

Indian Economy: Resilience during ongoing Global Realignment: FY 2025-26: End-Year Macroeconomic Review

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1. Introduction

In the FY 2026 year-end macroeconomic review conference held on 24th April 2026, the NIPFP team made four presentations which addressed key analytical questions regarding the highly uncertain global environment; the domestic growth, investment and inflation outlook in this context and monetary and fiscal policy issues. The main policy takeaways from these presentations are summarised in this policy brief.

2. Trade diversification is India's strategic priority in a fragmented & volatile global environment

In the context of a very uncertain and fragile global environment arising from the West Asia war, this section addresses three key questions:

- Where is the global economy headed?
- How effectively is India diversifying its merchandise and services exports?
- Is India adequately diversifying its oil imports?

Where is the global economy headed?

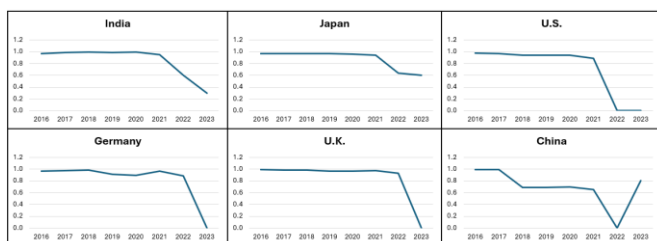
In its recent projections, the IMF presented a fairly benign baseline growth scenario of 3.1 percent and 3.2 percent in 2026 and 2027 respectively, attributing this to a carryover of strong growth from 2025, partial rollback of punitive U.S. tariffs and an easing of the macroeconomic policy stance in several economies. However, the economic turmoil unleashed by the ongoing war, especially the blockade of the Hormuz Strait, suggests that the Fund's 'adverse' scenario projection of 2.5 percent global growth in 2026 with inflation rising to 5.4 percent may be more appropriate. If the hostilities in West Asia persist, actual outcomes may even be closer to

the Fund's 'severe' scenario of only 1.9 percent global growth. Thus, India needs to prepare for a period of reduced global growth and elevated inflation.

Further, while global growth is moderating, it is also quite uneven across countries. U.S. growth is supported by productivity gains linked to heavy AI investment, expected monetary easing, and favourable terms of trade. Growth in Japan benefits from buoyant investment, consumption and fiscal support. The Euro Area and the U.K. are more exposed to war-related costs and tighter macroeconomic policies. Emerging and developing economies are growing faster but exposed to a sharper oil shock. China has rebounded mainly because of the reduction of punitive U.S. tariffs, redirection of its exports to other Asian and European markets and fiscal support. But its rebound is fragile because of continuing challenges in the real estate market, an aging labour force and slowing productivity growth. India is better placed because of the carryover of strong 2025 growth and, again, reduction of punitive U.S. tariffs. However, it faces several global headwinds as discussed below.

The uneven spread of growth across countries reflects increasing economic fragmentation. As displayed by **Figure 1**, correlation of individual country growth rates with global growth declined sharply after the Covid 19 pandemic, implying that country specific factors are dominating global trends in determining growth in individual countries, with China being an outlier. This increasing fragmentation is attributable to heightened geo-political tensions, intensifying political-economic rivalries and the spread of protectionist trade policies, with security concerns overriding cost efficiency considerations.

Figure 1: Rolling correlations of global growth component with country growth



Source: Author's construction based on data from IMF

How effectively is India diversifying its exports?

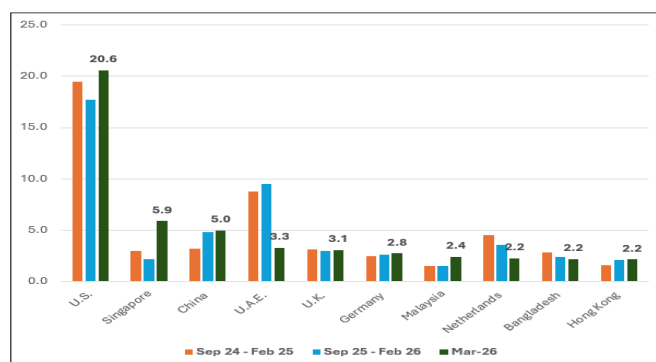
The tariff shock of 2025 underlined India's high export dependence on the U.S. market. The Gulf war and Hormuz closure have highlighted India's import dependence on Persian Gulf littoral trade routes for oil, gas, fertilizers and other products. Trade diversification is therefore the country's urgently required resilience strategy covering destinations, products, services, suppliers, contracts, shipping routes and domestic substitutes.

On the export front, about 80 percent of goods exports is fairly diversified, going to several markets (Figure 2). However, exposure is very high to the U.S., which accounts for roughly one-fifth of goods exports. It is urgent to reduce this exposure. Product concentration is a greater challenge. Engineering goods, electronics, petroleum products, drugs & pharmaceuticals, and gems & jewellery dominate the merchandise export basket, with the top two sectors accounting for almost 40 percent of exports.

Concentration of export services is even more challenging. It is much more concentrated than export of goods and its share in total exports is rising rapidly, already accounting for over 47 percent. The U.S. accounts for almost 55 percent of India's services exports (Figure 3). In software services, which now accounts for nearly half of service exports, the U.S. share is about 53 percent, followed by the E.U. at about 33 percent. One major strength of services exports is that, unlike goods, they can be offsite and less dependent on physical shipping routes.

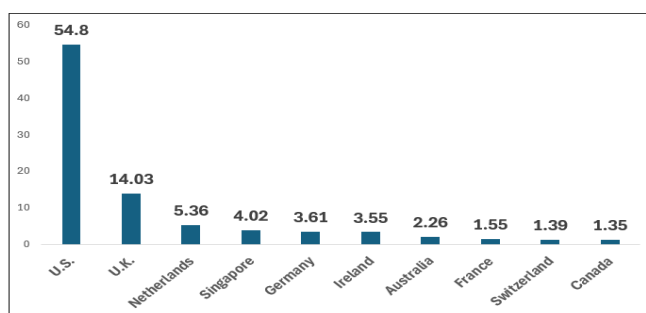
This has served India well because ninety percent of India's software exports are in offsite delivery. On the other hand, the current services surplus is still anchored in IT-enabled service delivery, not in advanced AI capabilities which are driving U.S. growth and also global trade. It is imperative that India should not miss this AI wave, while ensuring that policy remains pragmatic.

Figure 2: Top 10 Merchandise Exports Destinations (Percent share) in March 2026



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

Figure 3: Share of service exports (via SEZ & STPI) of top 10 destinations in 2025-26 (Percent)



Note: Software and non-software services exports through SEZ and STPI
Source: Ministry of Commerce and Industry

Thus, India's export policy priority should be to diversify away from the U.S., especially in services. The India-E.U. trade deal is critical in this context. E.U. is the most promising large market after the U.S. for export of services, especially software and business services. But there are many formidable barriers to expanding service exports to the E.U. in addition to tariffs. These include

local presence rules, country-specific regulations, data protection requirements, licensing, public procurement norms, and language differences across member states. Though the India-E.U. trade deal goes beyond goods tariff cuts, and seeks recognition of professional qualifications, easier movement of skilled personnel, and simpler compliance for Indian service providers; diversifying service exports to E.U. is challenging due to the barriers cited. If these barriers can be moderated through negotiations, the E.U. share of India's services exports could be enhanced significantly even as the absolute level of exports to the U.S. might continue to grow.

How effectively is India diversifying its oil imports?

India's import bill is heavily dominated by machinery, critical inputs and, especially, fossil fuels. Over the long run, expansion of renewable energy generation and storage capacity and improvements in energy use efficiency in domestic manufacturing will reduce fossil-fuel dependence. However, in the near term, energy import policy must focus on wider sourcing, longer contracts, alternative route options, larger strategic reserves and careful monitoring of price and supply risks.

Oil is the immediate test. India's oil import dependence on the Gulf countries was reduced by as much as 10 percent between February and March, following the Hormuz blockade. Nevertheless, these countries still account for 42 percent of India's oil imports (**Table 1**). Russia is the second major source of oil supply, its share rising from 24.8 percent in December 2024 to 28.4 percent in March 2026. However, Russia has been a very volatile source, with sharp month-to-month supply variations because of 'on again-off again' sanctions. Supplies from the U.S. and other countries like Angola, Nigeria and Egypt have been rising, but these are still adjustments at the margin. Incoming shipment data are pointing to a further drop in supplies from the Gulf countries while Russia's share has risen from about one-fifth to nearly half in March–April. Some diversification toward African and Latin American sources is also visible

but India remains primarily dependent on oil imports from the Gulf countries and Russia. India also remains heavily dependent on the Gulf countries for fertilizer, critical minerals and other products.

Table 1: Shift in India's Oil Sourcing Profile (2024–2026)

Top 10 Suppliers	Dec-24	Dec-25	Jan-26	Feb-26	Mar-26
Russia	24.8	20.3	14.8	20.5	28.4
Top 5 Gulf Countries (Saudi Arabia, Iraq, UAE, Oman, Qatar)	52.2	53.4	53.3	53.3	42.0
U.S.	5.0	6.5	7.4	5.4	6.05
Others (Angola, Nigeria, Egypt)	6.6	5.5	8.6	4.7	10.8

Source: Ministry of Commerce and Industry

It turns out that India has been more successful in route diversification than supplier diversification in oil imports. Oil imports through the Strait of Hormuz declined from 45 percent of total imports pre-war to 30 percent in March 2026, and this may have fallen further in April due to the blockade. Alternative routes include the U.A.E. inland pipeline to Fujairah, the Saudi east-west route towards Yanbu and the Red Sea, and long-haul open-sea routes from Russia, Brazil, the U.S. and West Africa. These routes are less risky than the Hormuz route but not all are riskless. Iran has bombed the refinery at Fujairah, for instance, and the Red Sea route could also be attacked. Alternative routes also entail higher refining, freight and other costs.

To summarise, India has to adapt its trade strategy to a fragmented, highly volatile and increasingly protectionist global trade environment. Diversification is the key. Though its merchandise exports are fairly diversified, it is still too dependent on the U.S. market. Furthermore, its service exports, especially IT enabled services, are very heavily dependent on the U.S. market. Thus, export diversification away from the U.S. is an urgent priority especially for services. Leveraging the India-E.U. trade agreement and addressing some of its constraints is very important in this context. On the import side, again, diversification of sources and products has to be the main priority. Specifically in the case of oil imports in the context of the ongoing hostilities in West Asia,

diversifying away from the Gulf region and to alternative routes within the region is essential for security considerations, even if this leads to higher freight and refining costs.

3. Though resilient, domestic growth is now being moderated by repeated and severe external shocks, which have also aborted an incipient revival of private investment

The Indian economy has maintained a robust growth trajectory of over 7 percent for several years, led by public investment. In FY 26 it recorded strong, broad based growth of 7.6 percent. On the demand side, private consumption grew by 7.7 percent followed by investment (7.1 percent), while government consumption and net exports both grew by 6.5 percent (**Table 2**). Different components led growth in different quarters during the year. Export growth was high (10.2 percent) in Q2 since shipments were frontloaded to pre-empt the tariff shock. Private consumption growth was high at 9.2 percent in Q1, moderated in Q2 (to 8 percent) then rose again to 8.7 percent in Q3. Investment growth was low at only 4.9 percent in Q1 then accelerated to 8.4 and 7.8 percent respectively, during Q2 and Q3. Public consumption growth was quite moderate through most of the year though there was a mild spike in Q2.

While investment demand growth has been a major driver of high GDP growth in the recent period, this has mainly been on account of public investment. The GDP share of public investment has remained stable at 7-8 percent during the past fifteen years or so but the share of private investment has declined from 27.5 percent to 24 percent during this period. After the pandemic driven slump of 2019-20, real growth in public investment increased steadily till FY24. Real growth of private investment on the other hand was declining during this period, barring the base effect driven spike in FY22 (**Figure 4**).

Table 2: Different components of aggregate demand recorded high growth in different quarters of FY 26

GDP & Demand side components Base 2022-23	2023-24 YoY	2024-25 YoY	2025-26 YoY
Private Consumption (PFCE)	5.8	5.8	7.7
Govt. Consumption (GFCE)	0.6	6.5	6.5
Investment (GFCF)	7.3	6.4	7.1
Net Exports	0.7	6.6	6.5
GDP	7.2	7.1	7.6
	2025-26 Q1	2025-26 Q2	2025-26 Q3
PFCE	9.2	8.0	8.7
GFCE	5.8	6.6	4.7
GFCF	4.9	8.4	7.8
Exports	6.6	10.2	5.6
Imports	7.4	5.9	8.6
Net Exports	13.2	-18.2	89.7
GDP	6.7	8.4	7.8

Source: CSO, MOSPI

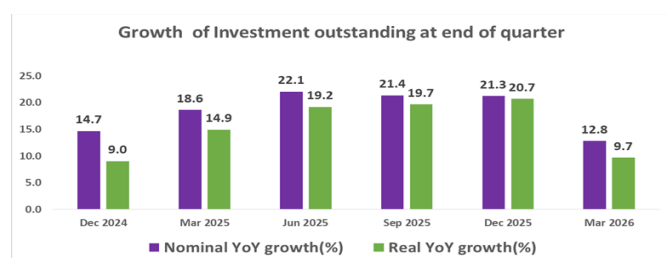
Interestingly, while public investment growth declined in FY25 due to fiscal consolidation, private investment saw a mild revival. High frequency indicators for private non-financial sector investments (CAPEX data from CMIE) indicate that this revival of private investment was sustained during the first three quarters of FY 26, growing at over 20 percent in nominal terms (**Figure 5**). However, this incipient revival of private investment collapsed in Q4 FY 26 as a consequence of the gulf crisis.

Figure 4: After post pandemic recovery, public and private investment growth showed opposite trends



Source: MOSPI

Figure 5: High FY 26 private investment growth collapsed in March 2026 due to Gulf shock



Source: Capex, CMIE

This deceleration of private investment growth has been spread across several sectors, including food & agro-products, chemicals & products, leather products, construction materials, hotels & restaurants.

Expected Growth in FY 27

The sharp decline in private investment in Q4 of FY26 points to moderation of growth in FY 26 which is likely to

carry over into FY27 as has also been indicated by IMF projections.

In addition to the slowdown in private investment, other indicators of growth moderation on the demand side include the contraction in non-Petroleum exports (- 9.2 percent year-on-year (y-o-y) in March 2026). On the supply side, the 8-Industry core IIP contracted by 0.4 percent y-o-y in March 2026. The contraction was particularly severe in fertilisers (-24.6 percent). Below normal rainfall during the south-west monsoon due to El Nino conditions predicted by the Indian Meteorological Department points to the likelihood of an additional adverse supply shock in agriculture.

Thus, real GDP growth for FY 26 is likely to slip below the February CSO estimate of 7.6 percent or projections of 7.3-7.4 percent by RBI, the Economic Survey and the Ministry of Finance if not the IMF and World Bank projections of 6.5 percent. For FY 27 the RBI, IMF and World Bank all project growth of 6.5-6.6 percent. However, the sharp moderation in both demand and supply side indicators suggests that these projected growth rates may not be achieved. The extent of growth moderation and how long it will persist will depend in large measure on how long hostilities continue in West Asia, in particular the blockade of Hormuz

4. Inflation is expected to rise

As a consequence of the West Asia war and blockade of Hormuz, global crude oil price rose by 42.9 percent in March 2026 and to 77.7 percent in April 2026 (Figure 6). However, this came after a long period of low crude prices and was nowhere near the massive crude price spikes seen earlier in 2021 and 2022.

Headline CPI inflation at 3.5 percent was still below the RBI target of 4 percent in April. It had been declining since November 2024 due to falling food and energy prices, and dropped to a low of 0.3 percent in October 2025 (Figure 7). It started rising from November 2025 driven by a revival of consumption demand. Among the

components of headline inflation, food price inflation recorded a turnaround, while price inflation for personal care & misc. services surged to 19.5 percent on account of a sharp rise in gold and silver jewelry prices. LPG gas price rose by 5.3 percent in March 2026 but moderated to 3.03 percent in April 2026. Retail price inflation was negligible at 0.22 percent and 0.04 percent in March for diesel despite the sharp spike in global crude prices. Petrol price inflation inched up by a mere 0.07 percent in April 2026, while the inflation in diesel prices moderated. This was partly due to a reduction in excise duty rates and partly due to the oil companies absorbing losses.

Figure 6: Global crude oil inflation spiked to 42.9 percent in March & 77.7 percent in April 2026 driven by Gulf Crisis

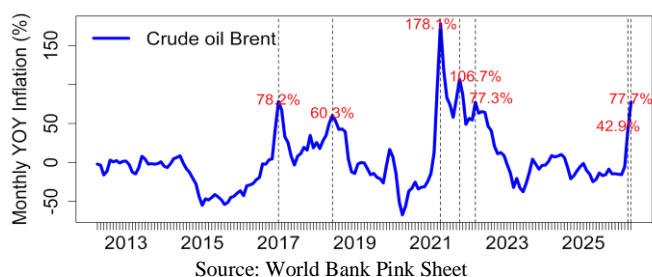
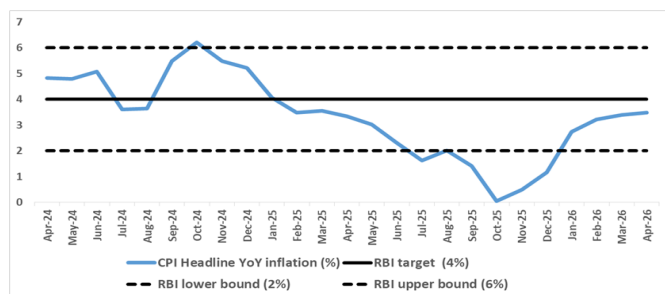


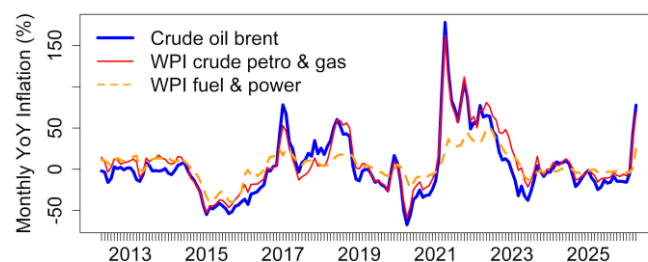
Figure 7: CPI inflation low but rising since November 2025



There is a high and instantaneous pass-through of global crude oil inflation to the inflation of WPI crude petroleum & gas prices, which has a weight of 2.4 percent in the total WPI basket (**Figure 8**). However, the impact on WPI fuel and power (consisting of electricity, coal and mineral oil) is quite muted. This is partly because the mineral oil component is subject to a fixed rate of central excise tax,

which has been lowered. It is also because the administered wholesale price at which POL products are sold by the petroleum companies were not raised until recently. How long the oil companies can continue to absorb losses or the fiscal implications of compensating them is a moot question. In April 2026, following the 77.7 percent global crude oil inflation, WPI crude petroleum and gas price inflation surged to 67.2 percent, while WPI energy inflation was high at 24.7 percent, compared to a mere 1.1 percent inflation rate in March, indicating that refineries and oil marketing companies had started passing on the price increase to mineral oil wholesalers. Second round effects of oil price inflation on the WPI non-energy basket led to 8.3 percent inflation in the overall WPI basket in April 2026.

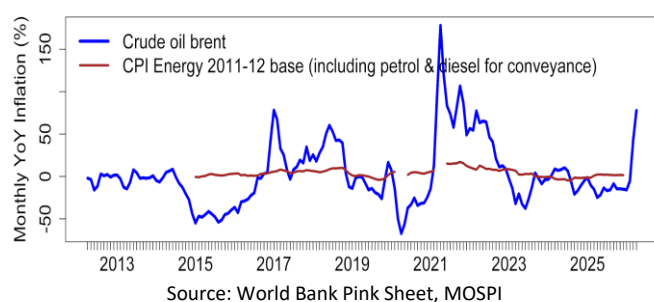
Figure 8: Complete pass-through of global crude oil inflation to WPI crude petroleum inflation, but muted pass-through to WPI energy inflation



On the retail price front, the main direct channels of first round oil shock transmission to retail prices are the basket of 'CPI Electricity, gas & other fuels' (weight 5.36 percent) and the 'Diesel, Petrol and CNG' components in the basket of 'Fuels and lubricants for personal transport equipment' (weight of 4.85 percent). Historically, energy retail price inflation in India has remained muted relative to volatile global crude oil prices due to administered pricing (**Figure 9**). Among the Central Excise rate and State sales tax (VAT), which constitute around 50 percent of retail oil price, Central Excise duty was reduced from Rs. 10 per litre to Rs. 3 per litre in March, while the State sale taxes remained unchanged. Hence, with no pass

through at the wholesale stage and lower taxes at the retail stage, energy retail price inflation in India has remained flat even as global crude prices have surged.

Figure 9: Low transmission of global crude oil inflation to CPI energy with low administered price pass through at the retail stage



In March 2026, while headline CPI inflation was at 3.4 percent, inflation for the basket of crude oil and its derivative was only 0.11 percent (Table 3). From May onwards, there is some pass-through to retail prices of petrol and diesel as the government has allowed the oil marketing companies to increase prices in gradual steps.

Table 3: In March 2026, CPI inflation in the basket of derivatives of crude oil is 0.11%

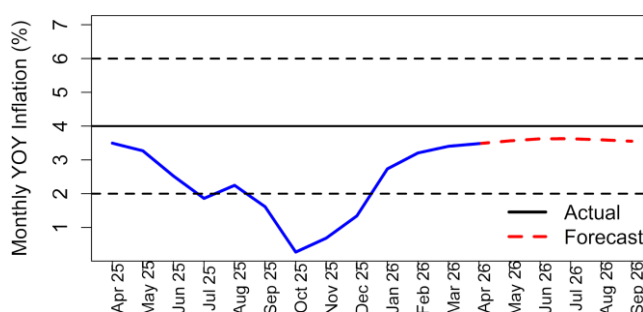
Component	Inflation (%) March 2026	Weight (%)	Contribution to overall CPI inflation (%)
Overall CPI	3.4	100	3.4
CPI LPG	5.3	1.98	
CPI Kerosene	0.87	0.0053	
CPI Kerosene PDS	0.15	0.0044	
CPI Diesel	0.22	0.3167	
CPI Petrol	0.04	4.4887	
CPI CNG	1.78	0.04	
Total			0.11

Source: MOSPI & Authors' estimates

Going forward, despite the upward pressure on inflation, our forecast indicates that headline inflation is likely to

remain within the 2-6 percent tolerance band of RBI in H1 FY27. It is projected to remain below the 4 percent target inflation rate in a benign scenario (Figure 10). The forecasts by RBI for April-June and July-September FY 27 are at 4 percent and 4.4 percent respectively, still below the upper ceiling of the tolerance band. Thus, despite the upside risks of disruptions in supply of oil, gas & fertilizers and rising input & logistic costs, the outlook for headline inflation in FY 27 remains fairly benign. However, if the crisis persists, it is possible that the headline inflation rate may exceed the target inflation rate.

Figure 10: Headline CPI inflation likely to remain within 2-6 percent tolerance band of RBI in H1 FY27



Source: Author's estimate

5. Monetary Policy & Financial Markets

We now turn to our analysis of monetary policy and financial markets in an open economy framework. Analysis of the external sector in open economies is often undertaken in the trilemma framework or 'impossible trinity', i.e., that a country can pursue only one of the following three policy options at the same time: a fixed exchange rate, free capital movement and an independent monetary policy.

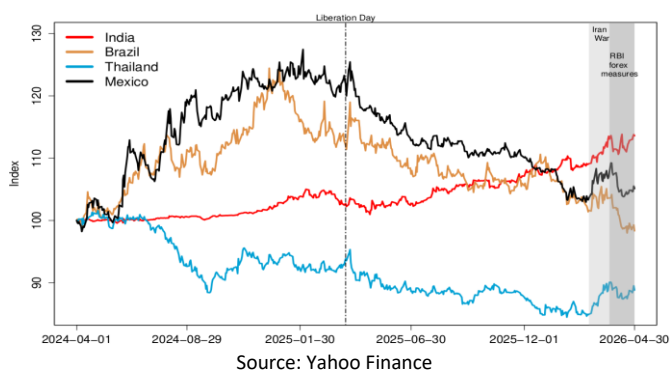
In this section, in the context of the war in West Asia, disruption of oil and other supplies from the Gulf region and strong depreciation pressure on the rupee, we address the question whether India is facing such an impossible trinity. We examine exchange rate movements and RBI interventions in the foreign

exchange market, followed by capital movements on the financial account, balance of payment, and the monetary policy outlook for India in the upcoming months.

Exchange rate movements and RBI interventions

During FY 26 the rupee experienced its steepest fall since 2011 of around 9.2 percent despite dollar weakness while the currencies of other emerging economies appreciated (**Figure 11**). The rupee had been remarkably stable till the first half of FY 2026 while the other currencies were depreciating. It then entered a phase of sustained depreciation while the other currencies started appreciating. In Thailand, the Baht appreciated following the Thailand- US trade deal in October 2025 and revival of the tourism sector. The Mexican Peso appreciated thanks to higher capital inflows, especially FDI, following the United States-Mexico-Canada FTA. The Brazilian Real also appreciated with higher domestic interest rates attracting higher capital inflows. The sustained depreciation of the rupee since Q3 of FY 26 is attributable to repeated tariff and trade related shocks, and the ongoing war in West Asia, which has led to an increase in the current account deficit combined with capital outflow due to a ‘flight to safety’ sentiment among foreign investors.

Figure 11. Indian rupee worst performer vis-à-vis dollar amongst peers in FY26

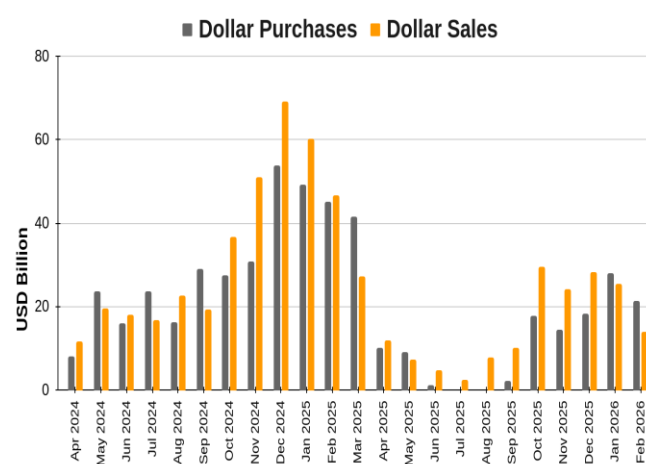


India does not have a fixed exchange rate policy. The announced policy of RBI is that it intervenes in Forex markets only to contain excessive exchange rate volatility

and not to maintain a stable exchange rate. However, as noted earlier, the rupee was remarkably stable during the period leading up to the first half of FY26 while other emerging market currencies were depreciating. The stability of the rupee during this period is attributable to active RBI intervention in the forex market. However, such intervention has not worked since Q3 of FY26 and the rupee has been on a sustained depreciation path, with depreciation accelerating following the war and supply disruptions in the Gulf region,

This is despite heavy RBI intervention in the forex market. During FY26 up until February 2026, RBI net sold \$43 billion in the spot market, higher than \$34.51 billion that it sold during all of FY 25 (**Figure 12**). These interventions continued during March and April 2026, leading to a further \$18 billion decline in Foreign currency assets from \$573 billion at end- February 2026 to \$554 billion at end- April 2026.

Figure 12: RBI interventions picked up in the second half of FY26.

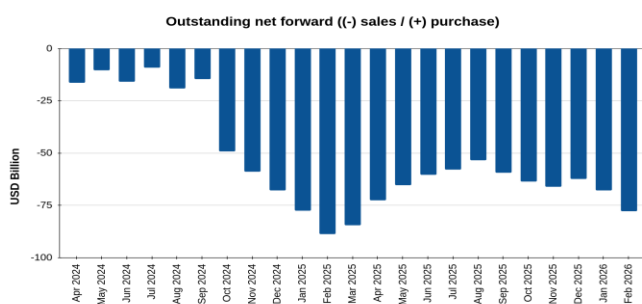


Source: RBI

RBI interventions have included spot market intervention as well as interventions in the forward market. In addition to impacting the stock of foreign currency reserves, spot market interventions also impact Rupee liquidity in the banking system. Interventions in the forward market don't result in an immediate change in dollar reserves

and hence have no impact on money supply. Further, such interventions are not limited by the current forex reserves. Hence, RBI has been actively intervening in the forward market for dollars. In the onshore market it has been selling dollars forward to banks. This makes spot forex reserves look stable even as RBI has pre-committed future dollar supply (Figure 13). Off-shore, in the non-deliverable forward market (NDF) it has been building short dollar positions. It has also been undertaking some extraordinary measures with the outbreak of hostilities in West Asia. All these measures have been undertaken to signal that the rupee is stable. However, the rupee has continued to depreciate and the offshore forward premium (the difference between spot rate of the currency and the forward rate) has been rising, indicating that the market expects the rupee to depreciate further.

Figure 13: RBI took large forward position to curb rupee depreciation



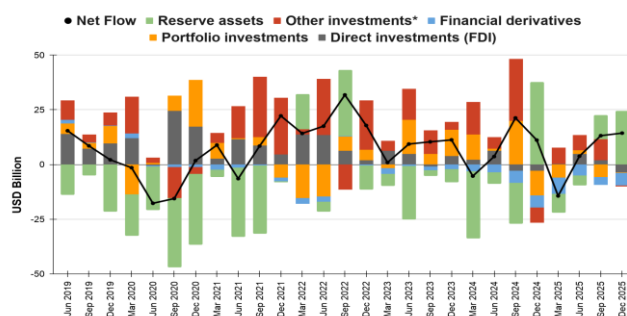
Source: RBI

Capital inflows into India have been mostly declining in recent years

Turning to capital flows, the financial accounts indicate that capital inflow into India has been declining since the quarter ending September 2022 barring an uptick during the quarter ending September 2024. By December 2025 the only component that registered an 'inflow' was Reserve Assets (Figure 14). While net inflows of all the other components were negative Reserve Assets increased, mainly on account of the valuation effect of an increase in gold prices, and the USD/INR buy-sell swaps undertaken by RBI to mitigate the impact of its forex

interventions in the spot market.

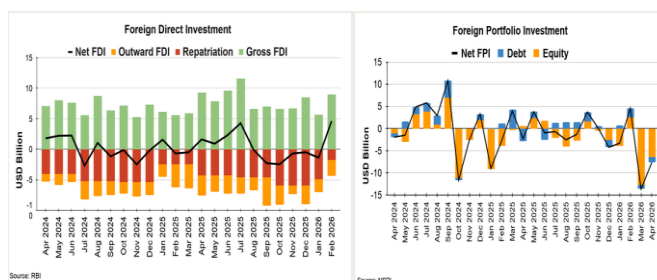
Figure 14: Reserve assets the only positive component of net inflows in financial account



Source: RBI, * Includes NRI deposits, External Commercial Borrowings, etc.

Further, it is very concerning that over the years, there has been a shift from stable sources of funding like net FDI to volatile sources of finance such as external commercial borrowing, NRI deposits and FPI, which can be easily reversed. A closer look at FDI and FPI reveals that gross FDI inflows have been more than offset by profit repatriation and Indian FDI abroad (OFDI) in most months (Figure 15). During Oct-Dec 2025 gross FDI grew by 11 percent y-o-y while Repatriation and OFDI together grew by 13 percent. However, recent data, i.e., for the months of January and February 2026, indicate that net FDI inflows have turned positive. Combined gross FDI has grown by around 26 percent y-o-y, while Repatriation has moderated by 34 percent and OFDI grew by 18 percent y-o-y. Foreign Portfolio Investors (FPI) also turned net sellers in FY 26, with net outflows of nearly \$17 billion when compared with net inflows of about \$3 billion.

Figure 15: Net FDI and FPI flows have turned negative



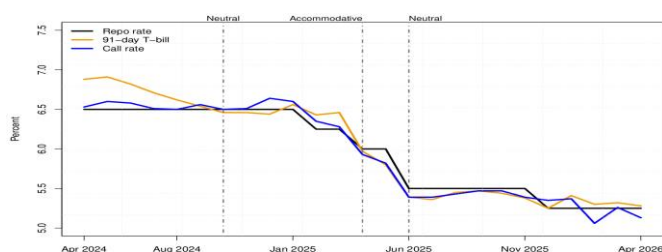
Source: RBI

Source: NSDL

Monetary policy: Neutral stance with a status quo on policy rate since December 2025, Yields rising for government securities.

RBI cut the policy or repo rate by 125 basis points to 5.25 percent between February and December 2025. Since then, it has maintained status quo on the policy rate combined with a neutral policy stance since the June 2025 meeting of the Monetary Policy Committee (Figure 16). Short-term rates have closely tracked the repo rate under conditions of adequate liquidity. Banking system liquidity has had a surplus of Rs. 2 trillion on average in FY 26 on account of liquidity infusion through VRR, OMO purchases, and USD/INR buy/sell swaps.

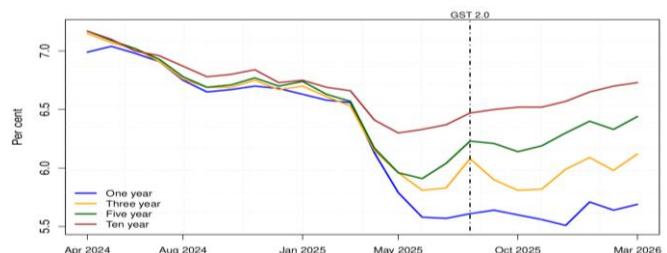
Figure 16: Status quo maintained after significant easing, short-term rates have inched lower than repo rate



Source: RBI

When compared with the first half of FY26, yields on government bonds for all maturities have hardened in the second half with the increased supply of longer-dated central government and state government securities in H2 of FY26, along with expectation of higher inflation (Figure 17).

Figure 17: Rising government bond yields



Source: RBI, CMIE Economic Outlook

Uneven transmission to fresh lending and deposit rates

Transmission of the policy rate cuts till June 2025 to commercial bank lending has been uneven for both public and private sector banks (Table 4). Banks have been cautious in terms of transmission during the easing phase of monetary policy to protect their net interest margins. Further, post August 2025 deposit rates have risen for both public and private sector banks, further constraining the transmission of policy rate cuts. However, transmission has been higher for private sector banks than public sector banks in terms of both lending and deposit rates.

Table 4: Across months and banking sectors, transmission has remained uneven to both lending and deposit rates of scheduled commercial banks

Month	Repo Rate Changes (Basis Points (bps))	Weighted Average Lending Rate (WALR, in %)		Weighted Average Domestic Term Deposit Rate (WADTDR, in %)	
		Public Sector Banks	Private Sector Banks	Public Sector Banks	Private Sector Banks
Feb-2025	25 bps rate cut to 6.25 percent	8.68	10.24	7	6.73
Apr-2025	25 bps rate cut to 6 percent	8.46	10.08	6.73	6.56
Jun-2025	50 bps rate cut to 5.50 percent	7.82	9.74	6.23	5.92
Aug-2025	unchanged at 5.50 percent	8.05	9.43	6.01	5.72
Oct-2025	unchanged at 5.50 percent	7.89	9.44	6.02	5.73
Dec-2025	25 bps rate cut to 5.25 percent	7.61	9.14	6.12	5.85
Feb-2026	unchanged at 5.25 percent	7.84	9.16	6.21	5.87
Total Transmission (bps)	125	84	108	79	86

Source: RBI

Outlook for monetary policy

Given the above background, how is India likely to navigate between the three poles of the policy trilemma? First, India does not follow a fixed exchange rate policy. However, it is continuing to intervene heavily, albeit not very successfully, in the foreign exchange market to contain depreciation of the rupee. Instead of using up limited forex reserves to shore up the rupee it may be best to let the rupee find its market clearing level, which

will also induce expenditure switching and reduction of the current account deficit.

Second, India has a partially open capital account and is currently facing the 'flight to safety' of capital due to the war in West Asia. However, bond yields which are already moving up may help to contain this outflow of capital. Raising rates and a tight money policy would add some tail wind to that process.

Third, as discussed in section 2, the West Asia crisis and Hormuz blockade has created severe supply constraints leading to a sharp increase in the price of crude oil and other imports from the gulf region. This imported inflation is pushing up the domestic WPI inflation rate though the CPI headline inflation rate is still quite benign due to limited pass through and reduction of excise duties on fuel. If the crisis persists and more pass through is to retail fuel prices is allowed to protect the balance sheets of the OMCs, the inflation rate could breach the target inflation rate. Even if the crisis eases, it will take some time before already embedded inflation expectations taper away. Further, as discussed in section 6 below on Fiscal Policy, central government borrowings are projected to rise by nearly 10% to Rs. 16 trillion in FY 27, implying sustained supply pressures on already elevated bonds yields. Unrealistic revenue projections in states' budgets imply that they will have larger than anticipated budget deficits and their borrowings are also likely to increase sharply. Meanwhile demand for government debt is likely to remain subdued due to high uncertainty. This mismatch and excess supply is likely to further increase government bond yields¹. Rising inflation and excessive government borrowing also point to the need for raising policy rates and tightening monetary policy. Thus, the required policy response on all three poles of the policy trilemma are in the same direction. India is neither facing a trilemma or a dilemma at present.

¹ However, this could be moderated because of inclusion of Indian government bonds in the Bloomberg global aggregate

6. Fiscal Outlook for Central and State Governments

In this section, we address three questions relating to the fiscal outlook for the central and state governments:

- i. What will be the impact of 16th Finance Commission recommendations on state government finances?
- ii. Are Central and State budget projections realistic compared to past performance?
- iii. Are government finances (Centre plus States) on a fiscal consolidation path?

i. Impact of 16th Finance Commission recommendations on state government finances

This is not an overall assessment of the recommendations of the 16th Finance Commission (FC). Instead, we focus on a specific aspect, namely, how different categories of states are affected by the recommendations of the Commission.

The 16th FC has retained the States' share at 41 percent of the divisible pool (i.e. tax revenues that are shareable with the states). However, this appearance of continuity is misleading since the share of the divisible pool in gross tax revenue (GTR) of the central government itself is shrinking. This is due to the proliferation of Central cesses and surcharges which are not shareable with the states. The share of the shareable pool is down from 89.8 percent in 2011-12 to about 79.5 percent in 2023-24. In other words, the vertical devolution of GTR has been shifted significantly in favour of the Centre vis-à-vis the States.

Second, for determining individual states' share (i.e., horizontal devolution) the Commission has used several criteria (with associated weights) as presented in **Table 5**.

Index, which could lead to some extra demand for Indian government bonds.

Table 5: Formula for Horizontal Distribution

Criterion	Weights (%)
Population (2011)	17.5
Area	10.0
Income Distance	42.5
Forest	10.0
Demographic Performance	10.0
Contribution to GDP	10.0

Source: 16th FC Report

Three of these are particularly important for their differential impact on different states. Contribution to GDP, Forest cover and Area.

(i) *Contribution to GDP*: Though allegedly a measure of efficiency, this indicator actually captures the economic size of states. Hence, the smaller and economically weaker states lose out on account of this criteria;

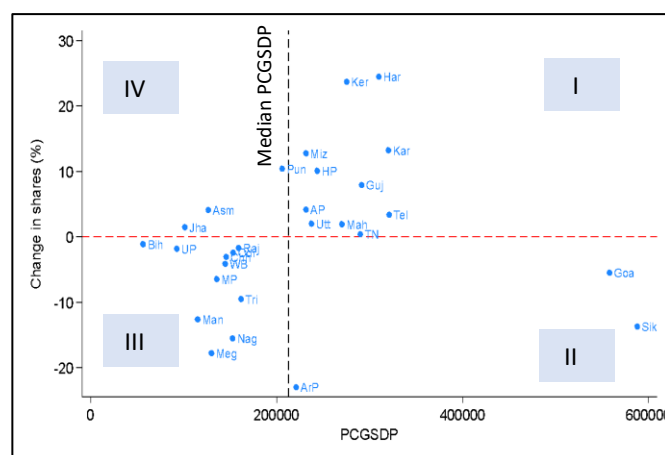
(ii) *Forest Cover*: The Commission has diluted the forest cover criteria by including open forest. The genuinely densely forested states, especially those in the north-eastern, have lost share due to this dilution.

(iii) *Area*: Small states incur a certain minimum cost in establishing the framework of government machinery. To protect such states the 10th FC provided that a minimum of 2 percent share would be counted for all states with less than 2 percent of geographical area of the country. This floor has been reduced to 1.5 percent by the 16th FC, again adversely impacting the smaller states.

It is routine that with any change in the horizontal devolution formula, some states gain and others lose in their shares since the total share is 100 percent, a zero-sum game. However, it is observed that the 16th FC formula is very inequitable: the shares of mainly the poorer states and north-eastern states have fallen while that of the richer states has risen. In **Figure 18** states lying below the dashed horizontal line are states whose shares have declined while those above the line gained shares. The vertical dashed line represents the median per capita income of states (PCGSDP). States to the left are states

with below median PCGSDP while those to the right have PCGSDP higher than the median. Note that the states are concentrated in two quadrants – Quadrant-I and III. Those in Quadrant-III are those which lost devolution shares and have per capita income below median per capita income. Most of the north-eastern states also fall in this quadrant. States in quadrant-I are high per capita income states which gained devolution shares.

Figure 18: Cross-state Scatter of per cent change in states' share against Per capita GSDP



Source: Author's derivation using 15th and 16th FC Reports; GSDP data from MoSPI

ii. Are Central and State budget projections realistic compared to past performance?

Central government

Growth of gross tax revenues (GTR) of the central government during FY26 (Apr-Feb) fell to 6.7 percent, down from 10.9 percent in Apr-Feb FY25. Hence the assumed growth of 8 percent in the FY 27 budget seems optimistic. Among components, Corporation tax growth accelerated to 12.4 percent in FY 26 and the growth in union excise and customs duties were high at 11.3 and 18 percent respectively. The decline in GTR growth was mainly due to a sharp decline in income tax growth (0.9 percent) and moderation of CGST growth (6.1 percent) as evident from **Table 6**. These two taxes account for over 56 percent of GTR on average. Income tax growth fell because the exemption threshold was raised in the FY 26

budget. Despite this the FY 27 budget assumes income tax growth of 11.7 percent.

In September 2025, GST rates were rationalised wherein rates of several goods and services were reduced while they were raised for a few. This moderated the growth of CGST revenues during FY 26. The FY 27 budget assumes a modest GST growth recovery to 6.3 percent while Corporation tax is assumed to grow at 11 percent and excise duties at 15.6 percent. This implies a buoyancy >1 for both, which is consistent with FY 26 performance. However, the excise duties are likely to fall short of the budgeted target due to the recent reduction in petroleum and diesel duties undertaken to protect retail consumers from the spike in petrol and diesel prices on account of ongoing West-Asia crisis. Non-tax revenue growth was high at 17.8 percent during FY25. This was mainly due to the enhanced dividend from the Reserve Bank of India. The FY 27 budget assumes non-tax revenue to fall in absolute terms vis-à-vis FY 26.

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

Indicators	Y-o-Y growth (%)		2026-27BE over 2025-26RE
	2024-25 Apr-Feb	2025-26 Apr-Feb	
Nominal GDP	9.7	8.6	10
Centre's Net Revenue*	13.5	8.7	5.7
Gross Tax Revenue	10.9	6.7	8
Corporation Tax	1.9	12.4	11
Income tax	22	0.9	11.7
Union Excise duties	(-1.4)	11.3	15.6
CGST	11.1	6.1	6.3
Customs duty	4.2	18	5
Non-Tax Revenue	36.9	17.8	(-10.2)

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, the assumed growth in total and revenue expenditure in 2026-27BE are much higher than during the last two years as is evident from **Table 7**. Among components, capital expenditure is projected to growth at 11.5 percent in FY 27 as compared to actual

growth of 14.5 percent during Apr-Feb FY 26 while major subsidies, i.e., subsidies on food, fertilizer and fuel are budgeted to decline by (-)4.5 percent compared to growth of 7.3 percent during 2025-26. However, these assumptions are likely to be belied and the subsidy bill is likely to rise as the West-Asia crisis driven increase in petroleum and fertilizer prices are not being fully passed on by the government.

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

Indicators	Y-o-Y growth (%)		2026-27BE over 2025-26RE
	2024-25 Apr-Feb	2025-26 Apr-Feb	
Total Expenditure	3.9	3.9	7.7
Revenue Expenditure	4.7	1.1	6.6
Capital Expenditure	0.8	14.5	11.5
Major Subsidies	0.6	7.3	(-4.5)

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

The unrealistic revenue projections coupled with expected increase in subsidies would imply an increase in the fiscal deficit (FD) of the central government. However, the actual FD during FY 26 (April-February) is considerably lower than both the budget estimate (BE) and revised estimates (RE) of FY 26. On balance, we expect that the FY 27 target is likely to be achieved through compression of expenditure, especially capital expenditure.

The States

Setting aside large inter-state variations, the assumed own revenue receipts growth of 13.3 percent for FY 27, aggregated across all state governments, seems unduly optimistic compared to 5.7 percent growth during Apr-

Feb FY 26 and 8.6 percent during Apr-Feb FY 25 (**Table 8**). Own-tax revenue, which accounts for about 86-87 percent of own revenues on average for all states, is budgeted to grow at 14 percent in FY 27. Growth of this key component of states' revenue decelerated to 4.7 percent during Apr-Feb FY 26, down from 9.4 percent during the same period in FY 25. Hence, the projected growth of own-tax revenues for FY 27 seems unduly optimistic given recent past performance in own-tax mobilisation. The growth in SGST revenues fell sharply to 1.6 percent during Apr-Feb FY 26 due to the rationalisation of GST rates from 22 September 2025. However, in FY 27, states in aggregate have budgeted SGST revenue to grow by more than 15 percent which is again unduly optimistic.

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

Indicators	Y-o-Y growth (%)		2026-27BE over 2025- 26RE
	2024-25 Apr- Feb	2025-26 Apr- Feb	
GSDP	12.2	10.2	12.1
Total Revenue Receipt (TRR)	8	3.9	12.6
Own Revenue Receipt (ORR)	8.6	5.7	13.3
- Own Tax Revenue (OTR), of which	9.4	4.7	13.9
- SGST	12.5	1.6	15.2
- Own Non-Tax Revenue (ONTR)	2.7	13.8	9.8
Central Transfers (CT)	7.2	0.7	11.7
- Devolution	17.9	3.4	10.7
- Grants-in-aid	(-)18.2	(-)8.6	14.1
Total expenditure	9.3	8.5	9.3
Revenue expenditure	11.1	8	8.3
Capital expenditure	(-)1.5	12.6	14.5

Source: Comptroller and Auditor General of India (C&AG); 2026-27 Budget documents of 26 states

Central transfers, the other main component of states' revenues, is budgeted to grow at 11.7 percent in 2026-27 which is much higher compared to the past performance as evident from Table 8. However, it is quite consistent with the assumed growth in transfers (Finance Commission and centrally sponsored scheme transfers) of 11.8 percent in the central government's budget. Central grants to states during Apr-Feb FY 26 contracted by (-)8.6 percent on top of a massive contraction of (-)18.2 percent during FY 25. For FY 27, the all-states combined budget indicates a 14.1 percent increase in grants, which again seems unduly optimistic compared to recent past performance.

As indicated above, the revenue projections of the central government for FY 27 seem unrealistic. Any fall in revenues of the central government will also further adversely impact central transfers to states. The central government has replaced the Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS) with the Viksit Bharat-Guarantee for Rozgar and Aajeevika Mission (Gramin) (VB-GRAMG). Unlike MGNREGS, VBGRAMG is not a demand driven scheme. Further, states' share has been enhanced to 40 percent in the scheme. Given the unrealistic revenue projections of states, uptake of CSS grants by states may fall if states are unable to meet their share in CSS, especially the new CSS VBGRAMG which accounts for about 18.4 percent of total CSS allocation. This would result in growth of grants to states falling short of the budgeted growth.

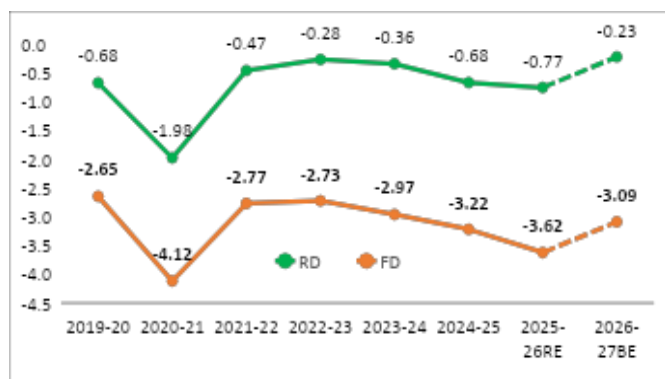
On the expenditure side, we find the expenditure projections, including revenue and capital components, to be consistent with recent past performance. Total expenditure growth of all-states is projected at 9.3 percent during 2026-27 compared to a growth of 8.5 percent during Apr-Feb FY 26 and 9.3 percent during Apr-Feb FY 25. Revenue expenditure is projected to grow at 8.3 percent in FY 27 compared to growth of 11.1 and 8.0 percent respectively during FY 25 and FY 26. Capital expenditure, which contracted by (-)1.5 percent during Apr-Feb FY 25 grew by 12.6 percent during Apr-Feb FY 26 and is projected to grow at 14.5 percent in FY 27.

While the 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 overshoot the all-state combined fiscal deficit of around 3.1 percent of GSDP budgeted for 2026-27. Factoring in the likely adverse impact of the West-Asian crisis on states' own revenues and central transfers may lead to further overshooting of the estimated FD, though some expenditure compression could moderate this.

iii Are government finances (Centre plus states) on a fiscal consolidation path?

The 'all-states' fiscal deficit (as percent of GSDP) gradually increased from 2.7 percent in FY 23 to 3.6 percent in FY 26(RE), indicating a loosening of fiscal prudence (Figure 19). The projected reduction to 3.1 percent in 2026-27 is based on unduly optimistic revenue projections and is unlikely to be realised.

Figure 19: Deficits – States (per cent of GSDP)

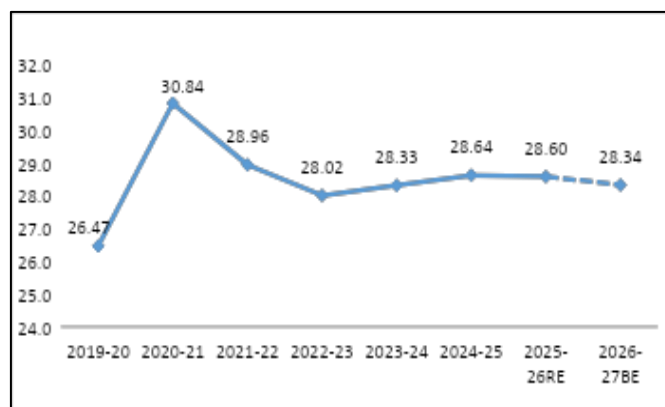


Note: Deficit (-)/ Surplus (+)

Source: Finance Accounts and 2026-27 Budget documents of states

The combined outstanding liabilities of all states is also higher at 28.6 percent in FY 26(RE) compared to the pre-pandemic level of 26.5 percent (Figure 20). Thus, from a medium-term perspective, fiscal consolidation is seen to be moving in reverse gear in the states.

Figure 20: Outstanding Liabilities – States (per cent of GSDP)

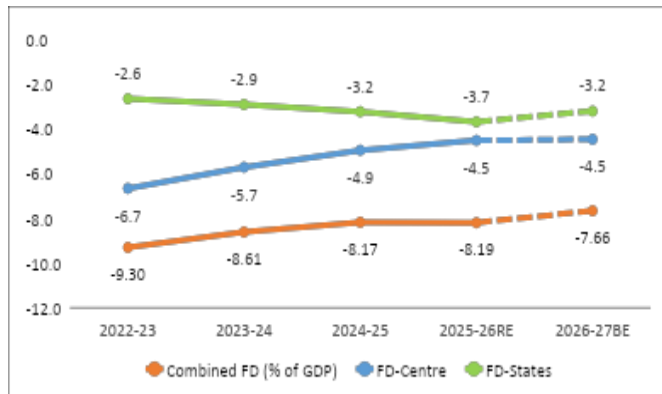


Source: Finance Accounts and 2026-27 Budget documents of states

Figure 21 presents the combined fiscal deficit (Centre + States) as a proportion of GDP. The RE for FY 26 indicates that consolidation at the central level was offset by higher deficit levels of the states leaving a combined fiscal deficit of 8.2 percent in FY 26, the same as in FY 25. Hence, the combined fiscal deficit target of 7.7 percent for FY 27 seems aspirational, with little reason to assume that it will be achieved.

From the 2025-26 budget, the central government shifted to a new fiscal consolidation framework with debt-to-GDP ratio as the key monitoring indicator. Since the 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 within the new fiscal consolidation framework. In its FY 26 budget the central government announced a new fiscal consolidation roadmap aimed at achieving a central debt-GDP ratio of 50 ±1 percent by 31 March 2031.

Figure 21: Fiscal Deficit – Centre, States & Combined
(per cent of GDP)



Source: Finance Accounts and Budget documents of Central and State Governments

The central government's debt stood at 56.5 percent in FY 27(BE). To meet the 2030-31 target of 50 percent, the debt-GDP ratio has to fall by 1.6 per cent every year. This is unlikely to be met. Evidently, governments both at the centre as well as the states are already off the fiscal consolidation path. When the adverse fiscal impact of the ongoing war in West Asia is factored in, the combined government will deviate even further from this path. It is important at this stage to consider alternative scenarios about how long the war and disruption will persist and prepare contingent fiscal consolidation road maps accordingly.