

Indian Economy in Turbulent Times: FY 2025-26: Mid-Year Macroeconomic Review

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Recent global developments

Resilient global growth likely to moderate as tariff and other shocks take hold

Global growth has remained resilient despite the Trump triggered tariff shock. IMF (WEO) and OECD now project the world economy will grow by 3.2 per cent in 2025. Most major economies performed better than expected in the first half of 2025. The driving factors include front-loaded trade and production, large-scale AI investments in the United States (U.S.), China, Japan, and continued fiscal and monetary stimulus across several economies. China and Japan are notable exceptions—fiscal support in China may be constrained by rising debt, while a policy rate hike is anticipated in Japan.

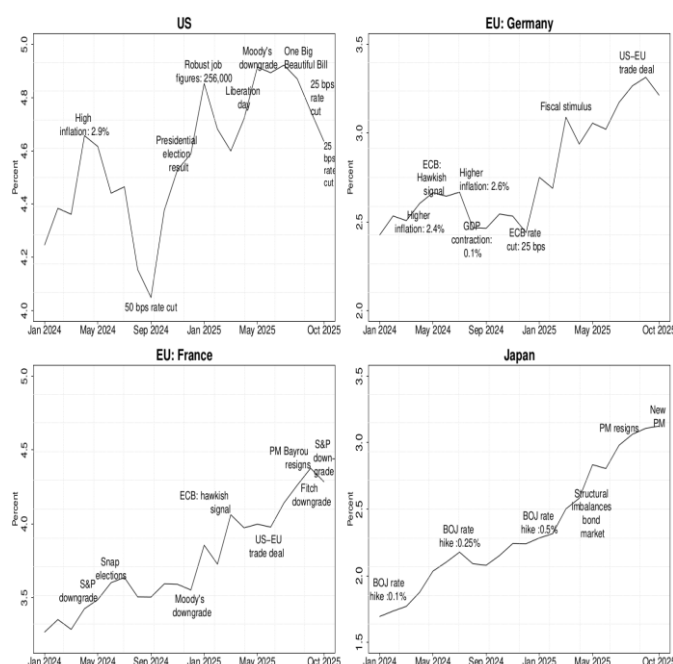
However, the U.S. tariff shock has now begun to weigh on global trade and manufacturing. Heightened policy uncertainty in the US beyond trade policy, both internal and external, ongoing global conflicts, and weakening demand and subdued consumer confidence particularly in advanced economies, are also adversely impacting the global growth outlook. Hence growth is likely to moderate in 2026.

Global inflation is expected to keep easing. Though remaining above target in the U.S., where risks are skewed upward, inflation is subdued in most other economies. Going forward, more accommodative macroeconomic policies, higher tariffs, and elevated food prices in some advanced countries pose some upside risks.

Rising fiscal concerns in advanced economies have hardened the long-dated bond yields, but stock markets continue to downplay fiscal concerns

Despite central banks across the advanced economies easing monetary policy, the ultra-long term bond yields have risen (Figure 1). Japan is an exception to this as rising food prices, and labour costs have induced the Bank of Japan to increase interest rates. Here, ultra-long term bond yields imply yields on bonds with 30 year maturity.

Figure 1: Ultra-long term bonds yields (30 year bond yields) are elevated



Source: Investing.com, and Ministry of finance: Japan.

Yields on ultra-long term bonds are very sensitive to changes in the fiscal fundamentals of a sovereign. The increase in bond yields reflects rising concerns on account

of rising fiscal deficit and sovereign debt ratios relative to Gross Domestic Product (GDP). For instance, in the US, passing of the One Big Beautiful Bill led to a spike in bond yields as it cemented the 2017 tax cuts in place which is expected to further raise the fiscal deficit. The various uncertainties indicated above in the figure are also pushing up long dated bond yields. Price sensitive investors are now preferring short and medium-term securities over the longer-dated ones.

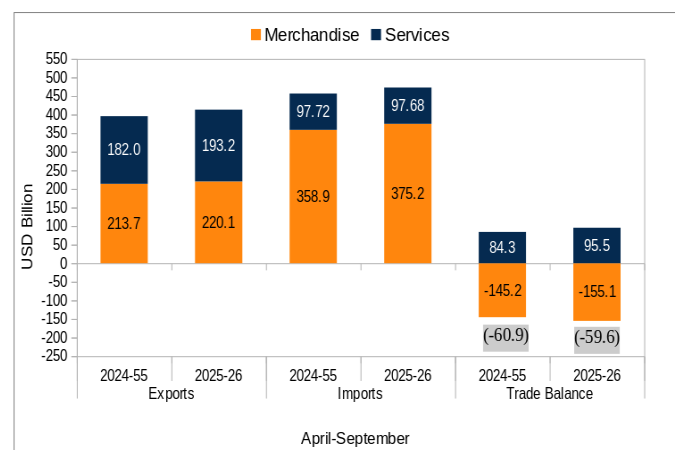
In contrast, these fiscal and other concerns are not adversely impacting stock market sentiments. Apart from the month of April 2025, when market valuations fell following reciprocal US tariffs, markets have mostly realised gains. This is mainly attributable to the 90-day pause in reciprocal tariff implementation by the US and its trade agreements with several countries, optimism around Artificial Intelligence, anticipation of fiscal stimulus in Japan and fairly buoyant economic data. Investors are evidently downplaying the potential impact of tariffs and other uncertainties on growth and inflation in different economies, believing they are transitory and will be quickly reversed.

India's external sector in the context of recent global developments

India's merchandise exports have slowed down since July 2025

Compared to the levels registered in July 2025, merchandise exports growth slowed down in September 2025 to around 6.7 per cent year-on-year (y-o-y). This was mainly accounted for by the contraction in exports of readymade garments, textiles, etc., reflecting the impact of the 50 per cent tariff imposed by the US on India in August 2025 (**Figure 2**).

Figure 2: Services trade surplus more than offset merchandise trade deficit leading to a slight moderation in trade deficit in the first half of FY 2025-26



Source: Ministry of Commerce and Industry

Merchandise imports, on the other hand, grew by around 16.6 per cent y-o-y to USD 68.5 billion on account of higher imports of gold and silver. Cumulatively, from April-September 2025, merchandise exports grew by around 3 per cent y-o-y to USD 220.1 billion, while imports grew by 4.5 per cent y-o-y to USD 375.2 billion, resulting in a merchandise trade deficit of USD 155.1 billion.

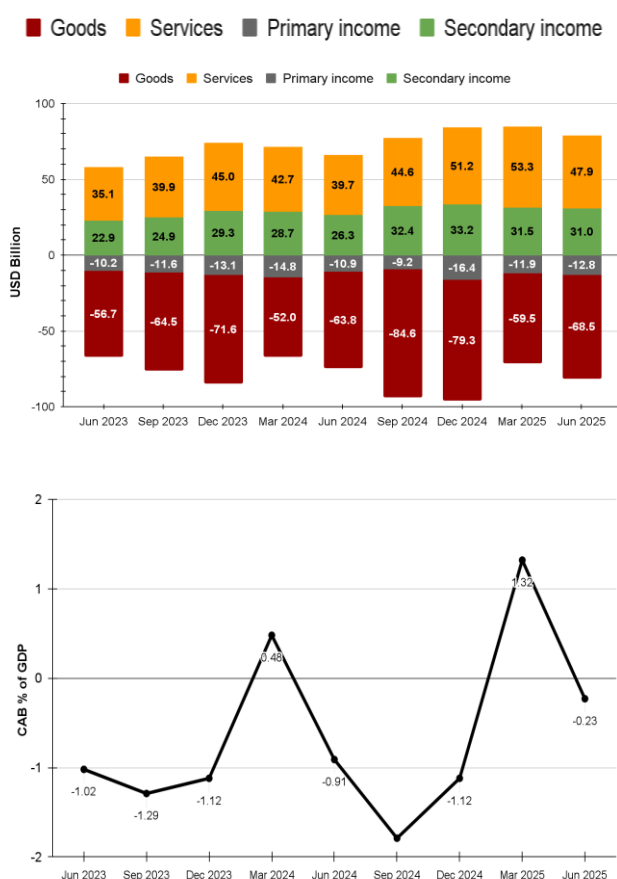
From April-September 2025, India's **cumulative total** exports (goods plus services) posted a growth of 4.43 per cent y-o-y while cumulative total imports grew by 3.57 per cent. Hence, the cumulative trade deficit marginally

moderated to USD 59.6 billion from USD 60.9 billion in the same period previous year.

Current account inverted to a moderate deficit

India's current account balance inverted from a surplus of 1.32 per cent of GDP in Q4 of FY 2024-25 to a deficit of 0.23 per cent of GDP in Q1 of FY 2025-26. However, this deficit is lower, when compared with the 0.91 per cent deficit during the same quarter in the previous financial year (Figure 3).

Figure 3: Current account balance turned negative due to merchandised trade deficit in the beginning of FY 2025-26



Source: RBI

The current account deficit is attributable to the higher merchandise trade deficit mainly on account of higher

imports in the non-crude oil, non-gold and silver category. The services trade surplus in Q1 2025-26 rose to USD 47.9 billion, up from USD 39.7 billion in Q1 2024-25. Secondary income also rose from USD 26.3 billion in Q4 FY 2024-25 to USD 31 billion in Q1 FY2025-26 on account of higher remittances from Indians employed abroad.

Net inflow in financial account turned positive in Q1 of FY 2025-26

Net flow to the financial account improved from a contraction of USD 14.2 billion Q4 FY 2024-25 to an increase of USD 3.6 billion in Q1 FY 2025-26. However, this was lower than the net inflow of USD 7.8 billion in Q1 FY 2024-25. This Q1 over Q1 moderation in net flows was on account of other investments (including external commercial borrowings and non-resident Indian deposits). Portfolio investments improved marginally.

Widening of the trade deficit, and sustained capital outflows during most of the period since March 2025, driven by elevated US bond yields, led to a depreciation of the nominal rupee-dollar exchange rate by around 3 per cent till October 2025, and this depreciation is continuing. Depreciation in Rupee is also attributable to the fact that RBI has held back its interventions in the foreign exchange market. Foreign exchange reserves have remained comfortable at around USD 700 billion. This has been aided by the RBI increasing its gold reserves along with the appreciation of gold prices. The value of gold reserves rose from around USD 84 billion in April 2025 to USD 95 billion in September 2025).

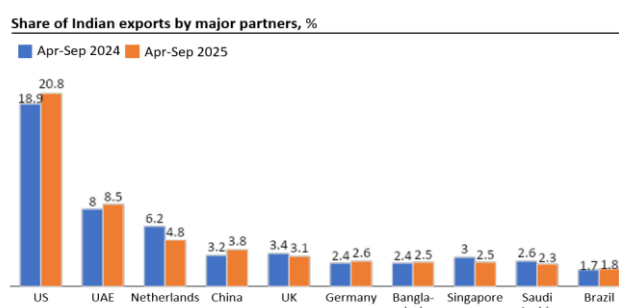
Exposure of India's merchandise exports to US is high for a few products but moderate overall (20 per cent) compared to highly vulnerable services exports over 50 per cent); diversification is the key policy priority

Geographically, US has the highest country share of India's merchandise exports. It rose from 18.9 per cent to 20.8 per cent between April–September 2024 and April–September 2025, partly due to front-loading to

beat the imposition of penal tariffs (**Figure 4**). But this implies that nearly 80 per cent of India's exports, directed to other diversified markets, are not vulnerable to U.S. tariff shocks.

Among the other major destinations, the collective share of trade with Africa, Latin America, and ASEAN economies has remained modest. This is also true for the U.K., where exports have yet to show a significant uptick despite the recently concluded trade agreement in July . Meanwhile, the U.A.E. has emerged as an increasingly important export destination for India.

Figure 4: Share of Indian Merchandise Exports by top 10 destinations



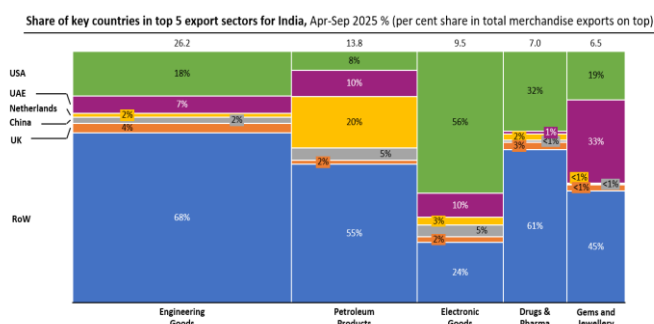
Source: Directorate General of Commercial Intelligence and Statistics, Ministry of Commerce and Industry, Government of India

Much room for diversification for India's merchandise exports despite concentration in a few sectors

In terms of products, high US exposure is limited to only a few products among the leading merchandise export groups. Engineering goods are the largest merchandise export category (24.2 per cent share), followed by petroleum products (13.8 per cent). Of these , the U.S. accounts for about 18 per cent of engineering exports and only 8 per cent of petroleum products among the leading merchandise export groups (**Figure 5**). Electronic goods, with 9.5 per cent share of goods exports, has the highest US exposure (56 per cent share). But currently it

is exempt from the 50 per cent punitive tariff. Drugs and pharmaceuticals are the fourth largest export product group with 7 per cent share and US accounting for 32 per cent of these exports. These products are subject to 100 per cent US tariffs. However, that applies to branded and patented products while India mainly exports generic drugs. Gems and jewellery are the next largest group with 6.5 per cent of exports and 19 per cent US share. However, diversification is most evident in gems and jewellery. The U.A.E. has emerged as a leading destination in recent years, accounting for roughly one-third of these exports. Two product groups which are not among the top five but high exposure to US tariffs shocks are textiles and apparel (US Share 29.7) and marine products, especially shrimp (US share 32.6 per cent). Thus, high exposure to US tariff shocks is limited to only a few product groups. In particular, for the top five exports 70 per cent are directed to other markets. It is likely that this exposure will be further reduced if the ongoing tariff negotiations are successfully concluded.

Figure 5: Share of top 5 export partners in top 5 merchandise export sectors, Apr-Sep 2025 (%)



Source: Directorate General of Commercial Intelligence and Statistics, Ministry of Commerce and Industry, Government of India

India's services exports are heavily concentrated and highly exposed to the U.S.

In contrast the US has a large share of India's service exports at 54 per cent. This dependence exposes India to high trade risks, especially since the surplus in service exports is the most dynamic component of India's export

performance, largely offsetting the deficit in goods exports. The U.S. has raised H-1B visa fees to USD 100,000 and proposed the Halting International Relocation of Employment Act (HIRE) Act, which seeks to impose a 25 per cent outsourcing tax. Together, these measures heighten the vulnerability of India's largely un-diversified services sector.

The U.S. has increasingly pursued selective bilateral deals that align with its industrial and strategic goals, securing critical minerals from China and attracting high-tech investments from South Korea and Japan in areas such as semiconductors and advanced manufacturing. India unfortunately has limited leverage in its negotiations with the U.S. To keep discussions progressing, it is even considering opening its long-protected agriculture and dairy sectors. The recently signed 10-year defence pact is also expected to boost U.S. defence exports to India.

Given this background, **geographical diversification of exports, especially highly vulnerable services exports, should be India's top export policy priority alongside efforts for a fair trade agreement with the US.**

India has been actively engaging with multiple partners to diversify its exports away from the U.S. market (Table 1). These efforts include a strategic focus on broader economic blocs such as the GC. However, bloc-wide agreement could not be reached, prompting India to adopt a phased bilateral approach, beginning with the UAE in 2022. Ongoing negotiations with Qatar are expected to conclude by 2026, and potentially Saudi Arabia thereafter. Similar engagements are underway with the EU, the Eurasian Economic Union, and Latin American countries such as Chile and Peru. India's recent trade strategy also reflects a shift towards more comprehensive economic partnerships rather than limited tariff agreements, aiming to secure stable markets for vulnerable sectors like textiles, pharmaceuticals, engineering goods, electronics, agriculture, and especially IT services. While these are welcome initiatives towards a more proactive and diversified trade policy, positioning India for a more

resilient export growth in the years ahead, it is important to underline that these efforts are all work in progress. Meanwhile, India remains highly exposed to US bilateral policy vis-à-vis India on service exports.

Table 1: Status of Recent Trade Negotiations and Agreements

Partner/Block	Countries	Type of agreement	Current status	Key beneficiary sectors
Chile	Chile	CEPA*	3rd round concluded in October 2025	Pharmaceuticals, Textiles, Engineering Goods, and Processed Foods, Digital Services, MSME sector
Eurasian Economic Union	Armenia, Belarus, Kazakhstan, Kyrgyz Republic, Russia	FTA***	ToR signed in August 2025; negotiations initiated	Pharma, Textiles, Engineering goods, IT services and Agri products
European Union	27 EU countries	TEPA**	14th round concluded in October 2025; deal expected Dec 2025	Pharma, Textiles, Engineering goods, IT services and Agri products
Gulf Cooperation Council (GCC)	Qatar (UAE concluded in 2022)	CEPA*	Negotiations ongoing; agreement expected mid-2026	Iron & Steel, Rice, Jewellery, Vehicles, Petroleum, Electronics, Buffalo meat and Sugar
New Zealand	New Zealand	FTA***	4th round of negotiation in November 2025; deal expected soon	Defence, Education, Tourism, and Aerospace, Agriculture, and Food Processing
Peru	Peru	CEPA*	9th round of negotiation in November 2025; talks to resume in January 2026	Critical Minerals, Pharmaceuticals, Automobiles, Textiles and Food Processing, Digital Services, MSME sector
United Kingdom	United Kingdom	CEPA*	Concluded in July 2025; further engagements ongoing	Agriculture, Marine, Textiles, Gems & jewellery, Footwear, Pharma and Engineering goods, IT/ITes, Financial & Professional services

*CEPA stands for Comprehensive Economic Partnership Agreement. **TEPA stands for Trade and Economic Partnership Agreement, and ***FTA stands for Free Trade Agreement.

Source: Authors' compilation based on trade agreement data from the Ministry of Commerce and Industry, Government of India.

Growth and Inflation

Aggregate demand growth in Q1 2025-26 has been robust and broad based while headline inflation has fallen below the lower bound of RBI's tolerance band in FY 26

Growth in the first quarter of FY 26 was significantly higher at 7.8 per cent compared to 6.5 per cent in the same quarter of FY 25. This aggregate growth acceleration was driven by acceleration in growth of all the major demand components except private consumption expenditure (**Table 2**). The latter moderated to 7 per cent in Q1 FY 26 compared to 8.3 per cent in Q1 FY 25. This moderation is mainly attributable to stagnant urban demand in the first half of the current fiscal year¹.

Table 2: Broad based growth in demand components improved real GDP growth in Q1 FY 26 compared to Q1 FY 25, despite widening of negative trade balance

Demand components	2023-24 YoY (%)	2024-25 YoY (%)	2024-25 Q1 YoY (%)	2025-26 Q1 YoY (%)
Aggregate demand (GDP)	9.2	6.5	6.5	7.8
Govt. Final Consumption Exp. (GFCE)	8.1	2.3	-0.3	7.4
Private Final Consumption Exp. (PFCE)	5.6	7.2	8.3	7.0
Gross Fixed Capital Formation (GFCF)	8.8	7.1	6.7	7.8
Trade Deficit	384.8	-71.5	-32.6	34.0

Source: NSSO

On the supply side, GVA growth rose to 7.6 per cent in Q1 FY 26, up from 6.5 per cent in Q1 FY 25, partly due to a rise in agricultural growth from 1.5 per cent to 3.7 per cent. This is attributable to a favourable early monsoon in FY 26. There was also a broad based rise in services growth from 6.8 per cent to 9.3 per cent. Industrial

growth on the other hand moderated from 8.5 per cent to 6.3 per cent despite a robust 7.7 per cent growth in manufacturing. The slow down in industrial growth in Q1 FY 26 reflected the slow down in utilities and construction sectors, and contraction in the mining sector.

Looking forward, growth in H2 FY 26 is likely to be propelled by an upswing in the urban component of private consumption demand following GST rate rationalisation and also robust growth in public capital investment.

According to RBI's Consumer Confidence Survey, both current and future perception of urban consumers are rising. Y-o-y growth of domestic passenger car sales, a significant coincident indicator of urban demand, has recorded a strong 8.5 percent growth in October 2025 compared to only 0.82 per cent growth in the previous month.²

The value of completed investment projects, a significant coincident indicator of investment demand for both public and private sectors, has also recorded robust growth. The exceptionally high growth in Q1 FY 26 was mainly due to the base effect of contraction during the previous year, but growth has remained high even in Q2 FY 26 (**Table 3**).

¹ In the preceding two years, the high 9.2 per cent real GDP growth of FY 24, driven by the multiplier effect of high public sector capex, had moderated to 6.5 per cent in FY 25 mainly due to the sharply reduced growth of public consumption expenditure. Investment growth also decelerated in FY 25 (**Table 2**). This was despite the rise in private consumption

demand growth and narrowing of the real trade deficit in FY 25.

²The factors which were driving up rural demand since 2023-24, such as good monsoon and the surge in pulse prices, have been moderating. However with favourable monsoon effects during kharif time this year, rural demand may also revive in H2 FY 26.

Table 3: Both public and private sectors record robust growth in investment

Year/Quarter	Public & Private combined	Public	Private
2024-25 Q1	-55.2	-63.0	-50.3
2024-25 Q2	-32.2	-50.2	30.2
2024-25 Q3	-27.1	-42.6	16.6
2024-25 Q4	-33.6	-39.3	-25.5
2025-26 Q1	224.5	551.6	73.3
2025-26 Q2	27.9	41.2	10.2

Source: CMIE Capex

Alternative growth scenarios for FY 25-26

Based on the information on various macroeconomic indicators available till September 2025, the baseline growth projection using the usual NIPFP high frequency indicator model is 7.1 per cent,³ which is slightly higher than the projections of RBI (6.8), IMF (6.6) and World Bank (6.5). However, in view of the high level of uncertainty, in this Mid-Year review we have laid out three alternative growth scenarios based on three alternative sets of assumptions relating to how the U.S. economy will perform in H2 FY 26, as a proxy for the global economic trends. The impact of GST rate rationalisation, which is assumed to reduce the effective GST rate by 1 per cent, on central revenue and expenditure has also been built into the scenarios, assuming that the budgeted fiscal deficit target is maintained. Scenario 1 is an optimistic scenario, which assumes that US growth will be 1 per cent above potential, scenario 2 assumes US growth will be 1 per cent below potential and scenario 3 assumes that it will be close to potential.

Based on these assumptions, our assessment is that the Indian economy will grow by 7.4 per cent in FY 26. However, the growth rate could vary in the range of 6-

8.8 per cent depending on whether the U.S. economy dips into recession or revives in H2 FY 26.

Table 4: Alternative growth scenarios for FY 26

Baseline	Scenario 1	Scenario 2	Scenario 3
7.1	8.8	6.0	7.4

Source: Authors' estimate

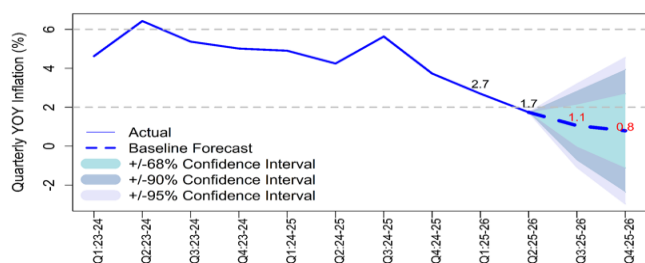
Turning to inflation, headline (CPI) inflation has been benign at 1.9 per cent during the first half of FY 26. It was followed by a drastic fall to 0.25 per cent in October 2025. This sharp decline in headline inflation is due to deflation in food prices (-5.0 per cent): vegetable prices fell by as much as 27.6 per cent) while pulse prices fell by 16.2 per cent). The price of spices also fell by 3.3 per cent). However, CPI core inflation was at 4.8 per cent in H1 2025-26, and rose further rose to 5 per cent in October 2025, mainly due to high and rising inflation of gold and silver prices.

For FY 2025-26, we forecast an annual inflation rate of 1.6 per cent, well below the lower bound (2 per cent) of RBI's tolerance band (**Figure 5**). Our inflation forecasts for Q3 and Q4 FY 26 are 1.1 per cent and 0.8 per cent respectively, implying the inflation rate will further moderate in H2 FY 26. Buoyant urban demand propelled by GST rate rationalisation will tend to raise inflation, but this will be dominated by the downward pressure on inflation due to the negative demand impact of the US tariff shock and moderation of energy prices.

³ Rudrani Bhattacharya, Bornali Bhandari and Sudipto Mundle (2023), "Nowcasting India's Quarterly GDP Growth: A Factor-Augmented Time-Varying Coefficient

Regression Model (FA_TVCRM)," Journal of Quantitative Economics, Volume 21.

Figure 5: FY 2025-26 inflation forecast of NIPFP at 1.6 per cent, well below the lower bound of RBI's tolerance band

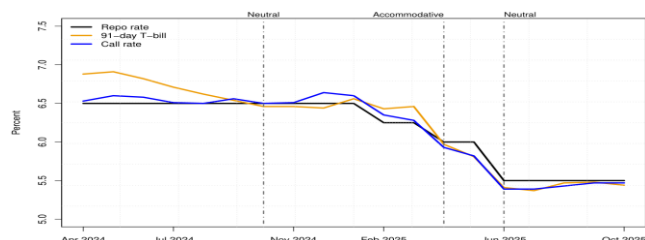


Source: CSO, Bhattacharya & Kapoor (2020)⁴

Monetary policy and Financial sector developments

After a cumulative 100 basis point rate cut between February 2025 and June 2025, RBI has maintained a status quo since June 2025 (Figure 6). During this period, the monetary policy stance was also changed from Neutral to Accommodative in April 2025. In the June 2025 meeting of the Monetary Policy Committee RBI changed the stance back to Neutral, and has kept it unchanged since then. A neutral stance provides policymakers with the flexibility of adjusting the policy rates in line with the prevailing economic conditions.

Figure 6: Status quo maintained after significant easing, stance changed to neutral and short-term rates have inched lower than repo rate



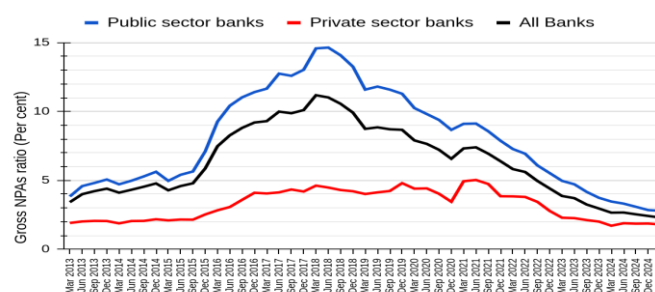
Source: RBI, CMIE Economic Outlook

⁴ Rudrani Bhattacharya and Mrikankshi Kapoor, (2020) "Forecasting Consumer Price Inflation in India: Vector Error Correction Mechanism vs. Dynamic Factor Model Approach

As a result of these actions, the short-term rates, represented by the 91-day treasury bill (t-bill) rates, have inched lower than the repo rate. Furthermore, liquidity infusion in the form of Daily Variable Repo Rate Auctions (VRR), Open Market Operation (OMO) purchases of government securities and USD/INR buy/sell swaps by the RBI from January 2025 end till June 2025 resulted in surplus liquidity in the banking system. The uptick in government spending has also contributed towards this. As a consequence, the weighted average call money rate has also inched lower than the repo rate.

The health of the banking system has continued to improve and converged over time across banking sectors on account of stricter regulatory norms on Non-Performing Assets (NPA). In March 2025, the Gross NPA (GNPA) ratio for all banks declined to 2.3 percent from a peak of 11.2 percent in March 2018 (Figure 7). The GNPA ratio of public and private sector banks declined to 2.8 per cent and 1.8 per cent respectively in March 2025 from peaks of 14.6 percent (in June 2018) and 5 percent (in June 2021). The GNPA ratio for Non-Banking Financial Companies (NBFC) has also moderated to 3 per cent in March 2025, down from a peak of 6.8 per cent in March 2020.

Figure 7: Public and private sector bank NPAs continue declining and converging



Source: RBI Financial Stability Report

for Non-Stationary Time Series." NIPFP Working Paper No. 323.

Transmission of policy rates cuts towards lending rates remains incomplete

The cumulative 100 basis point rate cut has been fully transmitted to fresh deposit rates (the Weighted Average Domestic Term Deposit Rates or WADTDR on fresh deposits), while the transmission to lending rates (the Weighted Average Lending Rates (WALR) on fresh loans) has been incomplete (**Table 5**).

Table 5: Transmission more effective for fresh deposit rates than loans

Months	MPC decision	Weighted Average Lending Rate (WALR; Percent per annum)		Weighted Average Domestic Term Deposit Rate (WADTDR; Percent)		Spread (Percent)	
		Public sector banks	Private sector banks	Public sector banks	Private sector banks	Public sector banks	Private sector banks
Feb 2025	25 basis points cut	8.68	10.24	7	6.73	1.68	3.51
Mar 2025		8.66	10.32	7.01	6.9	1.65	3.42
Apr 2025	25 basis points cut	8.46	10.08	6.73	6.56	1.73	3.52
May 2025		8.38	10.15	6.59	6.29	1.79	3.86
Jun 2025	50 basis points cut	7.82	9.74	6.23	5.92	1.59	3.82
Jul 2025		8.13	9.58	6.06	5.71	2.07	3.87
Aug 2025	Status quo	8.06	9.44	6.01	5.71	2.05	3.73
Sep 2025		7.8	9.34	6.04	5.74	1.76	3.6
Total moderation (Basis points)		100	90	96	99		

Source: RBI

Though bank margins can come under pressure during an easing cycle, in the current cycle the spread between the fresh deposit and lending rates indicate that bank margins are not only healthy but even excessive. This is especially so in the case of private sector banks.

However, transmission to fresh lending rate in the current easing cycle has been faster as compared to earlier easing cycles thanks to the adoption of the External Benchmark Lending Rate (EBLR) system. Typically, lending rates of a bank are composed of two components, a benchmark rate which moves in line with changes in monetary policy and a spread which is borrower specific and depends on borrowers credit worthiness, etc. Adoption of EBLR implies that the benchmark of the banks is now directly linked to the repo rate or any other rate that is published by the Financial Benchmarks India Private Limited (FBIL). In the previous benchmarking systems such as Marginal Cost of Fund-based Lending Rate (MCLR), banks computed their benchmark rates based on a formulation provided by the RBI. However, in the case of EBLR, the

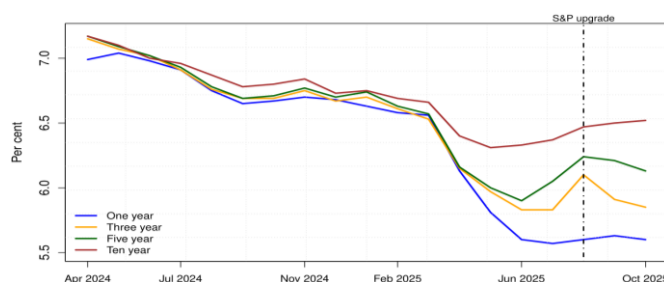
benchmark requires no further computation from the bank's side, entailing faster transmission.

In the case of outstanding loans, as of June 2025 the transmission towards lending rates has been faster for private sector banks. This is because 88 per cent of their total outstanding floating rate rupee loans are linked to EBLR as compared to only 47 per cent in the case of public sector banks.

Bond yields have eased over time but the yield curve has steepened

In the bond market, sovereign bond yields across maturities moderated between April and June 2025. This was due to monetary policy easing, the change in stance to accommodative, record surplus transfer by RBI to the government and lower inflation (**Figure 8**).

Figure 8: Diverging and moderating government bond yields



Source: CMIE Economic Outlook

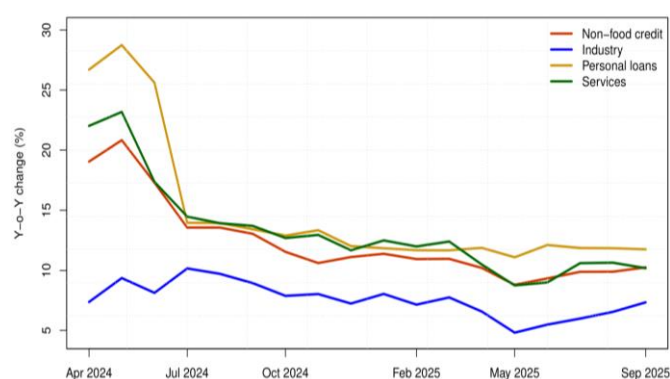
Subsequently, bond yields had started hardening for multiple reasons: the change in monetary policy stance back to neutral, expected revenue loss due to rationalisation of the Goods and Services tax (GST) and concerns about the 50 percent tariff imposition on India by the US. More recently, during September and October, bond yield movements have diverged. Long-term yields like the 10-year bond yield have hardened in response to the higher supply of long dated securities as indicated by the borrowing calendar for the second half of the current financial year. On the other hand, the short-term yields (i.e., 1-, 3-, and 5-year bond yield) have moderated

tracking lower inflation. This steepening of the yield curve indicates a shift in investor preferences in favour of short maturity bonds and also a shift in preference from government bonds to corporate bonds and equity as discussed further below.

Credit offtake remains moderated during the easing cycle as large industries and NBFCs deleverage

Credit disbursement marginally improved in the months of September on account of festival season (**Figure 9**). However, overall bank credit offtake has remained subdued despite faster transmission, surplus banking system liquidity and improved balance sheets of banks. The moderation is broad-based across industry, services and personal loans. The slow down in bank credit growth is attributable to deleveraging by large industries and NBFCs during the first half of the current financial year. Despite the fact that risk weights on unsecured personal loans have been rolled back, this category is yet to see any uptick in credit offtake. Bank credit to the services sector, apart from NBFCs, was also muted during the first half of the current financial year.

Figure 9: Bank credit has moderated despite policy rate cuts by the RBI

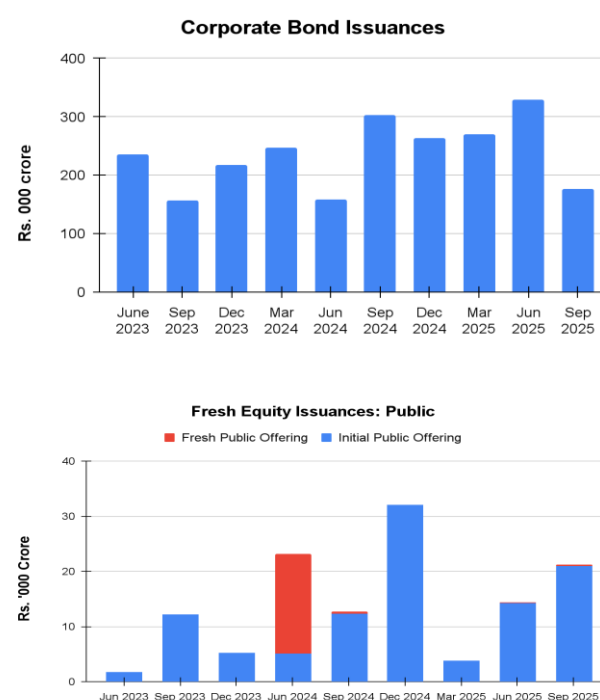


Source: CMIE Economic Outlook

Bank credit moderation comes as a result of corporates increasingly tapping the capital markets for funds

Faster transmission of monetary policy rate cuts towards bond yields implied that issuances of corporate bond yields became cheaper (**Figure 10**). As a result, corporates (or large industries) have increasingly issued corporate bonds to raise funds instead of borrowing from banks. Thus, during the June 2025 quarter, where monetary policy was eased by a cumulative 75 basis points (25 basis points in April 2025 and 50 basis points in June 2025), corporates raised around Rs. 3.29 trillion crores through corporate bonds. However, all these corporate bonds are being issued through private placement route. Through this route companies sell bonds directly to a select group of investors rather than to the public. Such investors tend to hold the bonds till maturity, thereby making the secondary market illiquid.

Figure 10: Corporates are tapping capital markets for funds



Source: SEBI, and CMIE

Apart from corporate bonds, fresh equity issuances by corporates have also risen. Most of the action around fresh equity issuances is concentrated in Initial Public Offering (IPO). Small and medium enterprises along with large corporates are increasingly raising funds through the equity market. During both the June and September 2025 quarters, funds raised through equity markets surged past the levels raised during the same quarters the previous year. In the September quarter, in particular, a total of Rs. 210 billion was raised through IPOs by 134 firms. This quarter registered the largest wave of IPO listings since December 1996. The IPOs were mostly floated by firms from the manufacturing and non-financial services sectors. However, it is important to keep an eye on whether these funds are being raised for actual physical investment or to exploit arbitrage opportunities in the financial markets.

Government Finances

Maintaining projected spending while both central and states tax revenues are under strain is likely to overshoot budgeted deficit projections.

Central government: Growth of gross tax revenues (GTR) of the central government during the Apr-Sept of the fiscal year 2025-26 (H1-2025-26) fell to 2.8 per cent as compared to 12 per cent growth during H1-2024-25. This was mainly due to the sharp decline in income tax growth (4.7 per cent) and CGST growth (5.8 per cent) during this period as evident from Table 6. Corporation tax growth also fell to 1.1 per cent during this period as compared to 2.3 per cent growth in H1-2024-25. Excise duty growth rate was an outlier, it rose to 8.1 per cent as compared to 3 per cent during H1-2024-25. This was probably due to the increase in excise duty on petrol and diesel in April 2025. In the 2025-26 budget, the government increased the exemption threshold of personal income tax. This explains the sharp decline in the growth of personal income tax.

The non-tax revenue growth jumped to 30.5 per cent during April-September 2025 as the Reserve Bank of India

approved a dividend of Rs 2.69 lakh crore to the central government, up from Rs 2.11 lakh crore transferred last year.

The government rationalised GST rates of around 450 goods and services effective from 22 September 2025. This is likely to adversely impact revenues of the government, at least in the short to medium term. The gross tax revenue target for 2025-26 is likely to be missed on this account as well as the sluggish growth of most other taxes.

Table 6: Central Government Revenue Collection: Apr-Sep (% change)

Indicators	Y-o-Y growth (%)		2024-25BE over 2023-24RE
	2024-25 Apr-Sep	2025-26 Apr-Sep	
Nominal GDP	12.0	9.8	8.0
Centre's Net Revenue*	16.1	4.5	10.8
Gross Tax Revenue	12.0	2.8	10.8
Corporation Tax	2.3	1.1	10.4
Income tax	25.0	4.7	14.4
Union Excise duties	3.0	8.1	3.9
CGST	10.8	5.8	11.3
Customs duty	6.4	-5.2	2.1
Non-Tax Revenue	50.9	30.5	9.8

Note: * net of states' shares in central taxes and collections under NCCD to be transferred to NDRF.

Source: Controller General of Accounts (CGA); Union Budget

On the expenditure front we see a massive increase in the growth of capital expenditure (40 per cent) during April-September 2025 as compared to a sharp contraction of 15.4 per cent during a similar period in the previous year (Table 7). Revenue expenditure growth fell to 1.5 per cent while the total expenditure growth was 9.1 per cent as compared to a contraction of -0.4 per cent during H1-2024-25. The high total expenditure growth during H1-2025-26 is attributed to a sharp increase in capital expenditure. Major subsidies of the union government comprising food, fertilizer and fuel subsidies contracted by (-) 5.7 per cent, mainly due to the contraction in food subsidies by as much as (-)27 per cent during this period.

In the 2025-26 budget the central government has budgeted capital expenditure to increase by 10 per cent, revenue expenditure by 6.7 per cent amounting to a total

expenditure increase of 10.1 per cent. Major subsidies are budgeted to remain at the 2024-25RE level.

Table 7: Expenditure of Central Government: Apr-Sep (% change)

Indicators	Y-o-Y growth (%)		2024-25BE over 2023-24RE
	2024-25 Apr-Sep	2025-26 Apr-Sep	
Revenue Expenditure	4.2	1.5	6.7
Capital Expenditure	-15.4	40.0	10.1
Total Expenditure	-0.4	9.1	7.4
Major Subsidies	4.0	-5.7	0.0

Source: Controller General of Accounts (CGA); Union Budget

The government has set the Fiscal deficit-GDP (FD-GDP) target at 4.4 per cent for 2025-26, lower than the earlier FD-GDP reduction goal of 4.5 per cent by 2025-26 which was announced by the finance minister in her 2021-22 budget speech.

From the 2025-26 budget, the central government shifted to a new fiscal consolidation framework with debt-to-GDP ratio as the key monitoring target. It announced a new fiscal consolidation roadmap for the period 2026-27 to 2030-31. The government has not specified any year-wise debt-to-GDP targets but it aims to set FD each year such that debt-GDP ratio of 50 per cent $\pm$ 1 per cent is attained by 31 March 2031. As debt to GDP ratio is less sensitive to change in fiscal deficit level compared to the FD-GDP ratio, this gives more flexibility for fiscal management. It gives more elbow room for increasing capex to revive growth.

The States: Setting aside large inter-state variations, total revenue receipts aggregated across all state governments grew at 6 per cent during Apr-Aug 2025 (Table 8). This is similar to the growth achieved during Apr-Aug 2024. On average, own revenues accounted for 68 per cent of total revenue of states and their own tax revenue (OTR) accounted for 89 per cent of total own revenues. Growth of this key component of states' revenue decelerated to 6.1 per cent during Apr-Aug 2025, down from 9.2 per cent during the same period in 2024. There are of course large inter-state variations around this average, ranging from (-) 3.7 per cent change in OTR in Tripura to 31 per cent in Jharkhand. In 2025-26, the

combined all-states OTR has been budgeted to grow by 14.1 per cent, which seems unduly optimistic given recent past performance in OTR mobilisation. The rationalisation of GST rates from 22 September will also adversely impact OTR of states.

Central transfers, the other main component of states' revenues, grew by 6.3 per cent during Apr-Aug 2025, up 3.1 per cent as compared to that during 2024. Devolution growth decelerated to 13.2 per cent, down from 19.9 per cent in 2024. However, the very modest growth of transfers is primarily due not to this deceleration but the *contraction* in flow of grants from central government. Central grants to states during Apr-Aug 2025 contracted by (-) 17.3 per cent on top of the massive contraction of 29.9 per cent during 2024. For 2025-26, the all-states combined budget indicates 10.4 per cent increase in devolution and 5.1 per cent increase in grants (Table 8), which again seems unduly optimistic compared to recent past performance. Decline in revenues of the central government on account of GST rate rationalisation will also further adversely impact central transfers to states. Thus, the revenue projections of state governments, both their OTR and central transfers, seem quite unrealistic

Table 8: Key Fiscal Indicators - All-State Governments: Apr-Aug (% change)

Indicators	Y-o-Y growth (%)		2024-25BE over 2023-24RE
	2024-25 Apr-Sep	2025-26 Apr-Sep	
GSDP	10.9	12.0	12.0
Total Revenue Receipt (TRR)	6.0	6.0	12.0
Own Revenue Receipt (ORR)	7.4	5.9	14.5
- Own Tax Revenue (OTR)	9.2	6.1	14.1
- Own Non-Tax Revenue (ONTR)	-4.9	4.4	16.9
Central Transfers (CT)	3.1	6.3	8.7
Devolution	19.9	13.2	10.4
Grants-in-aid	-29.9	-17.3	5.1
Total expenditure	7.9	9.3	10.1
Revenue expenditure	10.1	8.8	9.2
Capital expenditure	-6.8	14.0	15.1

Source: Comptroller and Auditor General of India (C&AG); 2025-26 Budget documents of all-states

On the expenditure side, the combined capital expenditure of all states increased by 14 per cent as compared to a contraction of (-) 6.8 per cent in 2024. Revenue expenditure growth at 8.8 per cent during Apr-

Aug 2025 was lower than that during the same period in 2024-25 as evident from Table 8. For 2025-26, all-state revenue expenditure is budgeted to grow by 9.2 per cent and capital expenditure by 15.1 per cent. Total expenditure which grew by 9.3 per cent during Apr-Aug 2025 is budgeted to grow by 10.1 per cent in 2025-26.

While these expenditure projections are broadly in line with recent expenditure growth, the revenue projections are quite unrealistic. Hence the combined fiscal deficit of all states is likely to significantly overshoot the all-state combined fiscal deficit of around 3.2 per cent of states GSDP budgeted for FY 2025-26.

Some Key Takeaways:

The Indian economy, like the rest of the world, is experiencing exceptionally turbulent times. Among the ongoing wars and other disruptions, perhaps the greatest uncertainty is the impact of President Trump's disruptive policies both domestically and in US international strategic and trade policies. The US being the world's largest economy, accounting for about a quarter of global GDP on nominal terms, these disruptions are likely to have a profound impact on countries around the world, including India.

Consequently, in this mid-year review we have replaced our usual model based growth forecasts by scenarios based on alternative assumption about whether the US economy will head into recession or recover. The good news is that even in a pessimistic scenario, India's GDP growth will not fall below 6 per cent and it could be as high as 8.8 per cent in an optimistic scenario. Our best guess is that the economy will grow at around 7.4 per cent in FY 2025-26. Meanwhile, inflation is very muted and is forecast at around 1.6 per cent for the full year, well below the lower boundary of the RBI's tolerance band.

Perhaps the most important takeaway from this mid-year review is on trade policy. The final shape of the trade agreement is not yet clear. What is clear however is that

the impact of any tariff shock on India's goods exports is likely to be quite muted, while it could be quite severe for service exports. Nearly 80 per cent of Indian goods exports have no exposure to US tariffs. Of the five largest Indian exports, 70 per cent are exported to other countries. For the handful of products highly vulnerable to US tariff shocks, such as textiles and apparel or marine products (shrimps), financial support can be extended as buffers against the tariff shock. The picture is very different for services exports, where the US accounts for well over half of these exports. Service exports are the most dynamic and surplus component of India's exports, a key driver of Indian growth. Unfortunately, they are also very vulnerable to US policies. The key policy priority for services therefore, but also for goods exports, is to diversify away from the US as much as possible while negotiating hard for a fair trade deal.

An important takeaway on the monetary policy front is that the reduced policy rates have shifted investor preference away from long dated government securities towards short maturity government securities and corporate bonds. Corporates are increasingly raising resources through their own bond issues and the equity market rather than from banks. Though the balance sheets of banks, both public sector and private sector, have become healthier, incomplete transmission of policy rate reduction to lending rates has constrained bank lending. However, adoption of the External Benchmark Lending Rate (EBLR) system is improving transmission.

In public finance, slow tax revenue growth has emerged as a significant constraint both for the Centre and the states. If budgeted expenditure levels are maintained despite revenue shortfalls, the fiscal deficit targets are likely to be breached. However, this may be accommodated under the forthcoming new fiscal monitoring framework which will switch from the fiscal deficit to the debt to GDP ratio as the key monitoring variable for fiscal consolidation.