DBS Flash

India: Growth, liquidity and policy response

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- *High frequency indicators might keep 2QFY growth close to 7%.*
- *Pace to moderate in 2HFY.*
- *Retail inflation is likely to continue rise and broaden in scope, necessitating a tighter policy bias. WPI likely to rise by double-digits.*
- *Special swap windows helped to stem bearish INR positioning.*
- *Organic capital flows need to catch up.*
- *Liquidity management is in focus, with a moderate correlation to inflation.*
- *Twin-deficit risks are partly offset by stronger macro buffers.*

GROWTH MOMENTUM TO SUSTAIN, EXTERNAL RISKS LINGER

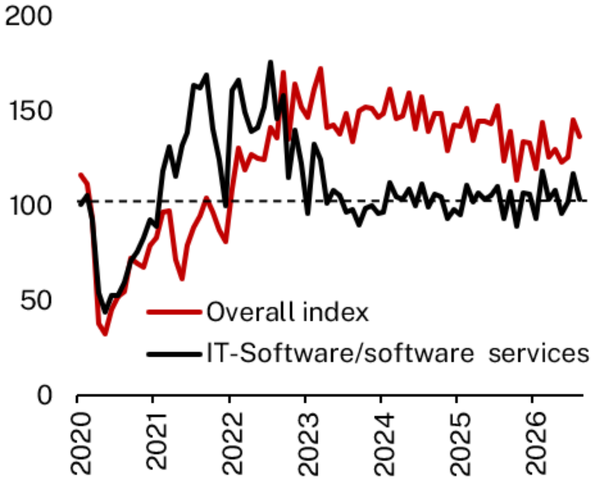
India registered strong growth at the start of FY27. Sustaining this performance will depend increasingly on how effectively it navigates a more uncertain global environment. Besides trade fragmentation, geopolitical tensions leading to higher energy prices, and shifts in international capital flows present key external risks.

India joined its Southeast Asian peers in posting an upside surprise on growth in 1QFY27 (Apr-Jun26), up a firm 7.8% yoy. few points of note:
A) strong 1Q growth print reinforced the view that India's domestic demand cycle was more resilient than initially assumed, with consumption, public capex and manufacturing providing a solid base despite external shocks.
B) prevailing tailwinds by way of indirect tax relief in 4Q25, real rate buffer, and easier monetary conditions (earlier cuts), were also supportive;
C) nominal GDP growth returned above 10% after two years on higher deflators, though some segments like manufacturing faced negative deflators as input prices rose at a faster pace than output due to commodity price increases and import intensity;
D) Revisions to backdated numbers, to account for output PPI series, pushed up FY26 growth to 7.8% (from 7.7% earlier). Two prior years were also revised.

High-frequency indicators

Into July-August, high frequency indicators are holding up, including GST e-way bills, indirect tax revenues, electricity demand and growth in digital payments, while toll collections and petroleum consumption slipped. **For demand**, a contained extent of increase in retail pump prices shielded households from the surge in global crude prices, but other market linked fuel variants have climbed in recent months. On the employment front, job reductions were witnessed in the software sector, even as fresh opportunities were reported in global capability centres, electronics/ semiconductors, healthcare, auto/ ancillary etc. Wage growth in services has improved, manufacturing has been steady, while farm sector moderated, according to consumption surveys by CMIE.

Naukri Jobspeak (sectoral); indexed to 4Q19



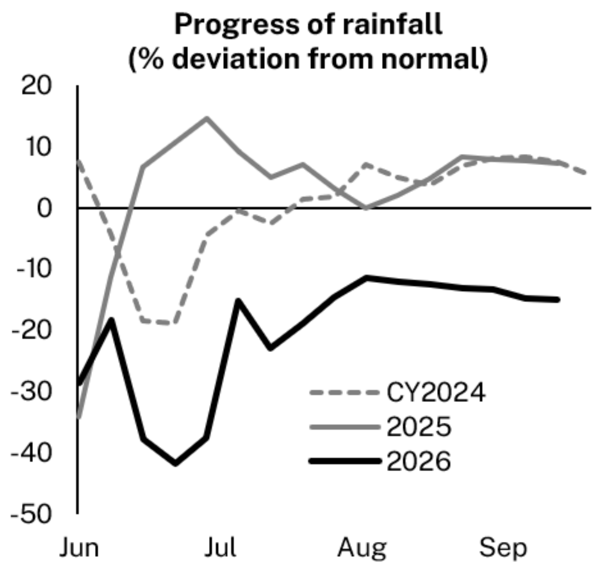
Source: CMIE, Naukri, DBS

Industry indicators are a mixed bag, with PMIs maintaining their foothold in the expansionary terrain, while production and eight core index growth come off highs. Auto production continues to expand, though output and sales might moderate in the next quarter on base effects due to indirect tax cuts in the same time year ago. Forward-looking firm surveys have improved, after initially coming under pressure.

RBI forecast - Industrial outlook survey

Source: RBI, DBS

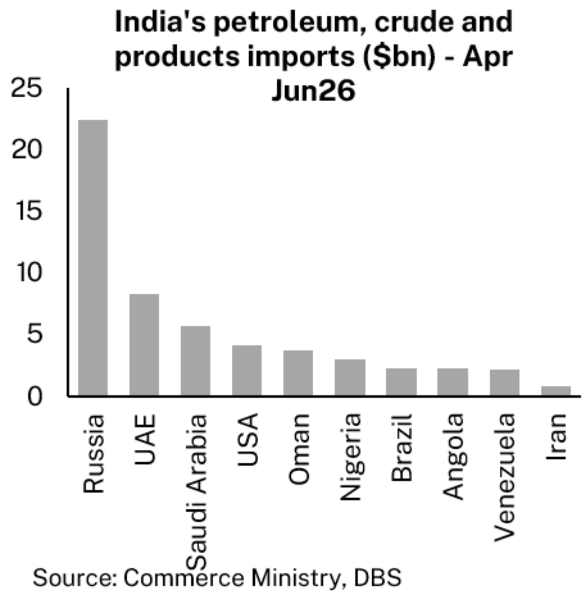
Sectors associated with rural demand might moderate amid weaker kharif sowing activity and lower reservoir levels impacting the rabi crop activity. Cumulative southwest monsoon is ~15% below the long-term average by tail end of the season. This takes the country on course to face its driest monsoon since 2009 (which was 18% below LPA). Uneven geographical spread is notable, with south and east India registering nearly 25% shortfall. While kharif sowing is on track with 99% of acreage completed, the winter crop might come under pressure as weather developments suggest El Niño could extend into 2027.



Source: IMD, CMIE, DBS

With nominal GDP growth to track 11-12% this fiscal year, corporate earnings growth is expected to fare better than recent few years. 1QFY27 performance had already set off the year on a strong note, barring selected sectors like O&G which faced sequential marginal pressures from operating costs. Add to this, the centre's capex growth is in firm double-digits, also backed by growth in core imports (non-oil non-gold).

On the external sector, despite better performance by exports, oil and electronics purchases have weighed on the goods math. **The trade deficit** is set to stay wide amidst elevated global crude cost, higher industrial fuels, cooking gas etc, even as a wider mix of suppliers have addressed energy shortages. **Notably, the net electronics deficit has widened considerably,** just as exports have improved. Likewise, core imports (ex oil ex gold) have stayed firm, which partly feeds into higher exports as well as broader domestic demand. Monthly service trade surplus has been rangebound around $17-18bn in recent months dwarfed by $25-$30bn goods gap.



Source: Commerce Ministry, DBS

Maintaining growth forecasts

High frequency indicators put 2QFY growth close to 7%. **We expect full year FY27 growth to average 7.3% yoy** from a revised 7.8% in FY26, assuming moderation in the momentum in the second half of the year on tighter policy conditions, lagged impact of high energy prices and base effects from indirect tax cuts last year fade. Assuming some spillover impact of exogenous uncertainties and tight financial conditions at home, we expect FY28 growth to average 6.8-7.0%.

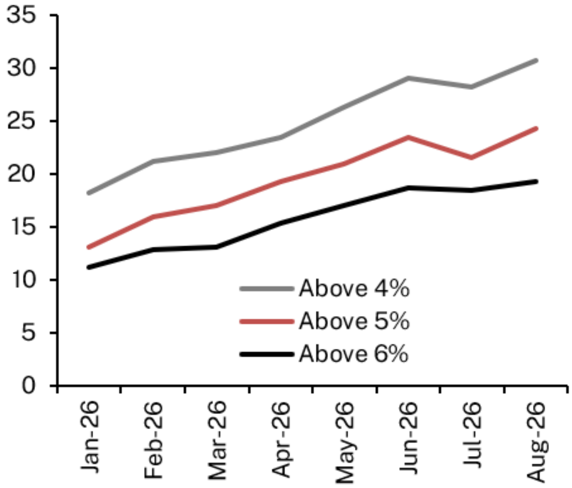
INFLATION OFF ITS BACK – THREE CATALYSTS

After two years of benign inflation, India's price trend is off its back this year, mainly on the back of three

catalysts: Food, energy and early signs of demand pass through.

Aug inflation rose to a 20-month high of 4.8% yoy from 4.5% month before. As the chart highlights, number of sub-segments growing by faster than the inflation target at 4% have continued to climb, pointing to a broadening out in the momentum.

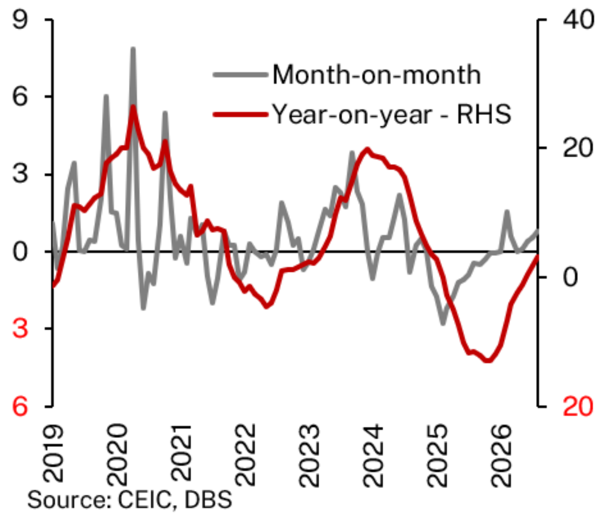
Percentage of CPI-segments above the target range mid-point



Source: CEIC, calculations are by DBS

Food inflation is gradually becoming more broad-based, shifting beyond vegetables and pulses to sugar, milk, protein groups, edible oils, amongst others. Sub-par weather has contributed to this upmove, besides idiosyncratic factors like swing in production trends, diversion for fuel usage etc. After two years of normal monsoon, cumulative southwest rainfall this year is currently 15% below the long-term average, alongside slower build-up in reservoir levels, which could impact upcoming rabi crops as well. El-Nino patterns continue to strengthen, adding to seasonal swings and risk of impacting farm output.

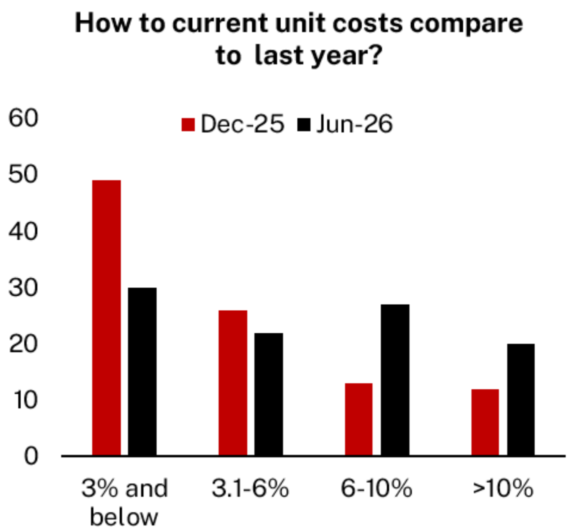
Pulses and products - inflation (average of 4 common varieties)



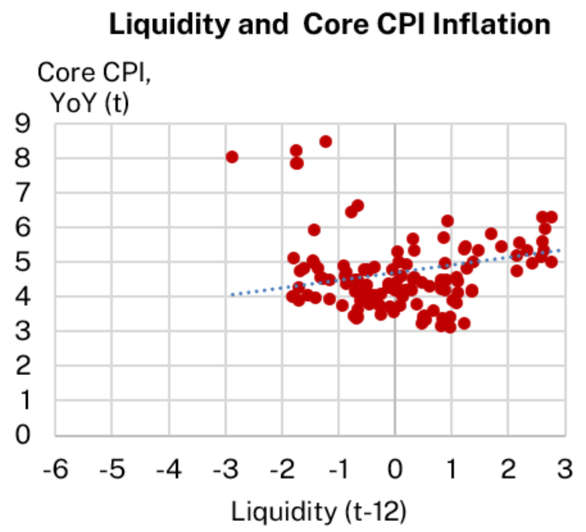
Source: CEIC, DBS

Beyond food, global oil prices have averaged ~$91pb in CY26, staying above $100pb for much of Seo26. Retail fuel prices were adjusted in quick succession back in May26 and have been left unchanged since then, while CNG, aviation fuel, LPG etc have continued to climb.

Transport inflation jumped to 4.6% yoy in Aug vs 0.1% in Jan26, besides utilities' component inching up. Business price expectation surveys (conducted by IIM Ahmedabad) have, nonetheless, captured businesses facing a notable increase in fuel costs, especially industrial fuels, base metals and derivative product groups. Imported price pressures are most notable in the producer price/ wholesale price indices. These gauges have been hovering at 9-10% yoy in recent months.



Source: BIES Survey, IIM Ahmedabad



Source: CEIC, BBG, DBS. Core CPI inflation ex food, fuel and light.

Lastly, core inflation (ex-food and fuel) rose to 1.5-month high in August, mainly due to a sequential rebound in precious metals – gold and silver jewellery. Excluding precious metals, the reading was more moderate at 2.9%, pointing to some extent of economic slack. Nonetheless, other pockets like telecom, restaurants, business services, transport fares etc have been inching up, reflecting early signs of broadening in price pressures (on sequential basis), warranting attention. These are set against the backdrop of strong bank credit growth, flush INR liquidity and resilience in headline growth.

Our correlation analysis between liquidity (as % of NDTL) and core inflation – see chart, points to a positive but modest corelation at 0.4 between the two variables, with an assumed year-worth lag on inflation. The inflation-fighting mandate will also push the central bank to reduce the surplus liquidity in the domestic system.

A sharp in global commodity prices is expected to feed into the wholesale price gauge, pushing up readings to double-digits next quarter.

A gradual broadening of price pressures is likely to keep headline inflation above 5% in second half of the fiscal year, sharply narrowing the real rate buffer, underscoring the need for a tighter policy bias. Add to this, recent developments, including a sustained rise in crude prices, tightening global financial conditions, firm domestic growth and signs of broadening in core pressures, strengthen the case for a shallow 50bp hike in second half of FY27, making October's meeting a live one.

TACKLING LIQUIDITY DELUGE, HIGHER YIELDS

Beating street estimates by a wide margin, the RBI's special swap windows raised a cumulative $143bn into Sep, with the highest contribution (~92%) by

FCNR(B) deposits at $133bn, while rest were via offshore borrowing facilities. These flows pushed up the foreign reserves stock to a fresh high past $780bn, providing considerable firepower to defend the currency. This is already noticeable in the recent shift in the intervention bias. USDINR, which was earlier stubbornly steady in the face of strong FCNR inflows but eased sharply due to strong intervention dollar sales and broader dollar swings, before being led higher due to external triggers.

Liquidity is a key watch factor. Given the swap arrangement, these inflows have added to already abundant INR liquidity backdrop, which was at a four year high, depressing overnight rates. The banking system surplus jumped past INR 10trn surpassing 2022 and Covid highs, with the durable balance widening sharply higher to INR 14trn, suppressing overnight call rates. This compares to average INR 1trn surplus in late-June.

While organic drivers like tax-related outflows, and seasonal currency leakage, in addition to CAD, portfolio outflows, and maturity of the forwards book will act as counter-balancing factors, yet concerted steps were required to drain the potential surge in liquidity.

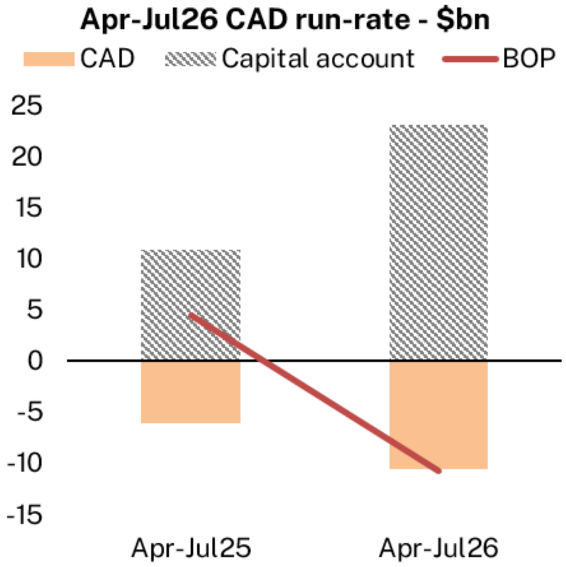
We discussed the various seasonal, near-term and permanent measures that the central bank might consider (see FCNR bonanza necessitates deft management) to absorb this surfeit. **Policymakers are being mindful of both the liquidity and signalling effects of the sterilisation tools at their disposal.** The RBI utilised tranches of market operations like VRRR across tenors, after which three tranches of open market operations (bonds maturing FY29 and FY32) worth a cumulative INR 1trn were conducted. These announcements fuelled a rise in yields, which were already inching up, tracking global counterparts. Sell/buy FX swaps for shorter rollovers were also being reportedly tapped.

When the dust settles, focus will also be on the bunched-up maturities that will fall due in 3Y and 5Y tenor of the deposits. A portion of the existing reserve stock could be earmarked against these liabilities, helping to mitigate concerns that deposit maturities or debt repayments could trigger a sharp increase in dollar demand and exert pressure on the FX market down the line. In the near-term, priorities will be to manage liquidity, gradually lower the sizeable forwards book, and support the domestic currency. Long-end yields continue to be influenced by the hardening global yields.

BALANCE OF PAYMENTS MATH TO BE COMFORTABLE

The FY27 current account math is expected to display two key counter trends, Firstly, the wider goods trade imbalance will raise the FY27 current account deficit. Secondly, the counterbalancing effect of a sharp improvement in the capital flows math will keep the annual balance of payments math in surplus.

India recorded a current account deficit (CAD) of $10.5bn during April-July 2026, compared with $6.1bn in the corresponding period last year. The deterioration was driven almost entirely by a wider merchandise trade deficit, which rose to $117.8bn from $97.1bn a year ago. Part of this offset by higher income, transfers and capital account flow. Capital flows found support from net FDI, portfolio investments and banking capital, especially NRI deposits (jumped sharply to $36bn vs $4.6bn same period last year), pushing up Apr-Jul26 BOP to $12.7bn surplus, more than double of $4.8bn same time last year.



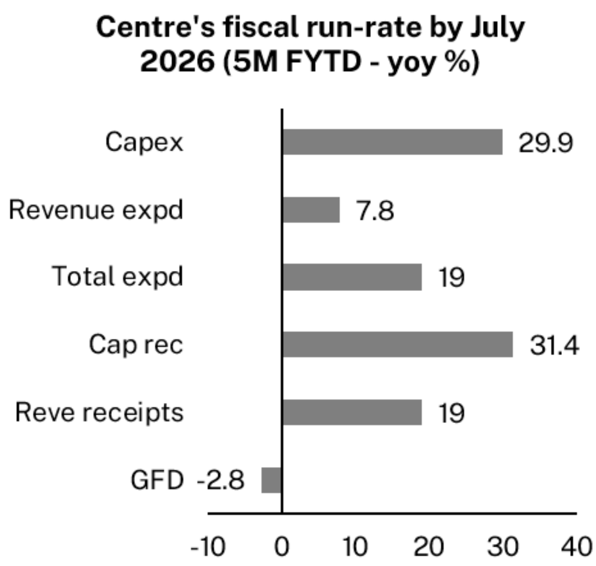
Source: CEIC, DBS

Oil prices are the main swing factor for the CAD this year, with the current run-rate tracking our forecast at -1.1% of GDP for FY27. This suggests that the widening in the CAD is commodity-price related rather than driven by higher demand.

On the other hand, capital flows are being buttressed by the special swap windows introduced by the central bank, which raised a cumulative $143bn between June and August, through non-resident deposits and external borrowings. This has helped to fill the gap from subdued portfolio flows and net investment trends. **We expect FY27 current account deficit to track -1.1% of GDP in FY27, with the balance of payments to register upwards of $80bn surplus (vs -$23.6bn deficit last year).** Into FY28, the dependency of capital flows on organic drivers like portfolio flows and FDI is set to increase, underscoring the need for higher vigilance.

FISCAL RUN-RATE

The FY27 fiscal run-rate points to a stronger revenue momentum, which has helped to keep the FYTD deficit in check, even as expenditure was frontloaded owing to subsidy payments and capex disbursements. April-July 2026 deficit stands at a third of the full-year balance.



Source: CGA, CEIC, DBS

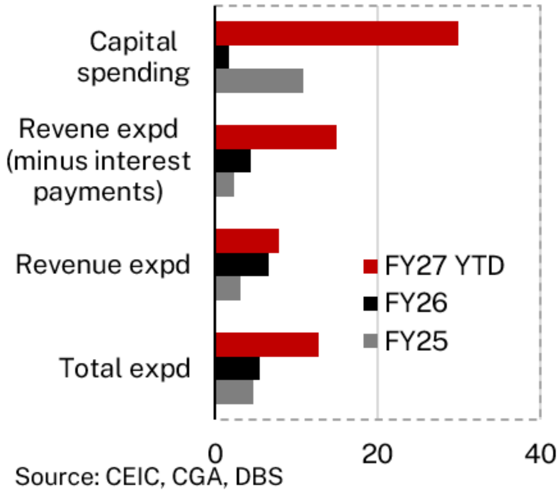
Both tax and non-tax receipts fared better than the comparable period year ago, helped by stronger corporate tax collections, STT transaction revenues, and RBI dividend, amongst others.

Setting 2QFY for a strong start, net direct tax collections rose 13% yoy by mid-Sep26, driven by net corporate tax collections up 19.5%. Net non-corporate tax collections were up 6%, besides STT collections up a sharp 53% yoy. Add to this, divestments have also fared better than expected this year, with ~78% raised by August, accompanied by dividends & profits (at 83% of budget by Jul26).

Under expenditure, about 33% of the full year allocation was allocated by July 2026. The subsidy outgo rose sharply, up 35% yoy, led by higher food at 23% and fertiliser at 46% (already accounting for nearly two-third of the full year budget) led by surging global DAP and urea prices. With global prices remaining high, the actual outgo might be higher than budgeted INR 1.7trn, likely towards INR 2.5trn. Capital spending also remained apace, up 30% yoy in first five months of the year.

Overall, strong growth in tax and non-tax receipts allowed the centre to sustain higher spending while containing the extent of fiscal slippage until July 2026 (FYTD). A strong nominal GDP rate (helped by higher inflation) will also provide a favourable denominator effect.

Central government expenditure - (% FYTD yoy)



Source: CEIC, CGA, DBS

IN SUM

The economy exhibited resilience in the face of a tough external environment in the first quarter, with part of that stability likely to extend to 2QFY27 as well. Tighter monetary conditions, El Nino impact and base effects from passage of post-indirect tax jump will moderate headline growth in 2HFY. Nonetheless for the year, we expected growth to stay north of 7%, factoring in a strong start.

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