained under pressure in August after weakening in July amid renewed geopolitical tensions and higher crude oil prices. Following a modest recovery by end-June, the rupee depreciated to Rs 95.39/US$ by end-July despite RBI intervention and deposit mobilisation through the FCNR(B) scheme. It weakened further to Rs 95.76/US$ by August 19, pressured by elevated crude oil prices and the early closure of the FCNR(B) swap facility, before recovering modestly to ~Rs 95.39/US$ (as of August 28th) amid higher dollar supply ahead of the FCNR(B) window's end-August closure. Foreign-exchange reserves rose to a new record high of ~US$729.3 billion as of August 21, providing a strong buffer against external pressures, although elevated oil prices and persistent FX demand remain key near-term risks.

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