AXIS BANK

Economic Research | India

Outlook 2026: Look! Growth above trend but low inflation

December 10, 2025
Economic Outlook 2026

With fiscal and monetary headwinds receding, GDP growth has picked up in FY26. In FY27, the pace of fiscal consolidation should slow further (20bps), and lagged effects of monetary easing should become visible, pushing growth to 7.5% (above trend). Regulatory reforms are likely to continue, supporting upgrades to trend-growth assumptions. Given the economic slack, the economy can sustain above-trend growth for a few years before inflationary pressures build up. Together with better management of the duration of bonds issued, and growing demand, 10-year yields can drift down to 6.1%, in our view. With the REER falling sharply, and BoP trends supportive, we expect INR depreciation pressures to abate.

Exhibit 1 - FY27E: India growth accelerates to 7.5%; inflation likely to average ~4%

Key macro indicators	FY23	FY24	FY25	FY26E	FY27E
GDP growth (%)	7.6	9.2	6.5	7.5	7.5
Average CPI inflation (%)	6.7	5.4	4.6	1.8	4.0
Current account deficit % of GDP	2.0	0.7	0.6	1.2	1.3
Fiscal deficit % of GDP	6.5	5.5	4.7	4.4	4.2
Repo rate year-end	6.50	6.50	6.25	5.25	5.25
10Y G-sec yield year-end	7.3	7.1	6.6	6.4	6.1

Source: Bloomberg, Axis Bank Research

India to remain the fastest growing large economy

Headwinds to growth from mostly intended fiscal and largely unintended monetary tightening that slowed the economy in FY25 have abated, resulting in the growth revival in FY26. In FY27 we expect monetary easing to drive above-trend growth of 7.5%; while regulatory easing (e.g., EoDB, revoked QCOs, new labour codes) boosts growth over the medium-term, their announcement boosts sentiment. Given significant economic slack, growth can stay above-trend for a while before inflationary pressures warrant policy tightening. While labour growth and global demand remain modest, sustained TFP gains (1.5–2%) and a rebound in capital formation, led by manufacturing, utilities, and real estate, support a 7% trend growth outlook. FY27 consensus appears conservative.

Weak inflation to persist, G-Sec yields to inch lower

That core inflation ex-precious metals is below 3% is well understood, but academic research, backed by Indian data, suggests median inflation is a better gauge of underlying price pressures. This has been stable near 3% for 18 months and signals persistent slack in the economy. This is why, despite the above-trend growth and a rebound in food prices, we expect FY27 headline inflation to average 4%. While policy rates have likely bottomed, to aid monetary transmission and boost credit growth, money supply can rise further, and supply-side measures (like issuing more T-bills and shorter-duration bonds) can reduce steepness of the yield curve. We expect 10Y yields to drift towards 6% in FY27.

India's external balance stable, USDINR weakness helps

The INR's recent weakness despite low inflation has brought the REER to competitive levels. We do not see an unduly stressed Balance-of-Payments. The impact of the surge in investor demand for gold, which is keeping import volumes high despite 50% higher prices is offset by weak oil prices. A higher non-oil/gold deficit due to a recovering economy and Chinese competition in export markets can be paid for by the continuing double-digit growth in net services exports. We expect the current account deficit to widen marginally to 1.2/1.3% of GDP in FY26/27 respectively. FDI repatriation and nearly worst-ever FPI outflows have pressured capital inflows, but we expect these to be temporary.

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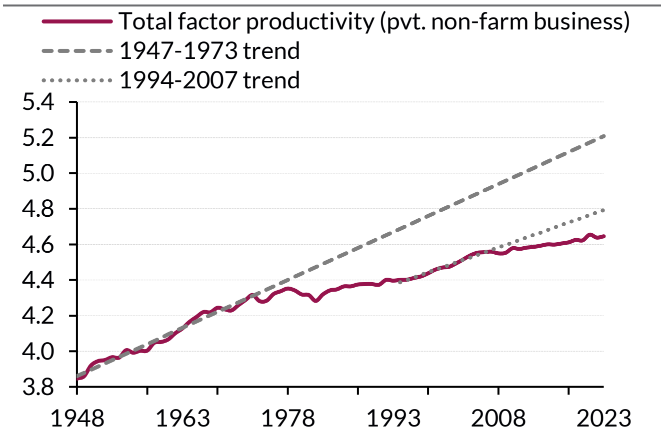
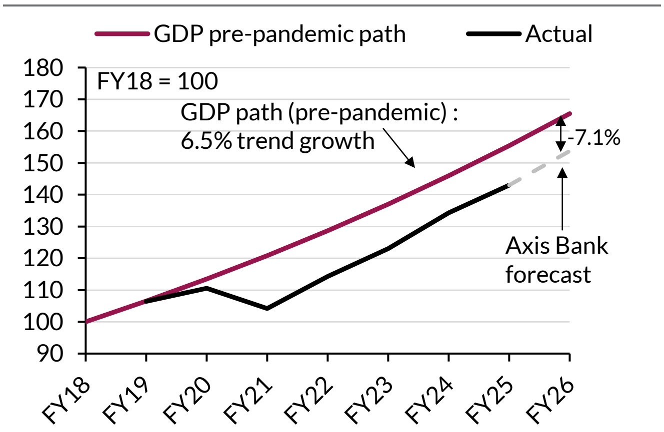


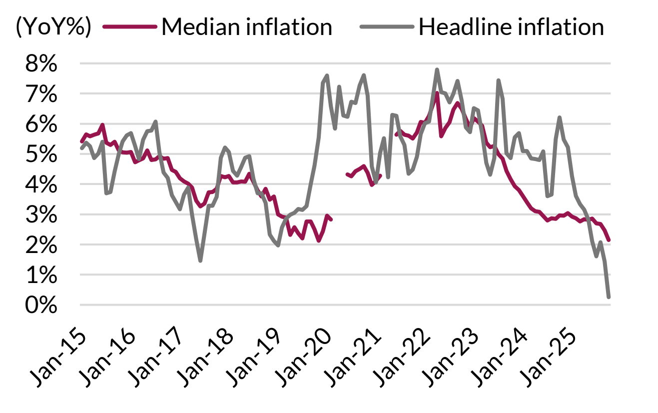
Source: BEA, Axis Bank Research

Exhibit 3 - India GDP: Gap vs pre-pandemic path at ~7%



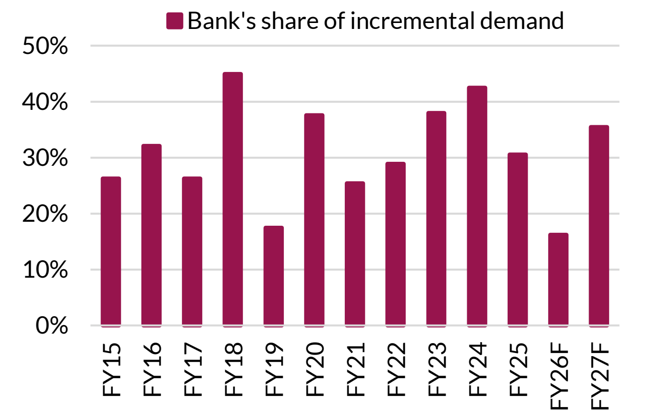
Source: MoSPI, Axis Bank Research

Exhibit 4 - Median inflation shows that price pressures remain stable and were at ~3% for the last 1.5Y



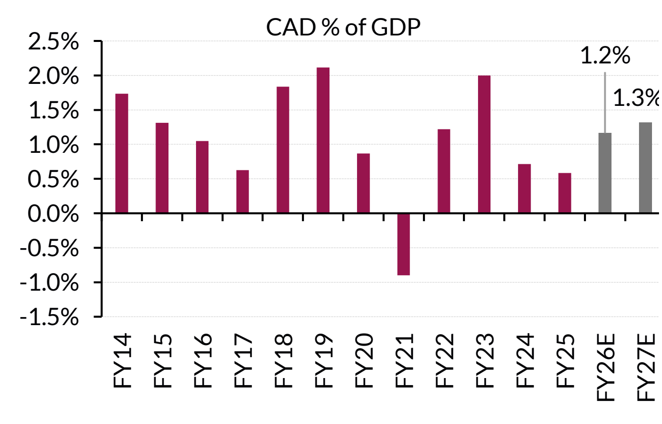
Source: CEIC, Axis Bank Research

Exhibit 5 - Banks' govt. bond purchases in FY26 likely at decadal low; to recover strongly in FY27



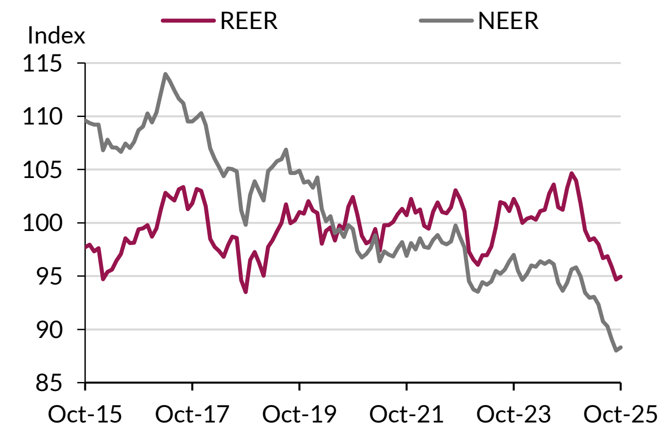
Source: RBI, Axis Bank Research

Exhibit 6 - CAD likely to expand to 1.2-1.3% of GDP in FY26 and FY27 as domestic demand recovers



Source: RBI, Axis Bank Research

Exhibit 7 - REER has weakened to a 2018 low from a record high – will it stop here?



Source: BIS, Axis Bank Research

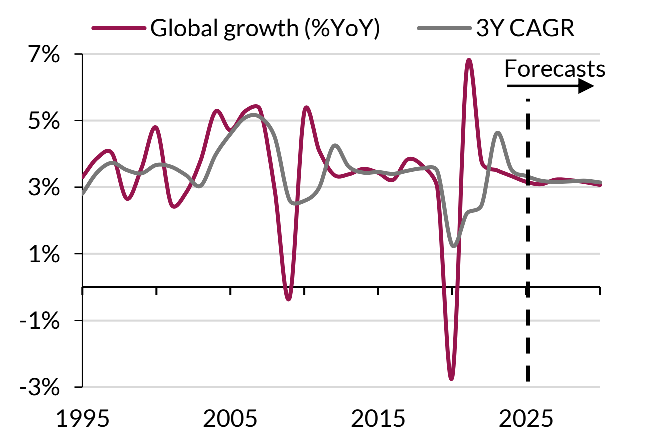
India to remain the fastest growing large economy

Headwinds to growth from mostly intended fiscal and largely unintended monetary tightening that slowed the economy in FY25 have abated, resulting in the growth revival in FY26. In FY27 we expect monetary easing to drive above-trend growth of 7.5%; while regulatory easing (e.g., EoDB, revoked QCOs, new labour codes) boosts growth over the medium-term, their announcement boosts sentiment. Given significant economic slack, growth can stay above-trend for a while before inflationary pressures warrant policy tightening. While labour growth and global demand remain modest, sustained TFP gains (1.5–2%) and a rebound in capital formation, led by manufacturing, utilities, and real estate, support a 7% trend growth outlook. FY27 consensus appears conservative.

Global growth expected to weaken by 10bps in 2026E, downside risks low

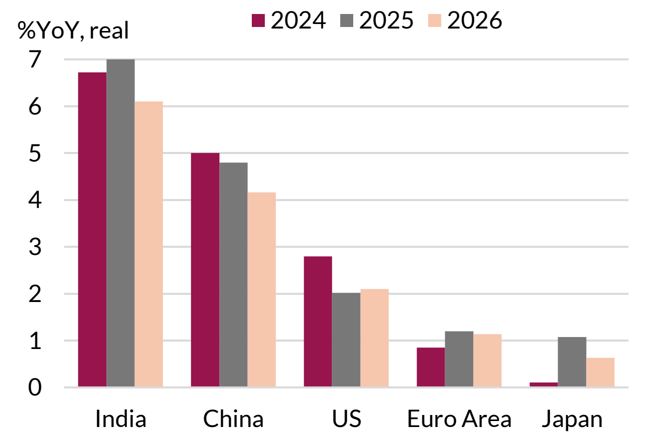
IMF projects the global economy may grow at 3.1% YoY in CY25E, 10bps lower vs. CY25, and keeping the three-year CAGR at ~30-40 bps below the pre-Covid level (Fig 8). The mix of growth among major economies though would be slightly different, with slower growth in India, China, and Japan and steady growth in the US and EU (Fig 9). Our India growth forecasts are 1pp stronger, higher growth surprise in CN/JP likely as well.

Exhibit 8 - IMF: Global growth steady, unlikely to accelerate



Source: IMF WEO Oct 2025, Axis Bank Research

Exhibit 9 - IMF projections: Economic growth in CY25/26



Source: IMF WEO Oct 2025, Axis Bank Research

US growth has exceeded expectations (including ours) for the past two years, and it remains the only major economy above its pre-pandemic path. Pre-Trump-II, it was due to a boost to labour supply through immigration, and the absence of meaningful fiscal consolidation. The US economy has weathered the tariff storm with 2% full year growth looking achievable this year. We discuss the role of AI in the next sub-section.

A steady growth slowdown in China over the medium term is now the consensus view, with demographics slowing labour input, limits emerging on capital formation (overbuilt real estate and excess industrial capacity), falling total-factor productivity, and the nature of growth in the past few decades constraining consumption. However, we believe the CN government has the balance sheet and political control to avoid a sharp growth slowdown.

Structural issues in Europe like weak demographics, overbearing regulation, and lack of fiscal cohesion have been compounded by disruptions to energy supply due to the Russia-Ukraine war: an early end should be a positive catalyst. In CY26, growth is expected to stabilize around potential: there should be some lagged impact of ECB rate cuts, but headwinds from US tariffs and Chinese competition may keep growth at the same level. Acceleration would be dependent on German fiscal spending on defence and infrastructure.

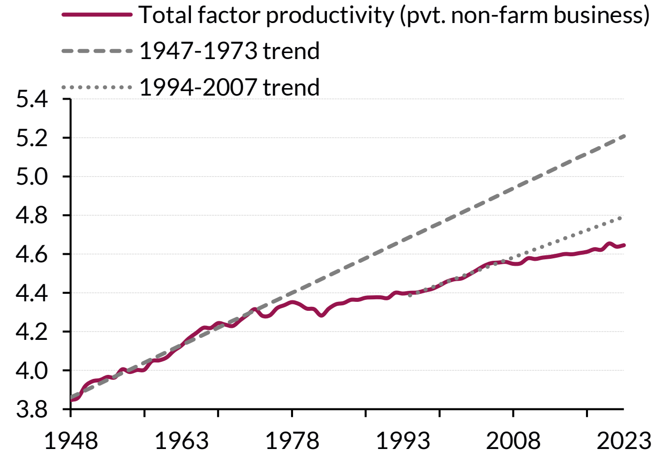
Despite adverse actions (immigration, trade), US growth less affected (for now)

As discussed in earlier notes, the intent of policy formulation under Trump administration was: reduce trade deficits, cut taxes and regulations, slow if not reverse immigration, and bring down energy costs. But we also highlighted how the US may get lucky.

Productivity can rebound with deregulation and the impact of AI

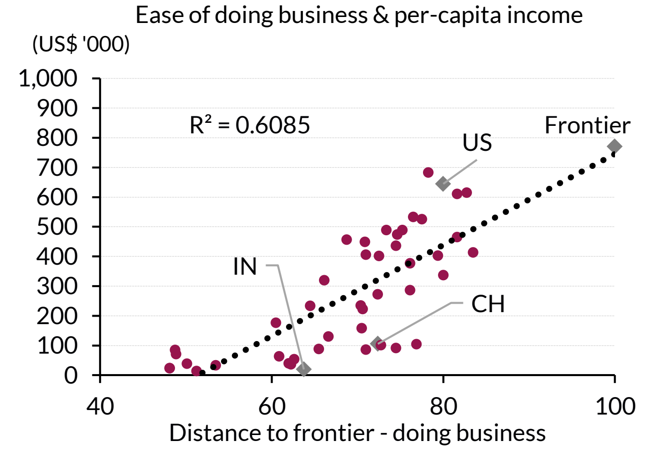
Between 2000 and 2019, US growth has been at half the rate seen between 1950 and 2000. Some ascribe the weak growth in total factor productivity (Fig 10) to a lack of innovation, some to secular stagnation that warranted negative real rates, and some to excessive regulation, with the US slipping to 34th in 2019 in the OECD Product Market Regulation Index from fifth in 2003, with compliance costs rising at 2x the rate of GDP. Excessive regulation is est. to have cost 0.8% of GDP growth annually since 1980 (linkExhibit 11 -).

Exhibit 10 - Can productivity growth pick up in the US?



Source: BEA, Axis Bank Research

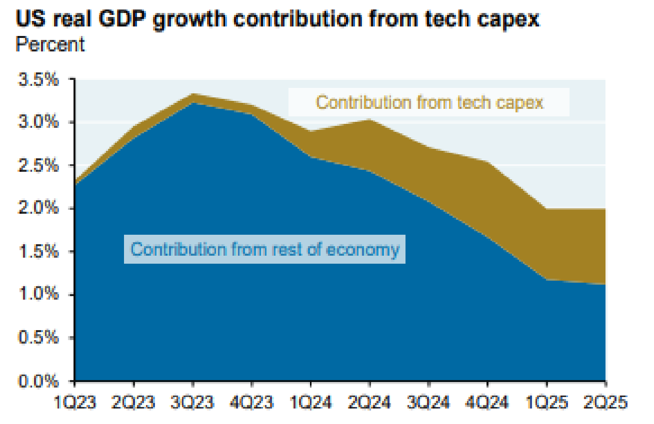
Exhibit 11 - Not just AI: Deregulation can boost TFP



Source: World Bank, Axis Bank Research

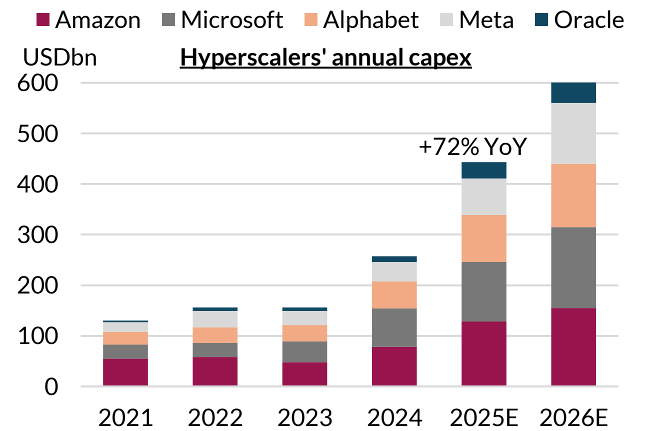
AI related capex has been a key boost to the US economy in 2025. Bottom-up aggregation suggests that AI is driving US$100 bn/year of incremental investments (i.e., YoY rise that wouldn't have occurred otherwise). This is as much as ~0.5% of total real growth (Fig 12). In addition, there is likely to be the impact of productivity gains (hard to measure), and some of the power capex linked to data centers is not counted in the above capex. While the chips are manufactured and packaged and servers are assembled elsewhere, a significant part of the value-add in the semiconductor and electronics value-chain resides in the US.

Exhibit 12 - Tech capex likely adds 0.5% to US GDP



Source: Bridgewater, August 2025, Sourced from JPMAM (link)

Exhibit 13 - Hyperscalers' CY25 capex ~$186bn up vs. CY24



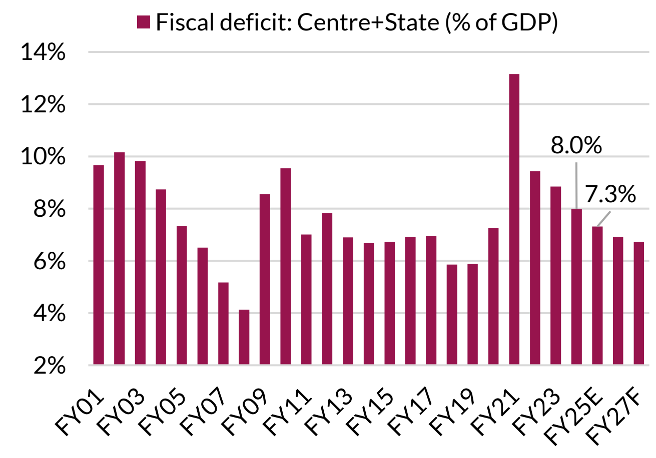
Source: Bloomberg, Axis Bank Research

Policy tightening in India reversed; benefits to be visible with a lag

The loss in economic momentum in FY25 in India, in our view, was cyclical, and due to somewhat intended fiscal and largely unintended monetary tightening (like forcing banks to cut LDR) which hurt credit growth. In FY25, there was a direct 80bps and an 'off-balance-sheet' 50bps fiscal drag related to the GST compensation cess.

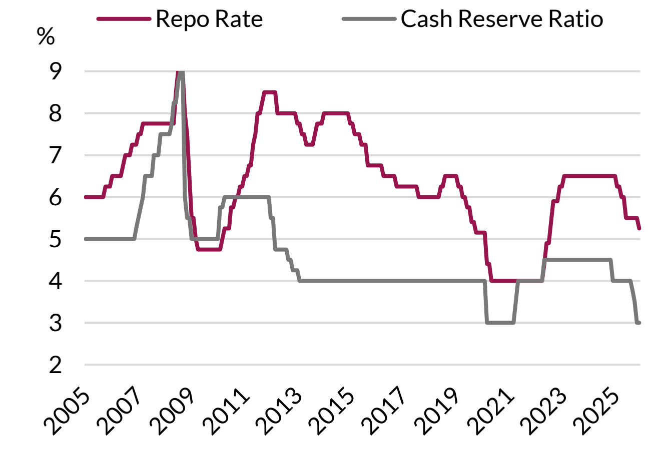
Not only has the fiscal drag slowed, but monetary policy is now supportive of growth. Domestic cyclical revival matters more for demand than US tariffs, and is supported by lower borrowing costs and regulatory easing. Consensus has raised forecasts for FY26 but is still too conservative, FY27 estimates are still unchanged: we expect upgrades to both.

Exhibit 14 - Low fiscal drag in FY27; weakest pace of post CoVID fiscal consolidation (FY25 saw ~1.2% of consolidation)



Source: RBI, Union budget, Axis Bank Research

Exhibit 15 - Transmission from monetary easing takes 2Q-4Q (CRR at all time low; repo rate lowest excl. crisis periods)

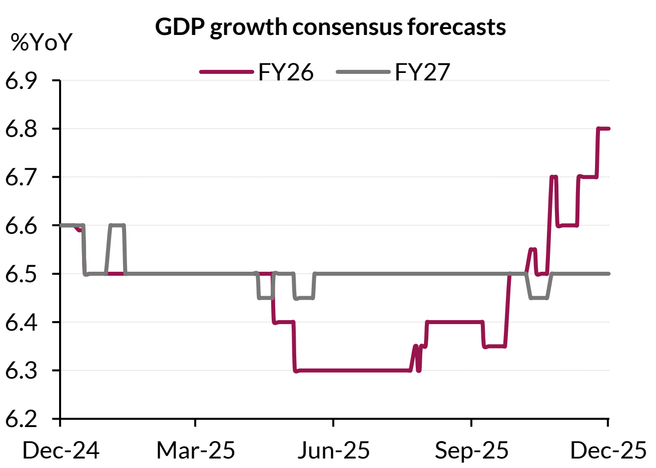


Source: RBI, Axis Bank Research

Cuts to CRR and risk weights are likely to strengthen the eventual recovery

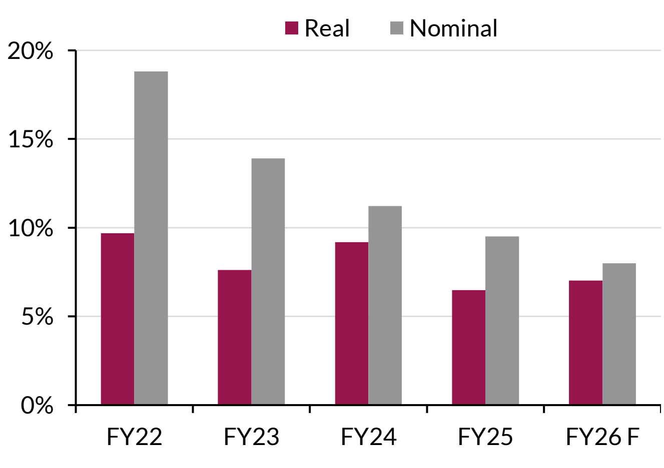
Decisive signals from the RBI have restarted the credit channel, the most important driver of monetary transmission, in addition to lower rates helping loan demand. Reduced risk weights and reserve ratios are likely to amplify the credit cycle (link). Once loan growth picks up, pro-cyclical momentum can take it to low-to-mid-teens growth YoY. Factors that dampened the credit recovery during the 2014-16 cuts like damaged balance sheets of borrowers and lenders, are absent; banks now have stronger capital buffers (link).

Exhibit 16 - FY27 consensus growth est. likely conservative



Source: Bloomberg, Axis Bank Research

Exhibit 17 - Pessimism on growth driven by slowing NGDP



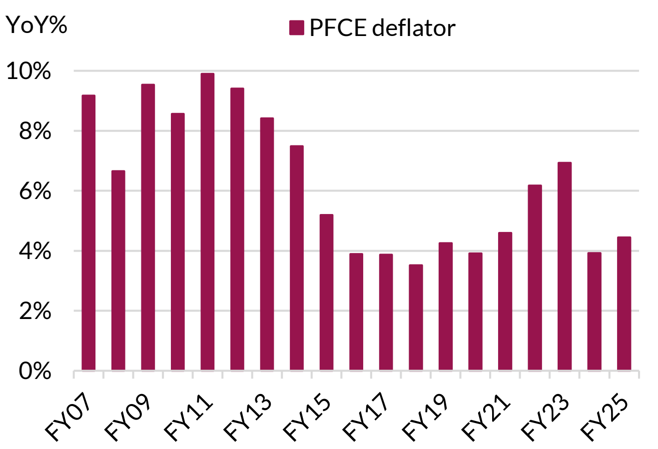
Source: MoSPI, Bloomberg, Axis Bank Research

Structural and regulatory reforms in 2025 impart additional growth momentum

India's macro stability an outcome of reforms over the last 10-years

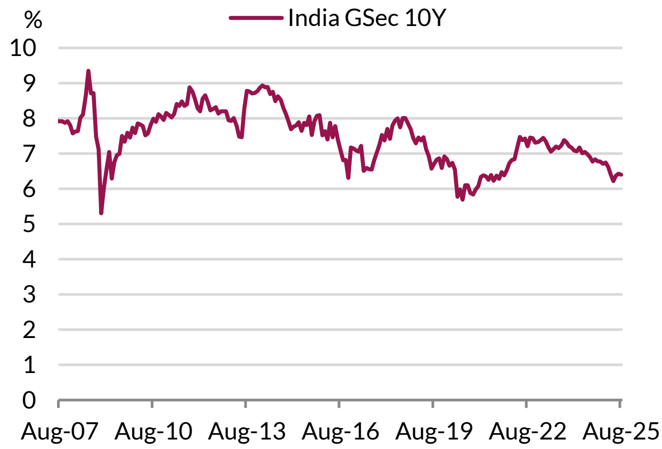
India's second-generation fiscal rules under the FRBM Review Committee and the adoption of a Flexible Inflation Targeting (FIT) framework represent foundational reforms. These measures anchored inflation expectations and delivered price stability (excl. COVID shock), with inflation averaging close to the 4% target. The credibility of this regime has been reflected in lower sovereign spreads, signalling improved risk pricing in bond markets.

Exhibit 18 - Inflation in India has seen a regime shift



Source: MoSPI, Axis Bank Research

Exhibit 19 - RBI credibility and fiscal discipline → lower rates

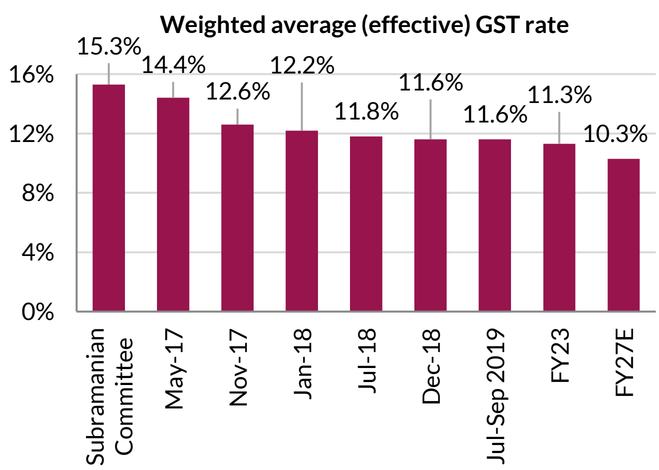


Source: Bloomberg, Axis Bank Research

GST redesign after 8-Years: A structural reform to boost growth

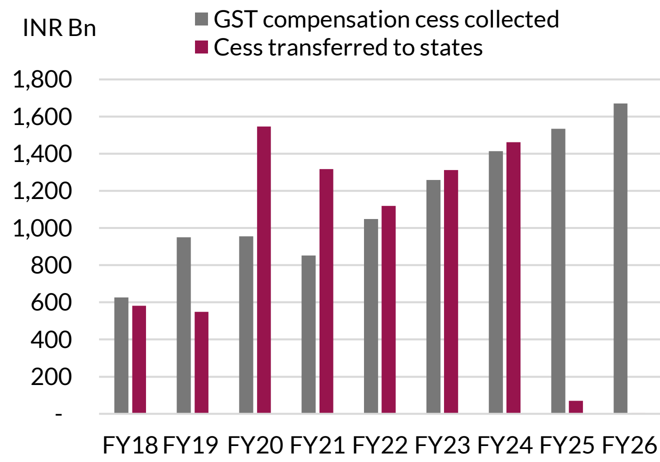
The GST changes undertaken in Sep-2025 were not only a fiscal boost to growth, but also a simplification (fewer slabs), and make the government's stance more contemporary: in today's India, small cars are not luxury goods, and branded FMCG do not warrant high rates. These changes should improve compliance, reduce disputes, and cut some working capital strain from delayed tax credits. As evidenced by the unchanged borrowing targets for FY26, this consumption stimulus (~0.5% of GDP) is paid for by the compensation cess being subsumed, making it broadly neutral fiscally (link, link).

Exhibit 20 - GST redesign a significant structural reform: ~1pp lower effective rates



Source: Finance ministry, RBI, GST RNR Committee, Axis Bank Research

Exhibit 21 - ...also a one-time fiscal stimulus (0.5% of GDP), as the compensation cess gets subsumed into GST



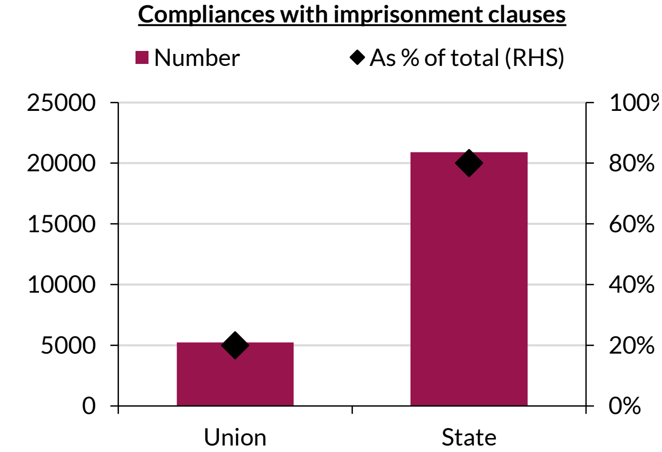
Source: Union budget, Axis Bank Research

The deregulatory agenda: Labor reforms occurred at the states before the centre

Indian firms are being governed by 1500+ acts and rules, must observe 69K+ compliances, and must make 6K+ filings, with labor being the most regulated segment (Fig 22, 23). Regulatory burden increases as the establishment's scale increases (licenses, registrations, filings), a deterrent for new businesses. Even before India consolidated 29 labor laws into four codes—Code on Wages, Industrial Relations, Social Security, and Occupational Safety & Health—effective November 2025, 16 states had enacted 38 major reforms (link).

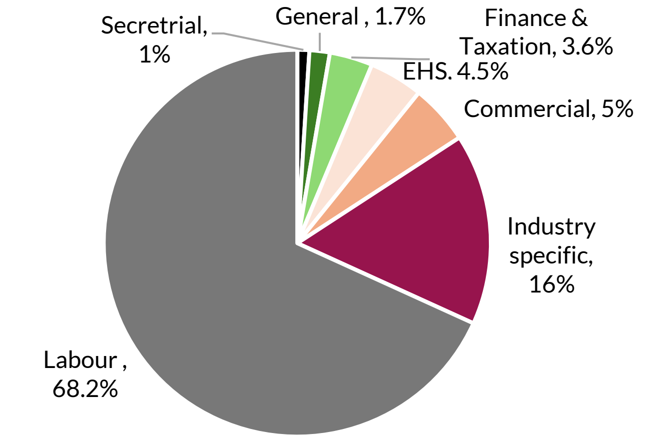
Labor reforms aim to simplify compliance, modernize outdated provisions, and expand worker protections thus enhancing formalization and aligning India with global standards (link, link).

Exhibit 22 - Businesses must comply with '000s of clauses



Source: TeamLease RegTech (link), Axis Bank Research

Exhibit 23 - Most criminal clauses for businesses labor-linked



Source: TeamLease RegTech (link), Axis Bank Research

Financial sector deregulation: Improving EoDB may help drive credit growth

The Oct MPC decision to remove the proposed bar on overlap in businesses undertaken by a bank and its group entities and leave the 'strategic allocation of business streams among group entities to the wisdom of bank boards' was a positive step. The RBI has allowed banks to do acquisition financing, reversing a 2004 decision, raised thresholds for lending against securities, and clarified the Expected Credit Loss (ECL) framework for provisioning.

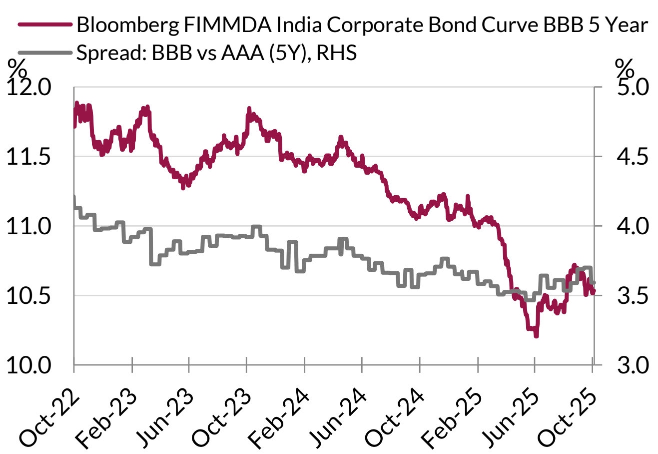
The RBI has also undertaken a comprehensive exercise of consolidating the regulatory instructions (link)

Credit to MSMEs driving growth, helped by policy support & technology

In FY25, MSMEs accounted for 22% of incremental non-food bank credit, taking their share to 18%. Reasons: i) sharp fall in rates (Fig 24); ii) government credit-loss guarantees (Fig 25); and iii) data-driven underwriting (GST returns/utility bills). (detailed note).

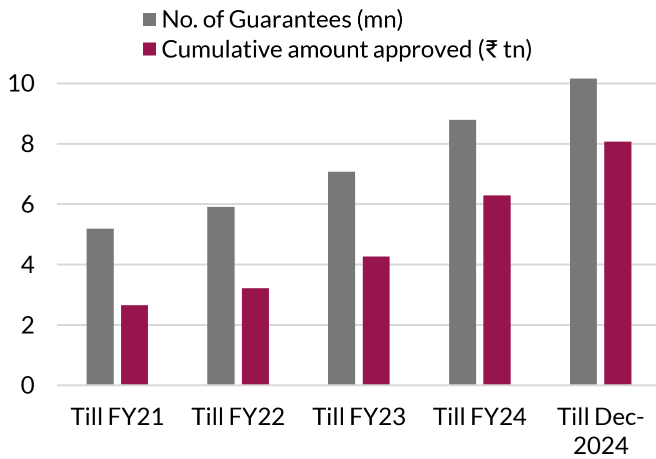
MSME credit drives loan expansion, aided by government-led guarantees and initiatives to increase registration (Udyam).

Exhibit 24 - Lower base rates help : risk premium ↓ + Rf ↓



Source: Bloomberg, Axis Bank Research

Exhibit 25 - MSE credit guarantee coverage up 3x vs. FY21

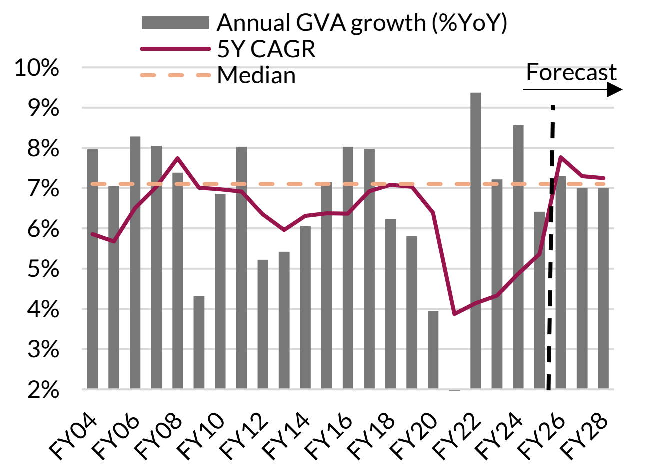


Source: MSME Reports, Axis Bank Research

Structural growth drivers intact: Recovery in capital formation to drive growth

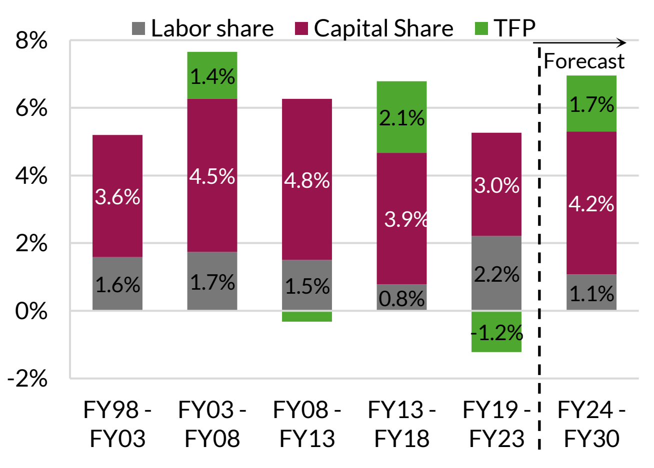
Over the past three decades, trend growth (seen as five-year average) through varying external environments, fiscal stance, and under different governments has been 6-7% (Fig 26). The five-year CAGR came close to 8% only in the FY03-08 period, when the workforce was expanding rapidly (Fig 27), and up-cycles in power generation, real estate, and global growth boosted capital formation. Over the next three to five years, labor growth is likely to be slower than in that period, as is global demand. In aggregate, we expect labor to add only ~1 pp annually to GDP growth for the next five years.

Exhibit 26 - Trend growth has been between 6-7% for 25Y



Source: MoSPI, Axis Bank Research

Exhibit 27 - Expecting 7% trend growth realistic



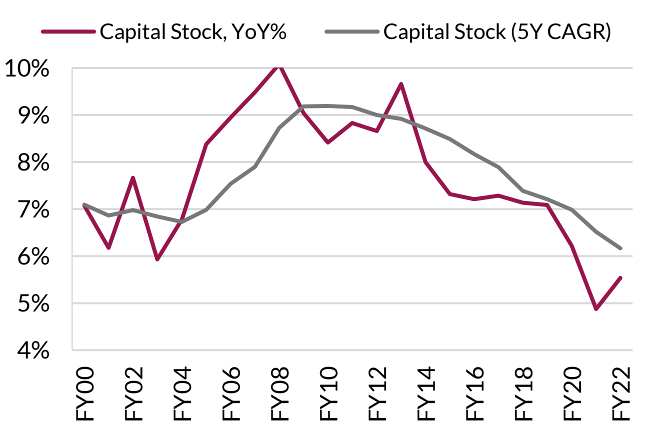
Source: RBI, Axis Bank Research

Total Factor Productivity (TFP) growth likely to be sustained at 1.5-2% annually

A shift in the government's mindset towards greater reliance on market forces has given some control to the private sector, as reflected in their rising share of capital stock (Fig 29). Additionally, (1) an expanded presence of foreign firms in India has helped with diffusion of global best practices and technology; and (2) there has been continued improvement in macro-infrastructure (roads, railways, highways, telecom, digital) and in micro-infrastructure (piped water to homes, cooking gas). Hence, we expect TFP to grow 1.5-2% annually for the next five years, adding ~1.7 pp to the growth.

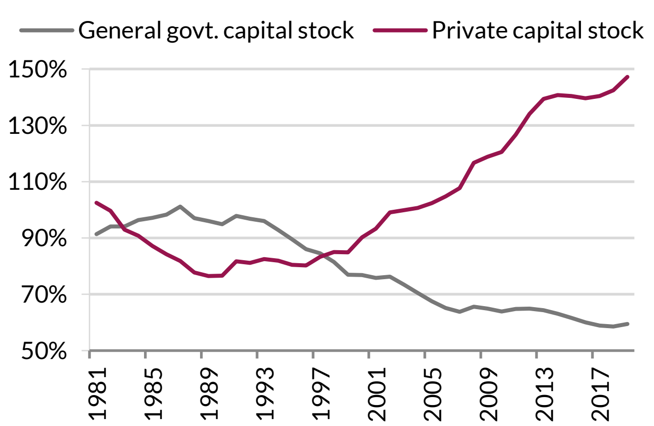
Total factor productivity (TFP) was also strong during the FY03-08 period, at 1.4%. Since then, it saw a deceleration during FY08-13 but has improved steadily thereafter; growth has increased to nearly 2% YoY in the past 10Y

Exhibit 28 - Capital stock (% of GDP) stagnated since 2011



Source: MoSPI, Axis Bank Research

Exhibit 29 - India's capital stock dominated by private

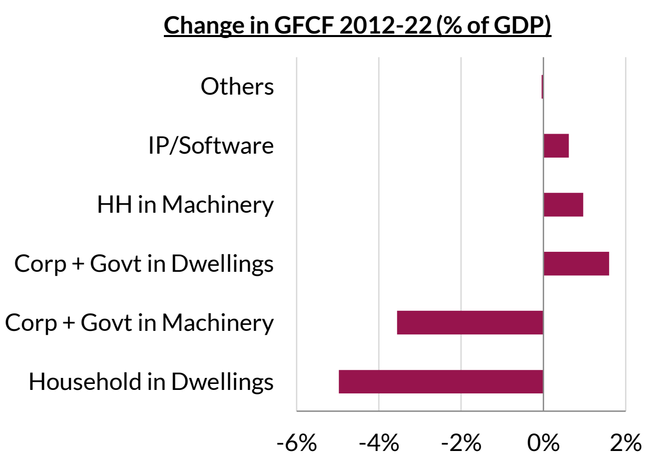


Source: MoSPI, Axis Bank Research

2012-21 investment slowdown driven by real estate, power generation, and mfg.

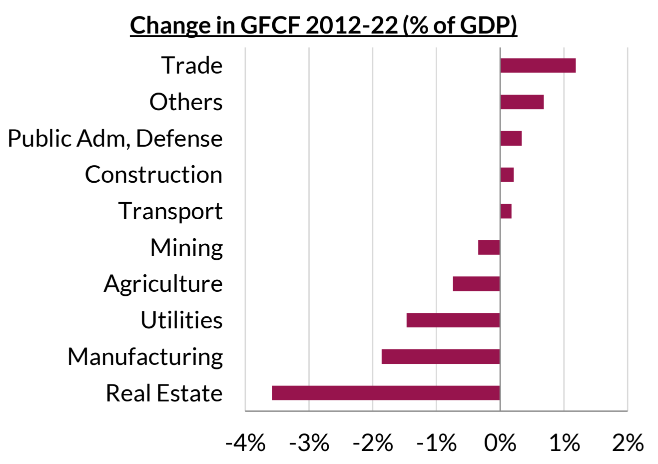
India's investment-to-GDP ratio fell sharply from 34% in 2012 to 27% in 2021, driven by a slowdown in households' spending on real estate, and corporate capex on machinery for utilities and manufacturing (Fig 30). Manufacturing capex by corporates as a share of GDP fell the most in sectors like cement and steel, affected by real estate (Fig 31).

Exhibit 30 - HH in dwellings led the 2012-22 capex slowdown



Source: Axis Capital Capex Report

Exhibit 31 - Within sectors: RE, utilities, and manufacturing

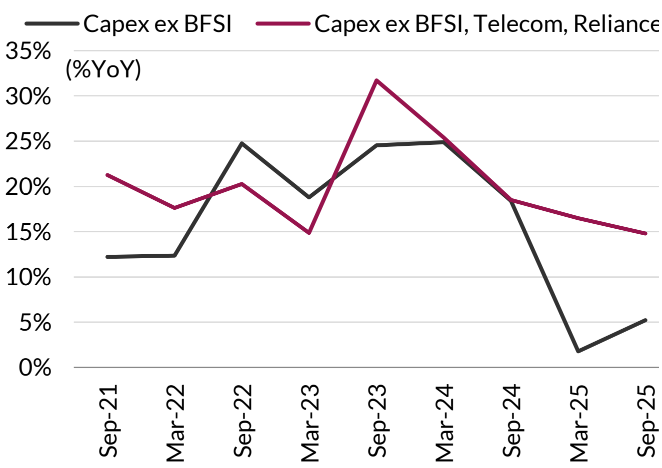


Source: Axis Capital Capex Report

1HFY26 corporate capex weak, but mostly due to lower capex in Telecom

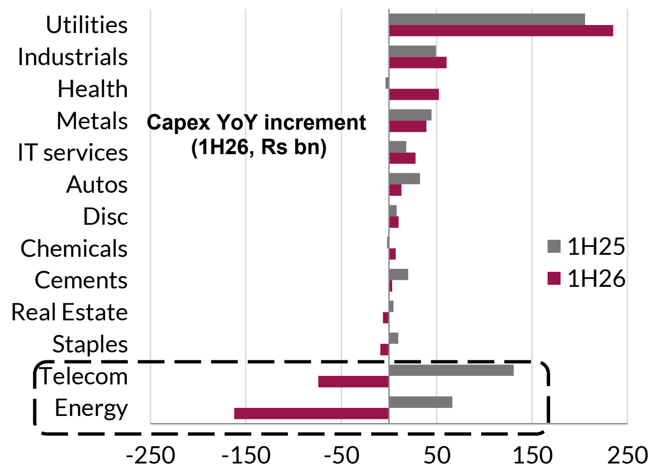
NSE200 (ex-Financials) capex grew just 5% YoY in 1HFY26, better than the 1% growth in 2HFY25 but well below the 18% CAGR between Sep-19 to Sep-24. Adjusted for the end-of-5G decline in Telecom and Reliance (likely to be Jio), the capex grew by 15% YoY, in-line with the trends seen in past few years (link). In aggregate, capex was only 62% of operating cash flows (OCF): a measure of how firms utilize internal accruals, below the post-Covid range and well below 2012-16 levels. Capex growth has been strong in Power and Industrials. Although weak power demand and elevated leverage especially in renewables are risks, we don't expect capex intensity to slow in 2026.

Exhibit 32 - NSE200 capex grew at 5% YoY in 1H26…



Source: Capitaline Axis Bank Research

Exhibit 33 - …driven mostly by Telecom and Energy (inc Jio)

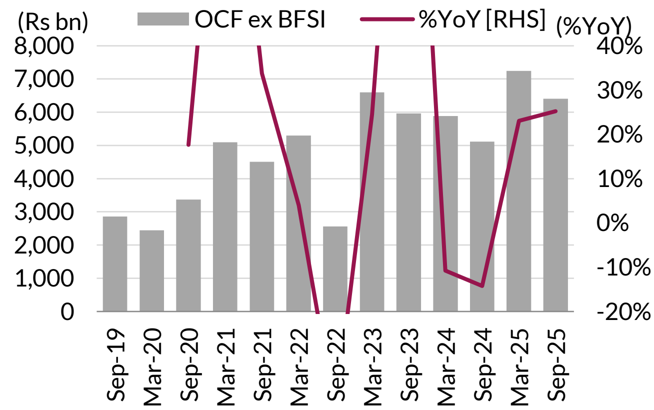


Source: Capitaline, Axis Bank Research

Strong OCF, lower leverage and low cost of capital → capex uplift in FY27

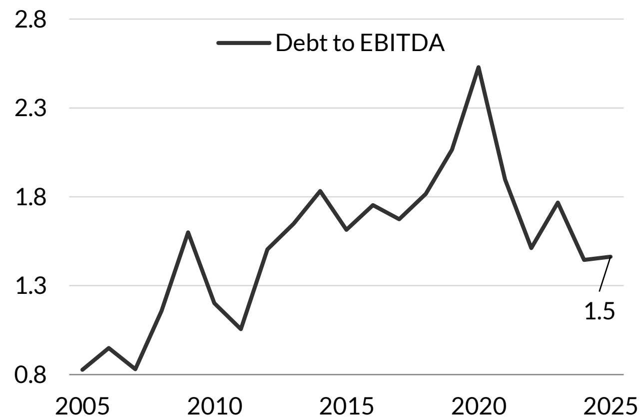
In 1HFY26, YoY growth in operating cashflow (OCF) for BSE200 ex-Financials picked up 25% YoY as PBT grew 23% YoY (mostly better margins; revenues grew just 7% YoY). Strong OCF and a weaker capex growth meant lower addition of net debt, resulting in net debt to EBITDA remaining near decadal lows. With strong internal accrual, reduced leverage levels and lower cost of capital (both debt and equity), we see limited capital constraints for corporates. We believe the real estate and power-generation cycles remain in good health and once cyclical headwinds fade, corporate capex is likely to pick up further in FY27.

Exhibit 34 - OCF growth rises to 25% YoY in 1H26



Source: Capitaline, Axis Bank Research

Exhibit 35 - Net Debt to EBITDA remains at decadal lows



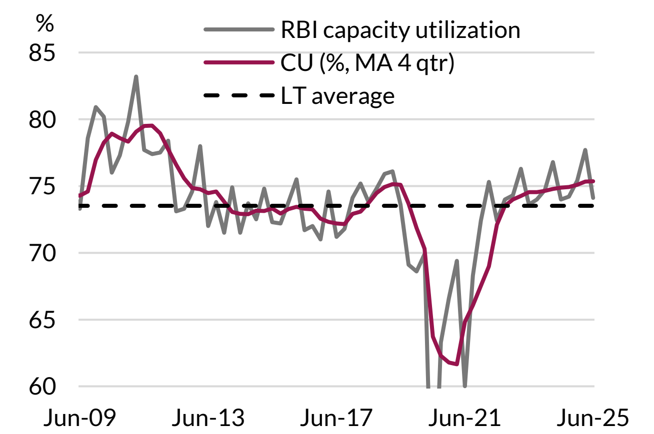
Source: Capitaline, Axis Bank Research

Industrial utilization now warrants new capex; power generation needs more capacity

Industrial capacity utilization has reached pre-Covid levels (Fig 36), and the order backlog for capital goods companies shows that going forward, investment activity is likely to grow rapidly. For example, in utilities, excessive capacity addition during 2012-16 necessitated a drop in capex, as India completed 20-25 GW of power generation capacity every year, much more than the growth in demand (Fig 37). With limited capacity addition for the past eight years, the industry needs more capacity, and we expect strong corporate capex in the energy ecosystem.

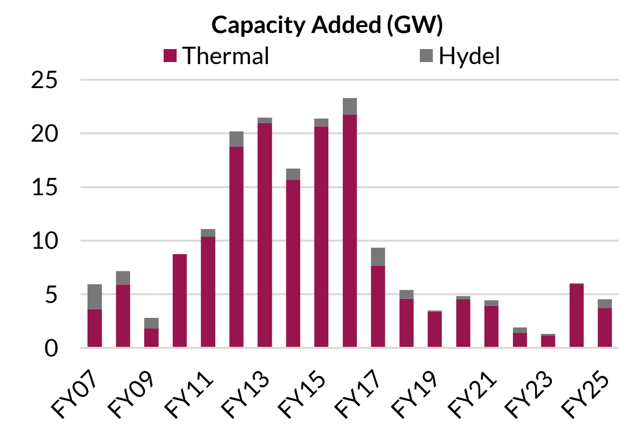
Power transmission capex should also grow, given the 5% CAGR expansion in the transmission line network and 10% CAGR growth in substation capacity.

Exhibit 36 - Industry capacity utilization > long-term avg.



Source: RBI, Axis Bank Research

Exhibit 37 - Thermal power generation capacity addition fell



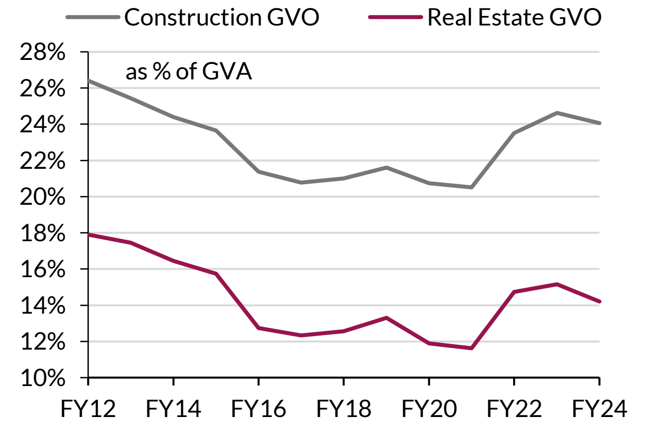
Source: CMIE, Axis Bank Research

Real estate investment cycle: low inventory necessitates increase in construction

We also expect construction to see strong growth, supported by continuing steady expansion of commercial real estate and structural demand drivers such as a growing population, shrinking household size, rising urbanization, higher built-up area per capita, and improving construction quality. Housing inventories in the Top 8 cities, when seen as the number of months of sales, are now down to levels seen 15 years back. This was the point in the earlier cycle where we saw the pace of construction pick up. We expect the improvement in real estate construction to also boost demand for construction materials, implying a strong corporate capex in steel and cement. In prior real estate up-cycles, their demand growth was 4-5 pp faster annually than in down cycles.

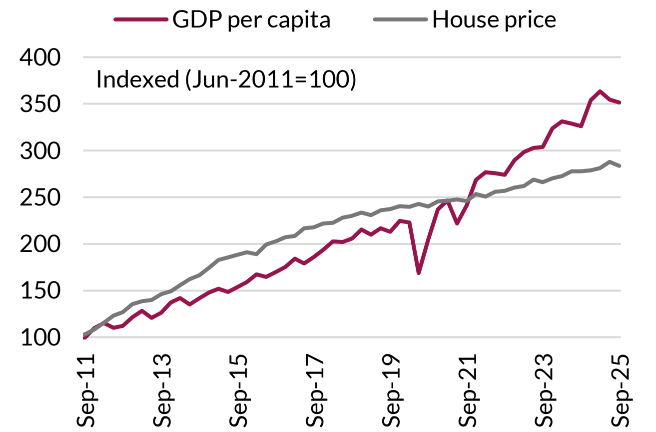
Cycles form only in urban real estate: there are no inventory cycles in rural areas, as most households own the land on which their houses are built; large-scale development of residential real estate is primarily an urban phenomenon

Exhibit 38 - Real estate can be a larger part of GDP



Source: MoSPI, Axis Bank Research

Exhibit 39 - Income growth now faster than real-estate prices

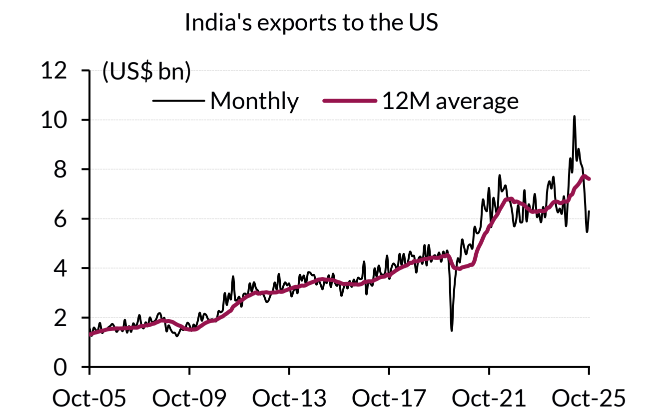


Source: RBI, MoSPI, Axis Bank Research

Competition from China, not just US tariffs, are hurting India's export growth

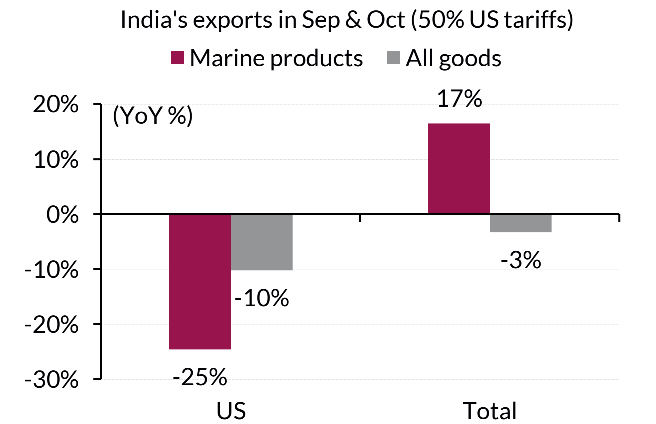
In Sep and Oct 2025- the 2 months under 50% US tariffs- India's exports fell 3% YoY (-10% YoY to the US). This export weakness is not solely due to US tariffs though: (i) exports to the US are still adjusting to past-front loading (Fig 40); and (ii) India's marine exports, where the US share was 30% pre-tariffs, grew 17% YoY (Fig 41), indicating exporters can find alternate markets to sustain growth. Indian exporters are likely hurting due to aggressive Chinese dumping in their markets (link, link), a threat that is set to worsen (link, link).

Exhibit 40 - India's exports to the US are still adjusting to past front-loading, confounding weakness in recent months



Source: MoCI, Axis Bank Research

Exhibit 41 - Exports of marine products grew 17% YoY in Sep-Oct: inability to compete, not US tariffs the impediment?

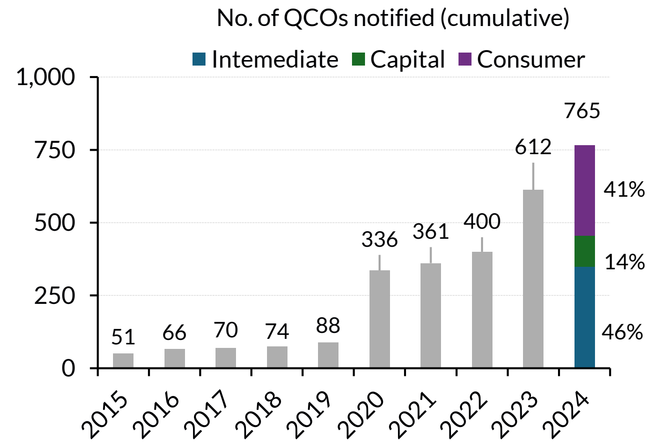


Source: RBI, MoCI, Axis Bank Research

Regulatory easing, such as the recent rollback of QCOs, a meaningful tailwind

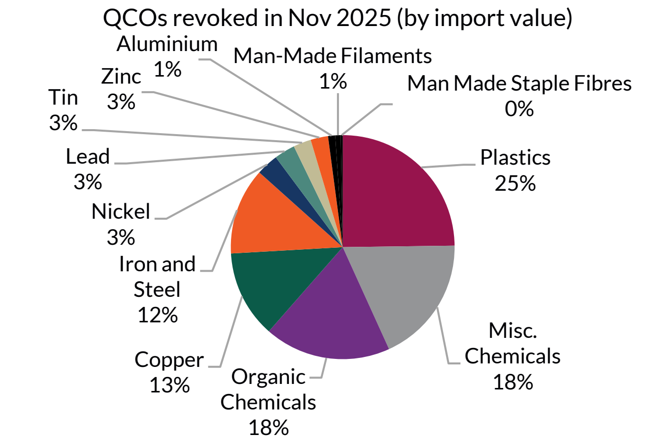
Beyond temporary relief and support measures from the RBI and the Government of India, in Nov-2025, four ministries revoked multiple Quality Control Orders (QCOs) on 114 intermediate products (plastics, chemicals, textile raw materials, metals). While only 16% of the 355 HS6 codes affected by QCOs end-2024 have seen relief, the reversal of the trend is encouraging (Fig 42,43). We do not expect QCOs on finished goods to end given the threat of Chinese dumping in domestic market and rising use of industrial policies globally. However, better and cheaper access to intermediate goods should help Indian firms compete better in export markets; manmade textiles are likely to be a key beneficiary (link).

Exhibit 42 - QCO use ramped up after 2019, mostly affecting intermediate goods



Source: Prabhakar P., Decoding India's Quality Control Orders, CSEP (WP 105; Sep 2025; link)

Exhibit 43 - Revoked QCOs could help textiles, packaging and electronics manufacturing

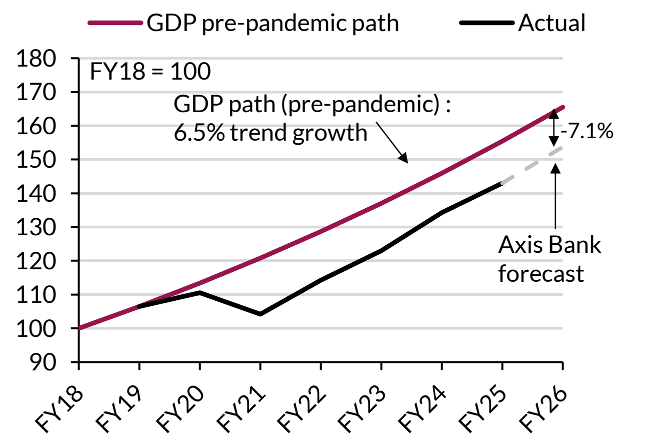


Source: Axis Bank Research

We expect India real GDP growth at 7.5%; slack to prevent inflationary pressures

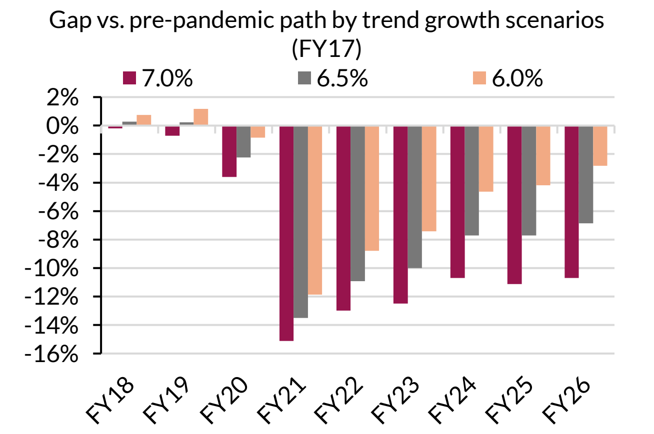
India's trend growth at 7% represents the economy's long-run potential, determined by structural factors such as labour force expansion, capital accumulation, and productivity. However, actual growth can exceed this trend through fiscal or monetary measures and can stay elevated without inflationary pressures till there is slack —meaning under-utilized resources like idle labour or excess capacity. As we explain in the next chapter, inflation indicators show significant slack in the economy. Through lower fiscal drag than last year, monetary and macroprudential easing, growth can be above-trend for a while.

Exhibit 44 - Gap vs. pre-pandemic path (FY18 base)



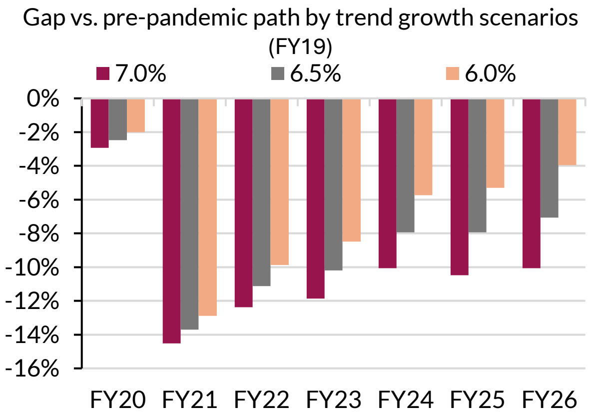
Source: CEIC, Axis Bank Research

Exhibit 45 - FY17 base, different trend growth assumptions



Source: CEIC, Axis Bank Research

Exhibit 46 - Gap vs. pre-pandemic path (FY19 base: at different trend growth assumptions



Source: CEIC, Axis Bank Research

Exhibit 47 - Gap vs. pre-pandemic path (different base years: at different trend growth assumptions)

	Gap b/w pre-pandemic growth path and actuals at FY26 end		
Trend growth	FY17	FY18	FY19
6.0%	-2.8%	-3.5%	-4.0%
6.5%	-6.9%	-7.1%	-7.1%
7.0%	-10.7%	-10.5%	-10.1%

Source: CEIC, Axis Bank Research

Weak inflation to persist, G-Sec yields to inch lower

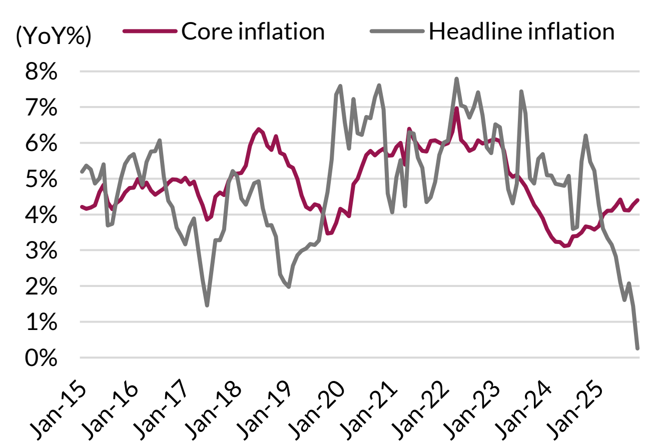
That core inflation ex-precious metals is below 3% is well understood, but academic research, backed by Indian data, suggests median inflation is a better gauge of underlying price pressures. This has been stable near 3% for 18 months and signals persistent slack in the economy. This is why, despite above-trend growth and a rebound in food prices, we expect FY27 headline inflation to average 4%. While policy rates have likely bottomed, to aid monetary transmission and boost credit growth, money supply can rise further, and supply-side measures (like issuing more T-bills and shorter-duration bonds) can reduce steepness of the yield curve. We expect 10Y yields to drift towards 6% in FY27.

Underlying inflationary pressures very weak, expected rapid rebound unlikely

We expect inflation to average 4% in FY27E, but economic slack to persist

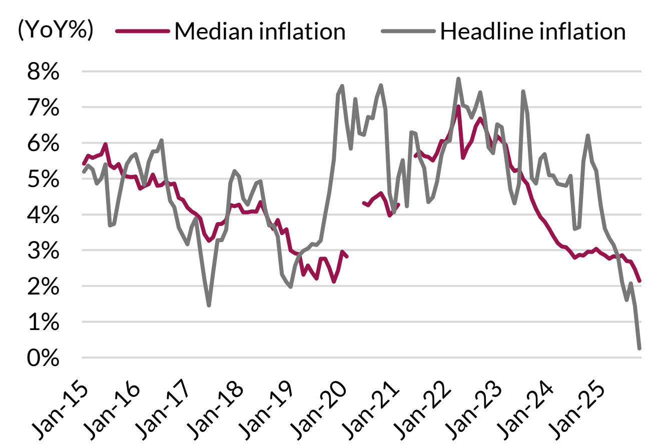
In Dec-25, the Monetary Policy Committee lowered inflation projections for the next two quarters by 110bps and 60bps respectively (link). We expect headline inflation to rise, averaging 4% in FY27E limiting the room to cut rates. Since Jan-2025 headline inflation has fallen sharply (Fig 48), and core inflation ex-gold/silver is now sub-3% with weak inflation in both goods and services (Fig 51, 52).

Exhibit 48 - Monthly inflation: standard 'core' less volatile than the headline and has been rising for last 1.5 years…



Source: CEIC, Axis Bank Research

Exhibit 49 - … however, median inflation shows that price pressures remain stable and were at ~3% for the last 1.5Y



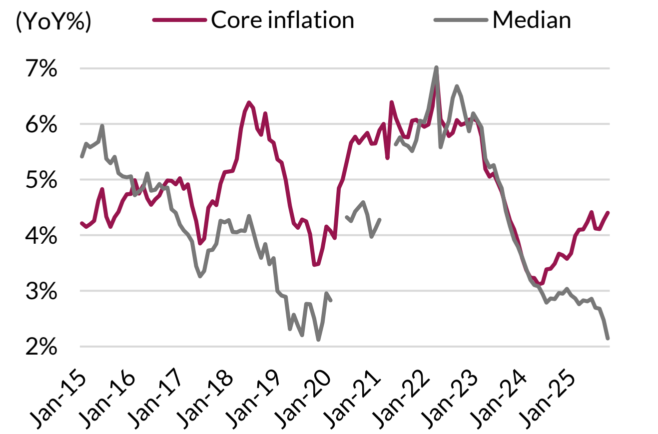
Source: CEIC, Axis Bank Research

Filtering supply noise: Why median inflation best captures demand-led trends

Recent research underscores that weighted-median and trimmed-mean inflation measures provide a clearer signal of demand-driven pressures than headline or standard core indices. Ball et al. (2023) show that weighted-median inflation correlates strongly with economic slack and forecasts future inflation better, reinforcing its relevance for demand-side analysis. Ball & Mazumder (2019) find that median inflation restores the Phillips Curve relationship, filtering out transitory supply shocks and isolating persistent demand effects. Rich & Steindel (2005) and Rich (2024) confirm that limited-influence estimators outperform exclusion-based cores in tracking underlying trend inflation, aiding monetary policy in demand-sensitive contexts. Indian evidence (Sharma, 2015) supports asymmetric trimming to capture persistent demand-led price changes, improving policy targeting.

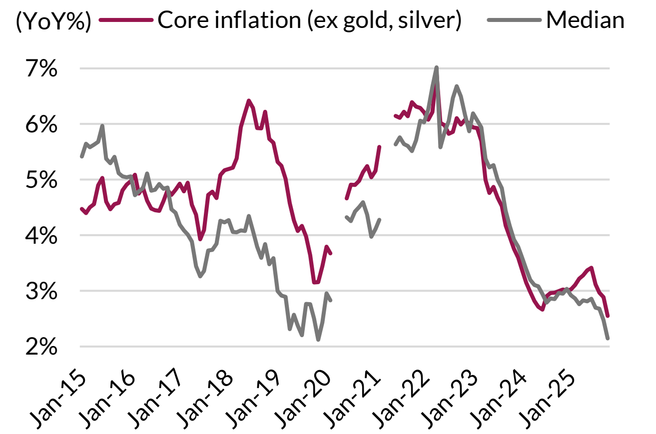
To summarize, a better measure of underlying inflationary pressures in academic literature is median inflation: it is less volatile, correlates better with economic slack (output gap) and forecasts 1Y-ahead inflation better (Fig 50,51,54); "asymmetric trimmed-mean" further improves on this (Fig 53); both suggest inflation is well below target and likely to remain so.

Exhibit 50 - Divergence between core vs. the median started in May-24 and has sent opposite signals w.r.t. the outlook



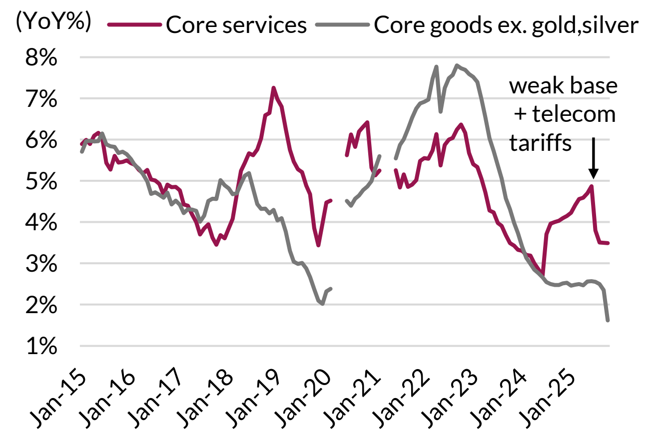
Source: CEIC, Axis Bank Research

Exhibit 51 - ... but core ex-gold aligns with median: price pressures remain stable at ~3% for 1.5Y (last dip due to GST)



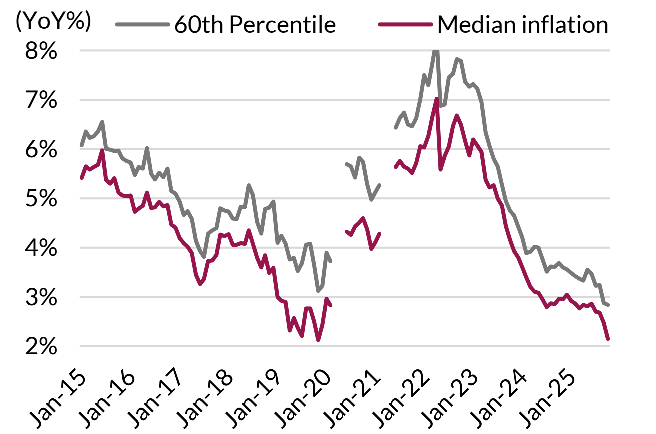
Source: CEIC, RBI, Axis Bank Research

Exhibit 52 - GST reforms → even weaker goods inflation, core services inflation has avg. ~3.8% for 2Y; implies slack



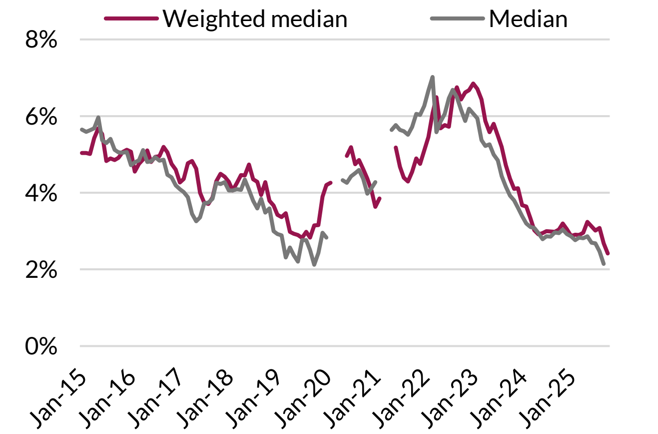
Source: CEIC, Axis Bank Research

Exhibit 53 - If asymmetric median is a better measure (adj. for '+' skew), inflation <4% for ~2 years now, and trending lower



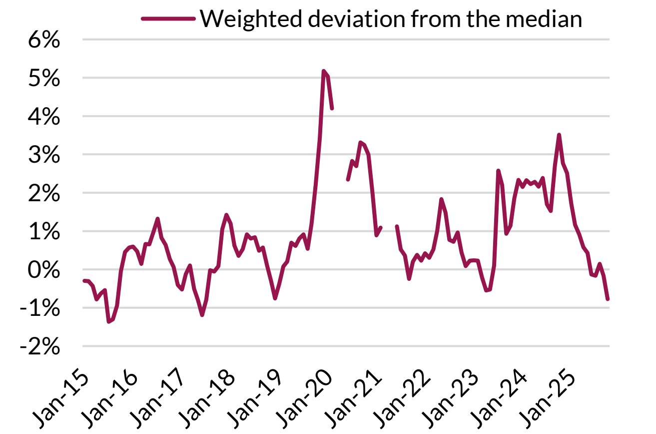
Source: CEIC, RBI, Axis Bank Research

Exhibit 54 - Median inflation a better leading indicator vs. weighted median as weights are fixed and likely outdated



Source: CEIC, Axis Bank Research

Exhibit 55 - Currently, the weighted sum of deviations from the median has turned negative → weak inflation a problem

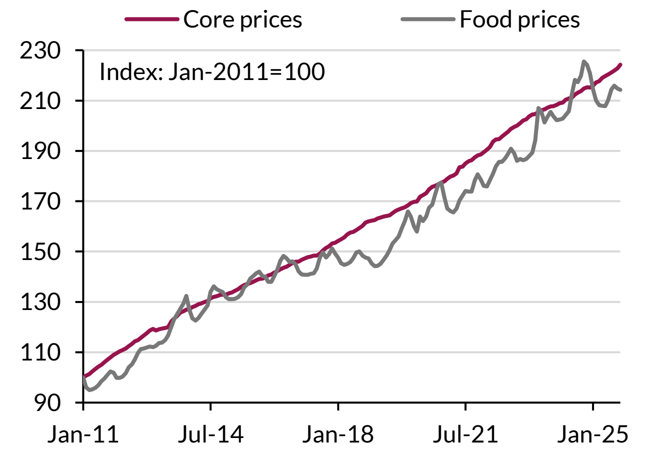


Source: CEIC, RBI, Axis Bank Research

India inflation driven by food; headline and core prices converge over time

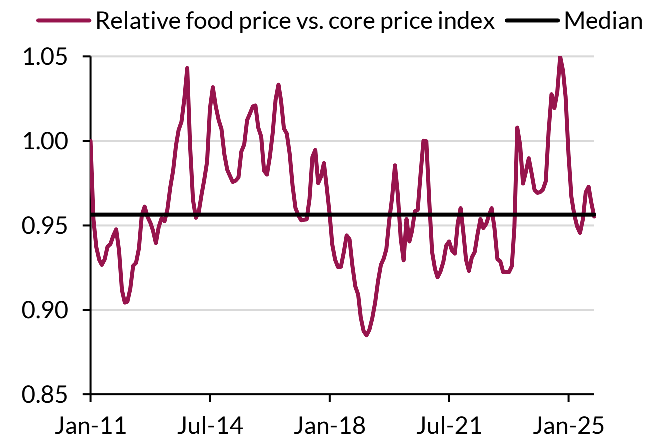
The significant and persistent divergence between food and core inflation in the past three years has brought back the debate on whether the MPC's target of headline inflation is appropriate. Until the law changes, the debate is inconsequential. However, we note that while core and food inflation trends may diverge over short time periods, over longer periods, they move together (Fig 56).

Exhibit 56 - Food and core prices tend to converge over time



Source: CEIC, Axis Bank Research

Exhibit 57 - Relative prices of food lower vs. the cyclical high

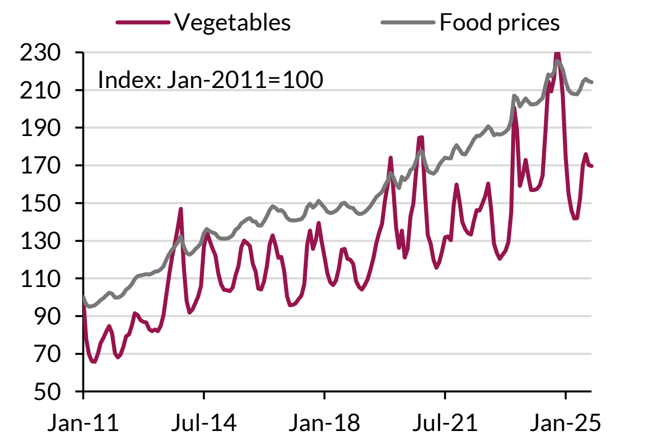


Source: CEIC, Axis Bank Research

Core services inflation is driven primarily by wages, where price increases are relatively stable, with volatility caused by telecom tariff hikes (Fig 52). Core goods inflation is weak too (weak oil, GST cuts, China dumping). Food prices relative to core have fallen from an all-time high in Oct-24 to the median level now (Fig 57) suggesting balanced risks to inflation.

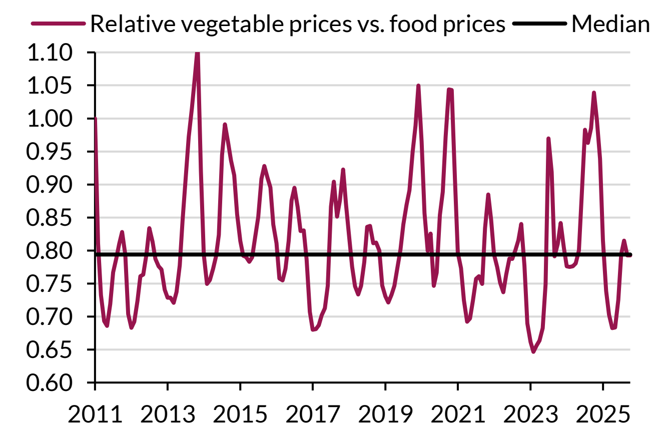
We focus below on why food prices are volatile. A major driver of food price volatility are vegetables: while over a long period of time the vegetable price index moves in-line with overall food prices, there are significant seasonal variations in vegetable prices (Fig 58). Relative to food, vegetable prices are now slightly below the median level (Fig 59). This volatility is primarily due to inflexibility in supply – it is harder for farmers to shift acreage in the absence of sufficient market access unless prices remain high for an extended period.

Exhibit 58 - Vegetable prices volatile but converge broadly



Source: CEIC, Axis Bank Research

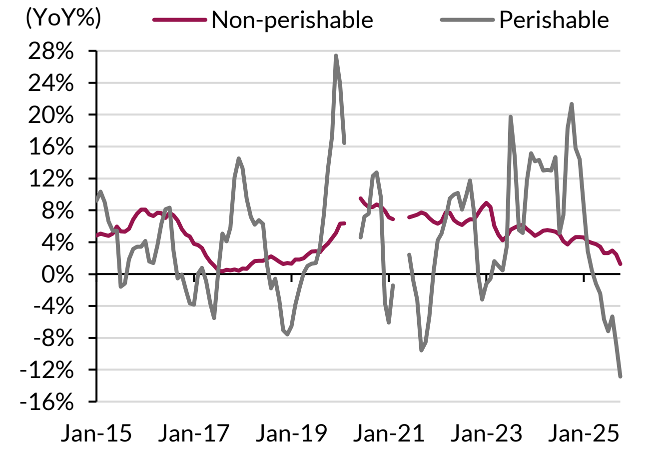
Exhibit 59 - Vegetable prices relative to food also normalized



Source: CEIC, Axis Bank Research

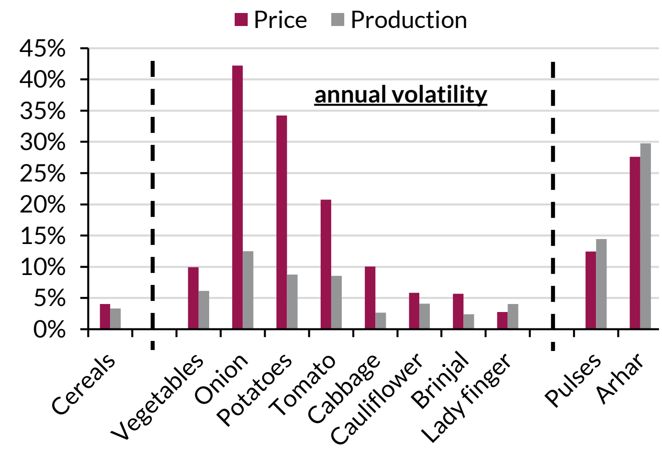
Among major food items, cereals have the lowest volatility in production volumes and prices (Fig 61). Due to the Minimum Support Prices (MSPs) being enforced via government procurement, acreage allocation does not change much, and output volatility is mainly due to weather affecting yields. As India has a significant surplus in cereals, and they are distributed through the Public Distribution System (PDS), price volatility is also contained.

Exhibit 60 - Non-perishables food inflation averaged 4.3% during Jul-24 to Jan-25; perishables predictably volatile



Source: CEIC, Axis Bank Research

Exhibit 61 - Price volatility much higher than production volatility for vegetables as compared to pulses or cereals

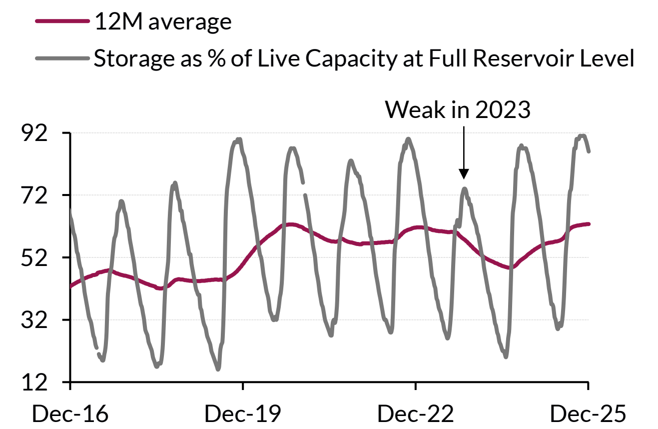


Source: CMIE, Axis Bank Research

Volatility of output is much higher in pulses, as sown area under pulses is often not irrigated, and therefore more dependent on rainfall. Over the past several years price volatility has been contained by an increase in warehousing by the government and supply diversification (earlier ex-India supplies were limited to Madagascar and Myanmar, which are also affected by the south-west monsoon; now pulses also come from Canada and Australia).

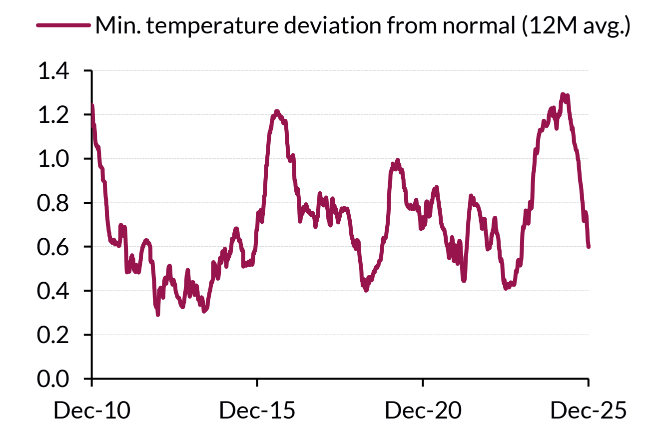
Output volatility is relatively low for vegetables overall, and in most of the green vegetables despite minimal government intervention. It is slightly higher for onions, potatoes and tomatoes, given crop-specific factors, and some dependence on rainfall patterns, water availability (Fig 62) and temperature variations (Fig 63). However, the price volatility is significantly higher, given low price elasticity of demand – to reduce demand by a few percentage points, prices need to rise substantially – and limited storage.

Exhibit 62 - Low reservoir levels in 2023 affected 2024 output; normalized now



Source: CEIC, Axis Bank Research

Exhibit 63 - Unexpected temperature variations hurt yields in 2024; 'normal' variations in 2025 (key variable to watch for)



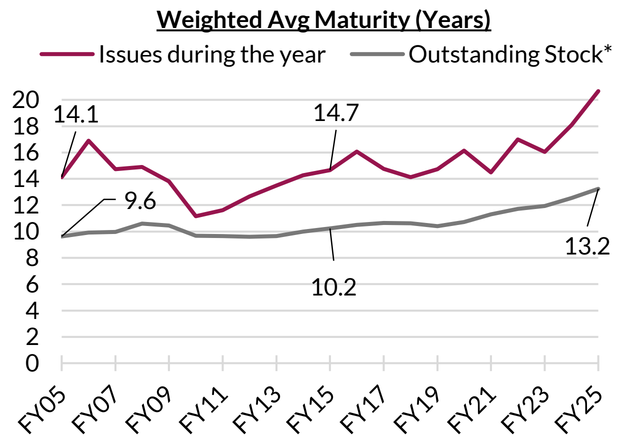
Source: CEIC, Axis Bank Research

India policy rates have likely bottomed, but 10Y G-Sec yields may move lower

Duration extension has a cost to the economy; slows monetary policy transmission

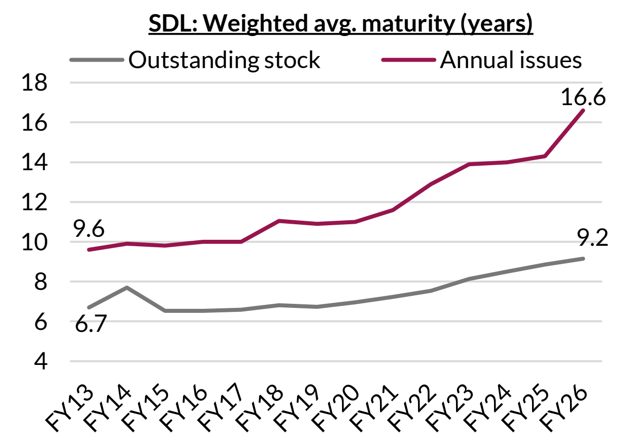
Over the past decade, policymakers in India have sought to increase the average duration of India's sovereign debt. The 2013 taper tantrum exposed risks of short-term borrowing, and the need to reduce budgetary volatility and de-risk from higher interest rates in the future. The government (link) and the RBI (strategy/reasoning: link) both committed to it. But we may have gone to the other extreme. The Weighted-average maturity (WAM) of outstanding stock has risen from <10 years in FY13 to >13 years now (Fig 64). WAM of annual issuances rose to 20-21 years in FY25 and 1HFY26, well above the 14-16Y range between FY14-22. States' duration rose to 17Y in 1HFY26 (Fig 65).

Exhibit 64 - G-Sec WAM for annual issuance higher post FY23; needs to fall below 14 years



Source: RBI, Axis Bank Research

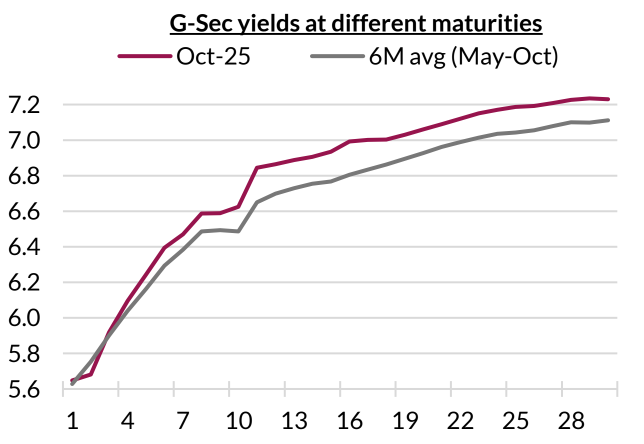
Exhibit 65 - Maturity elongation can continue even as WAM for new issuances is brought below 14 years



Source: RBI, CCIL, Axis Bank Research

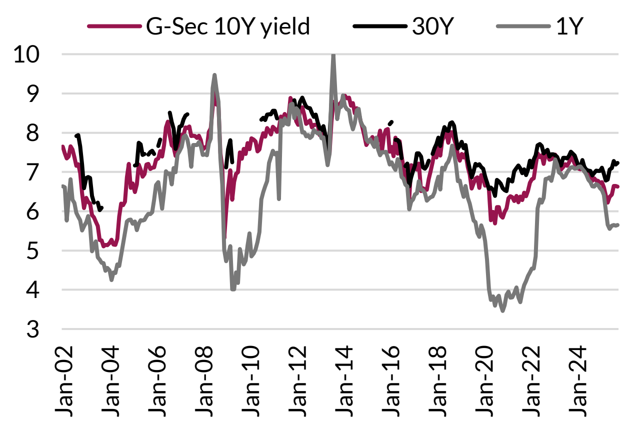
Whereas maturity-extension improves stability, it comes at a cost. The demand for longer-duration assets being finite, excessive duration extension keeps sovereign yields elevated, raising borrowing costs for the economy and slowing monetary transmission. Despite significant monetary easing by the RBI, bond yields haven't declined as much (Fig 66, 67). The duration for issuances needs to fall meaningfully in FY27, in our view.

Exhibit 66 - The effect of long duration borrowing is visible in higher yields at the long end



Source: RBI, Axis Bank Research

Exhibit 67 - Transmission effected: abnormal vs. other easing cycles, 1Y-30Y yield gap 40bps higher vs. even the median

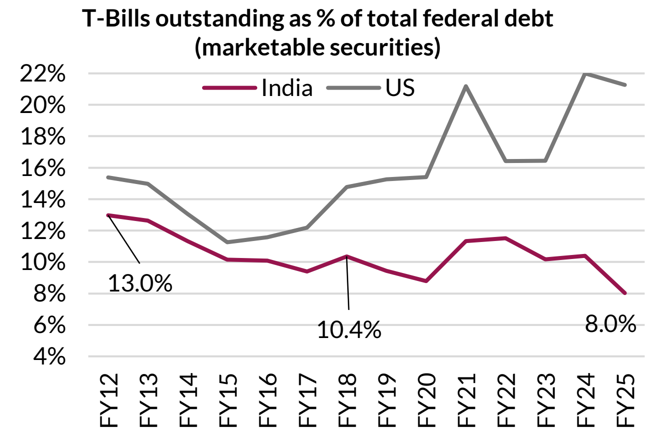


Source: RBI, Bloomberg, Axis Bank Research

T-bill issuance needs to rise at a steady pace; has impact on financial stability

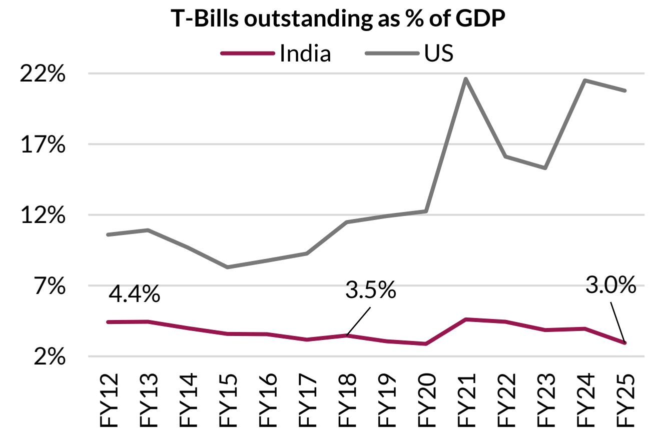
Notwithstanding the choice of average duration of issuance, the government should borrow more in T-bills, in our view. Net issuance of T-bills has been negative Rs2.5tn since Mar-2024, bringing to 15-year lows both T-bills outstanding as share of overall debt and as share of GDP (Fig 68, 69). This was likely a consequence of the just-in-time funds transfer scheme to states, which drove up government cash balances with the RBI.

Exhibit 68 - T-bills a smaller portion of overall issuances…



Source: RBI, Axis Bank Research

Exhibit 69 - T-bills outstanding as % of GDP also at its lowest

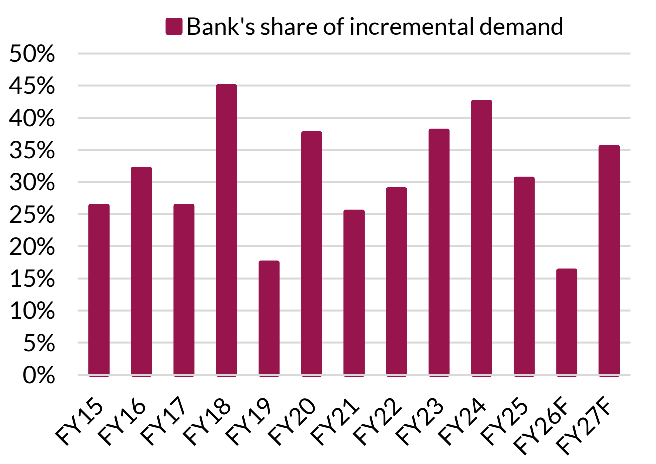


Source: RBI, Bloomberg, Axis Bank Research

Demand/supply mix remains favourable for G-Secs

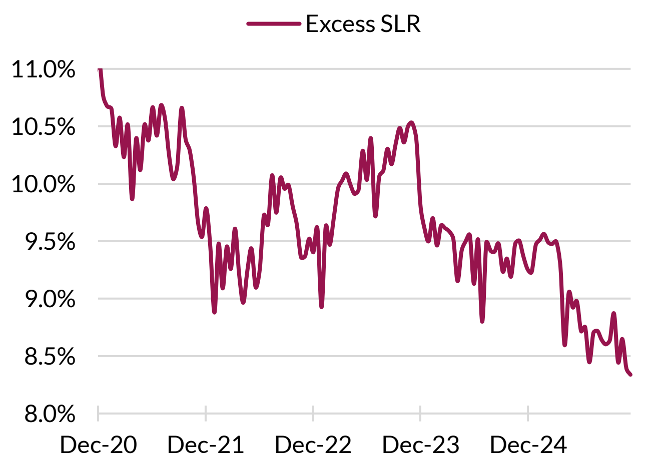
However, longer term general government consolidation – we expect 20bps consolidation at general government level (Fig 14) - combined with increased demand from banks as well as increased financialization provide positive demand/supply dynamics (Fig 70). These are also boosted by the potential for the RBI to infuse liquidity from OMO purchases. India's likely inclusion in Bloomberg Global Agg index may boost market sentiments as well (link). With these, we continue to expect yields to trend lower. We forecast G-Sec 10Y rates to fall closer to 6% sometime in FY27. This is likely to manifest as markets price "lower for longer" policy path and the government significantly lowers the duration of overall issuances. Lower uncertainty around USDINR and lower FX premia should help as well.

Exhibit 70 - Banks' govt. bond purchases in FY26 likely at decadal low; to recover strongly in FY27



Source: RBI, Axis Bank Research

Exhibit 71 - The FY26 trends are visible in falling SLR (1.2pp lower vs. Feb-25); we expect SLR to stabilize in FY27



Source: RBI, Bloomberg, Axis Bank Research

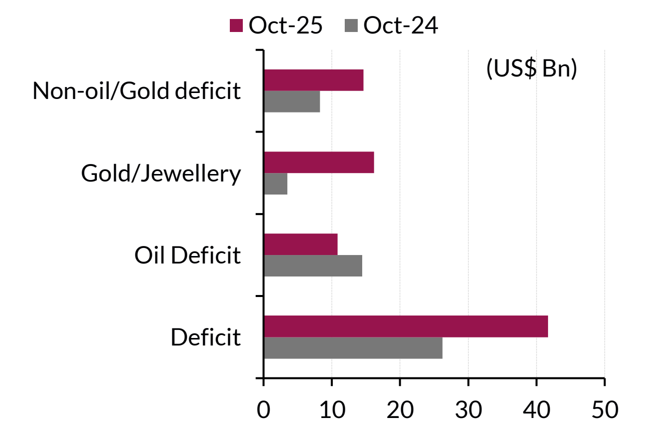
India's external balance stable, USDINR weakness helps

The INR's recent weakness despite low inflation has brought the REER to competitive levels. We do not see an unduly stressed Balance-of-Payments. The impact of the surge in investor demand for gold, which is keeping import volumes high despite 50% higher prices is offset by weak oil prices. A higher non-oil/gold deficit due to a recovering economy and Chinese competition in export markets can be paid for by the continuing double-digit growth in net services exports. We expect the current account deficit to widen marginally to 1.2/1.3% of GDP in FY26/27 respectively. FDI repatriation and nearly worst-ever FPI outflows have pressured inflows, but we expect these to be temporary.

Some deterioration, not a lot: FY26 current account deficit may widen by 0.6%

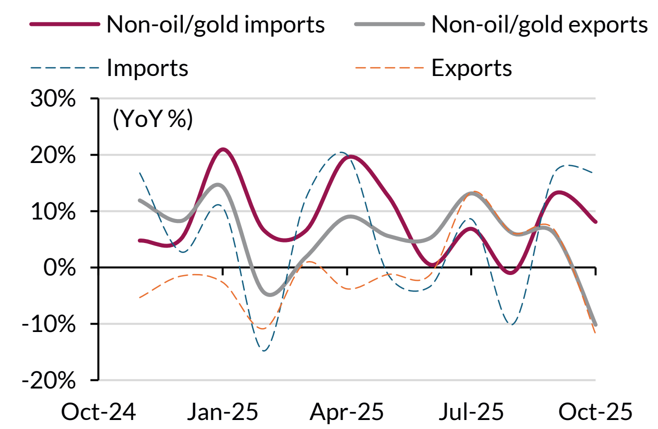
The Oct-25 goods trade deficit was the highest on record at US$42bn (Fig 72). Much of the incremental deficit was due to gold, where a jump in investor demand (sharp rise in gold-backed ETFs in India), pushed up import volumes by 10% despite a 51% jump in gold prices (Fig 73). While the deficit ex-oil/gold was near record highs too (reviving economy, exports face China competition), weak oil prices helped. With a growing services surplus, we estimate CAD to widen to 1.2/1.3% of GDP for FY26/27 from 0.6% in FY25 (Fig 77).

Exhibit 72 - Record Oct-25 deficit mainly due to gold (+$13B)



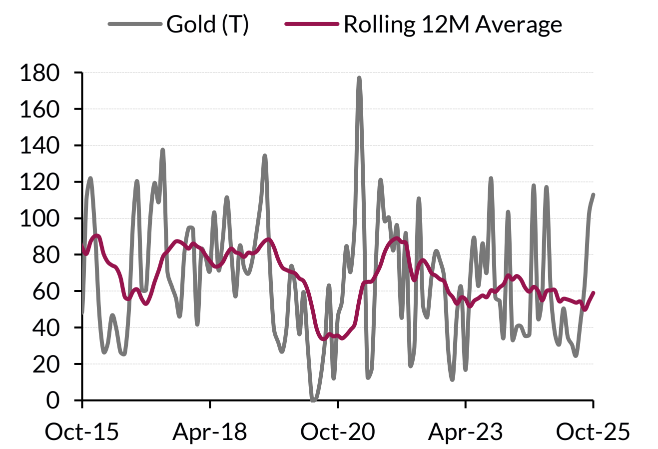
Source: MoCI, Axis Bank Research

Exhibit 73 - Non-oil/precious imports steady, exports weak



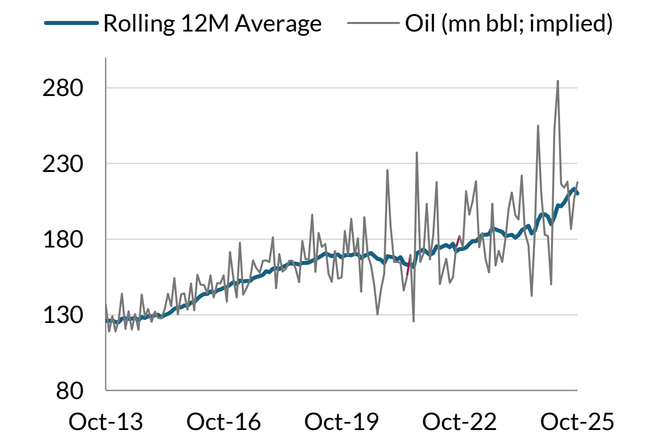
Source: MoCI, Axis Bank Research

Exhibit 74 - Gold import volume spike as per seasonality due to investor demand; (price rise usually means volume falls)



Source: MoCI, Axis Bank Research

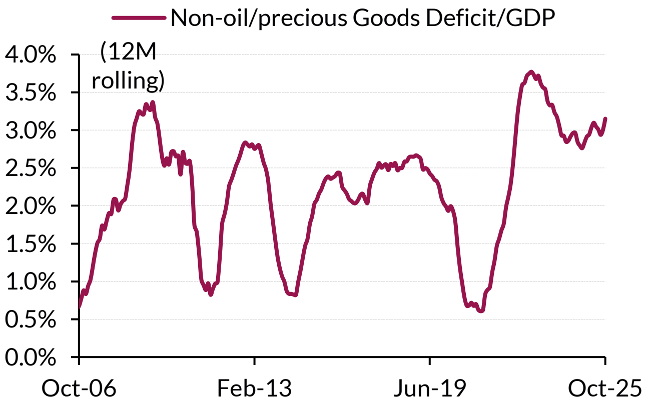
Exhibit 75 - Implied oil & gas imports stable; lower oil prices are helping keep oil deficit in check



Source: MoCI, Axis Bank Research

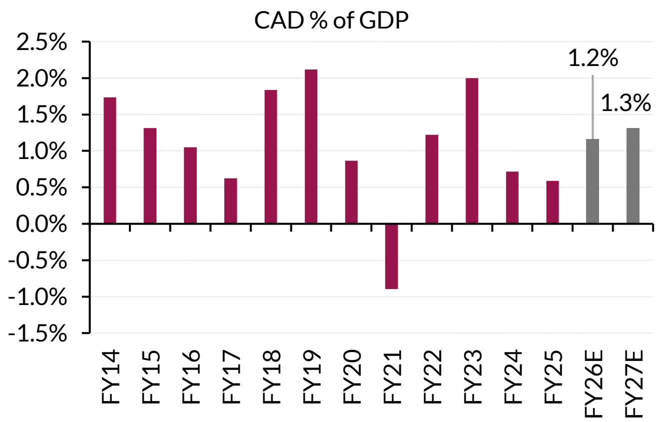
A major and medium-term challenge to this balance is rising exports from China into markets India ships to. In Oct, goods exports fell across all major categories ex-electronics not due to the US tariffs (exports to the US down 8% YoY, but up 15% MoM with exports still adjusting to the front-loading of prior months. Instead, in our view, this was due to diversion of Chinese exports to non-US markets. We fear these pressures are likely to intensify going forward. A weak job market growth (link) and a continuing real-estate downcycle are likely to keep consumption under pressure even as investments in industrial capacity persist.

Exhibit 76 - Non-oil/precious deficit as a share of GDP at 3% is growing again



Source: MoCI, Axis Bank Research

Exhibit 77 - CAD likely to expand to 1.2-1.3% of GDP in FY26 and FY27 as domestic demand recovers

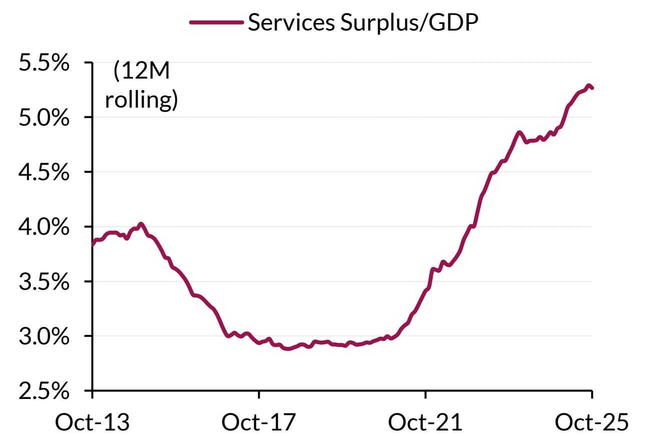


Source: RBI, Axis Bank Research

Growth in services exports remains robust, offsetting primary income outflows

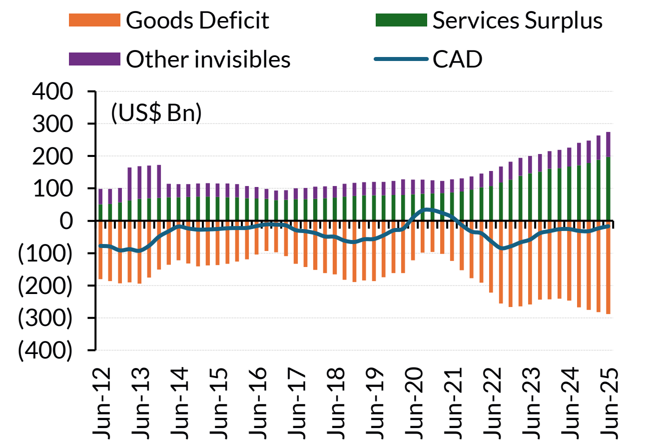
In Sep-2025, India's services exports grew 13% YoY, allaying concerns aired by many that US policies were beginning to hurt services. 2Q growth was still only 8.6% YoY, vs. 10.1% in 1Q, but the stronger exit momentum bodes well for 3Q. Even in the Jun-2025 quarter (last available data), 'modern services' grew 22% YoY, whereas the rest fell 13% YoY. The main challenge was a drop in tourism: beyond weak volume growth visible in global trends, the war in May, accidents and an early monsoon eroded inbound tourist arrivals in India. Hotel bookings have re-accelerated in Q3, with the momentum likely to sustain in FY27.

Exhibit 78 - India's services surplus as a share of GDP at 5.3% (12m rolling) is growing



Source: RBI, Axis Bank Research

Exhibit 79 - Services surplus (12m sum at $200 bn) helps keep CAD in check and supports GDP growth

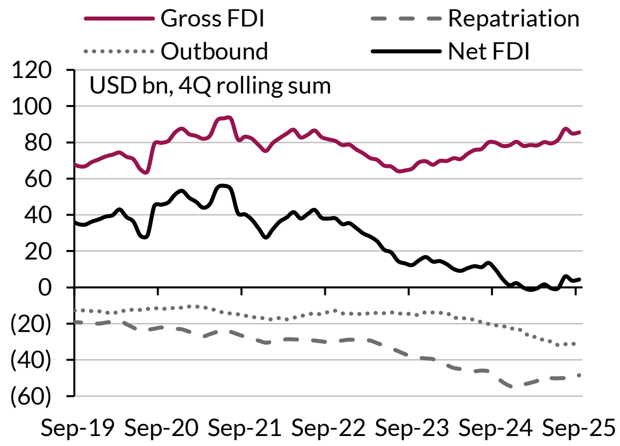


Source: RBI, Axis Bank Research

Capital outflows close to cyclical bottom, likely to improve in FY27

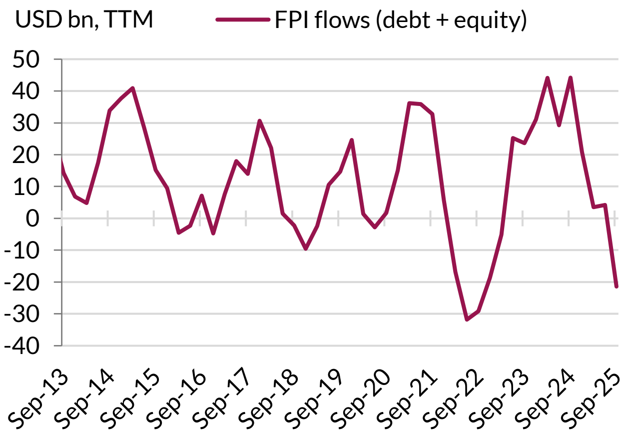
Net capital inflows plunged to just US$1 bn in 2QFY26, as portfolio outflows surged (Fig 81), while net FDI stayed weak (Fig 80). Dependence on volatile portfolio flows to finance the CAD has grown as the US$30bn/yr rise in FDI repatriation has negated the strong net FDI which earlier provided stability. Net FDI collapsed to $1 bn in FY25 versus an average US$33 bn during FY20–FY24 and has been weak in 1HFY26 as well.

Exhibit 80 - TTM net FDI flows weakened further in last 1Y



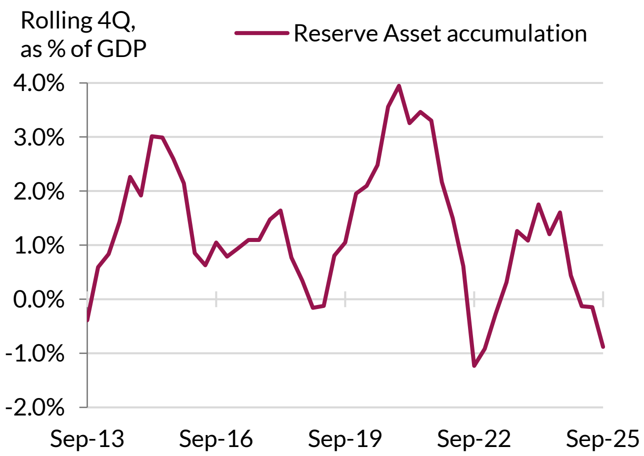
Source: RBI, Axis Bank Research

Exhibit 81 - FPI flows have weakened as well



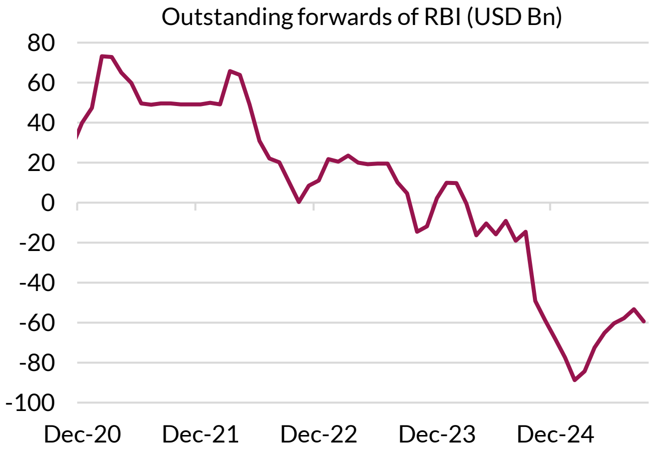
Source: NSDL, Axis Bank Research

Exhibit 82 - Higher CAD pressure and weak capital inflows led to loss of reserves



Source: RBI, Axis Bank Research

Exhibit 83 - In addition, RBI's net forward shorts are high and have risen even further post Sep-25



Source: RBI, Axis Bank Research

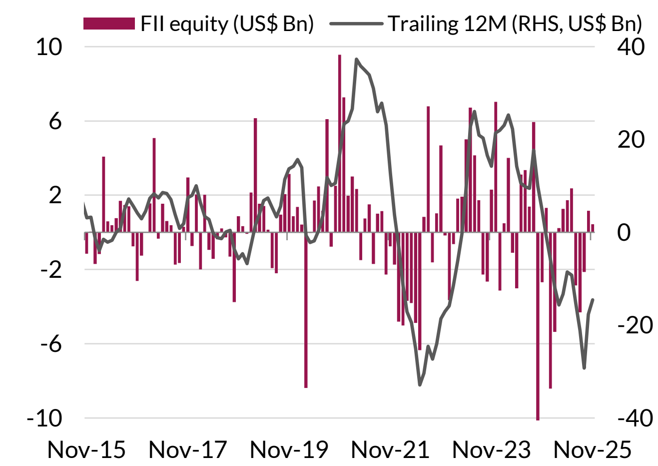
India's inclusion in the global bond index inevitable, we think it can happen in CY26

Factors in favor of India' inclusion in the Bloomberg Global Aggregate Bond Index: 1) India's size: by 2030 it could be ~5% of global GDP; 2) strong economic growth and macroeconomic stability; 3) Fiscal stress in nearly all developed markets (DMs): US, EU and JP; 4) Several DMs now show policy volatility and institutional weaknesses earlier attributed to EMs; and 5) Low yields in China. A 2019 estimate of the assets under management (AuM) that track the Index is ~USD2.5tn. If approved, we estimate India's weight at 0.7%, implying direct passive flows of USD ~18bn. This also raises the likelihood of other indices doing so: like the FTSE WGBI (AuM: ~USD 2tn), and allocation from pension funds and endowments which may not be benchmarked but take comfort from inclusion and the resultant rise in liquidity.

FII equity inflows patchy in CY25, as flows shifted to "AI winners"

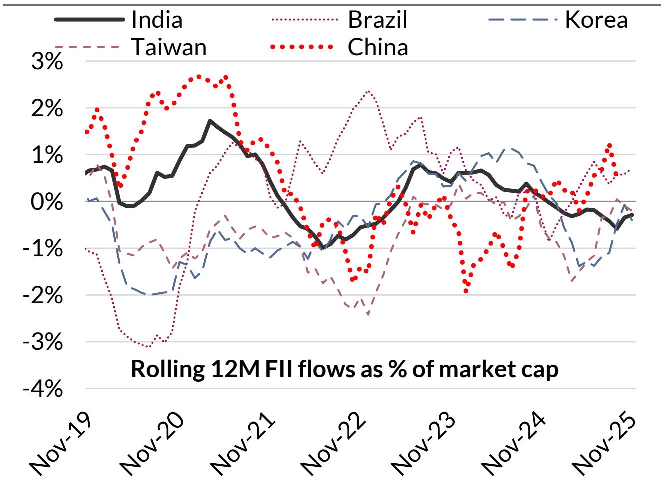
FII flows have remained patchy over the last 12 months, with a net outflow of US$16bn. This is only partly due to India-specific factors of the worst EPS revisions among major markets and being perceived as an 'AI Loser', as Indian IT firms (11% of Nifty market cap) may be hurt by AI (this assessment is premature, in our view). Over the past year, capital flows have been concentrated towards markets that are seen as benefiting from AI: the US, South Korea, Taiwan, and China. But a more important factor has been outflows from EM and Asia funds, as a large part of FPI investments are through these channels.

Exhibit 84 - India FII equity flows volatile, TTM outflows at US$16bn



Source: RBI, Axis Bank Research

Exhibit 85 - FII flows shifted to CN, KR, TW — "AI winners"

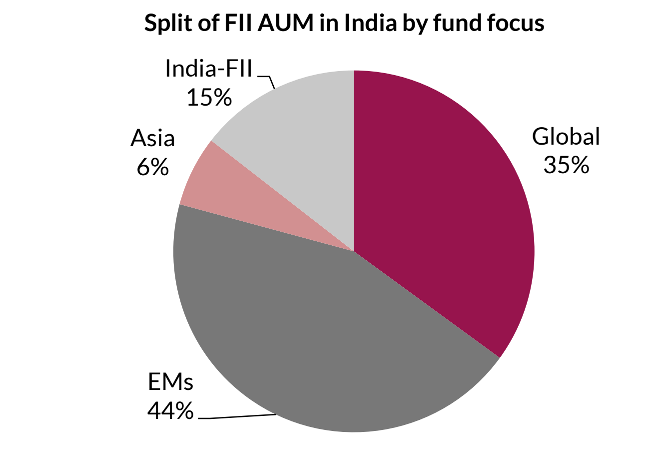


Source: Bloomberg, Axis Bank Research

India's falling weight in benchmark equity index causing passive outflows

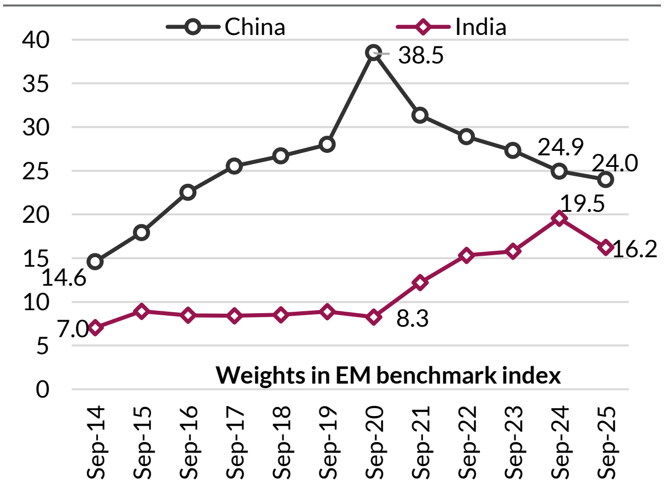
Nearly 74% of FII AUM in India come through broad-based funds or HFs, while the rest 26% are from SWFs/Pension funds which tend to be sticky. A large part of broad-based funds/HFs come through EM/Asia focused funds, and these have seen anemic inflows.

Exhibit 86 - 50% of India FII flows from EM/Asia funds



Source: Bloomberg, Axis Bank Research

Exhibit 87 - Cuts to India weight in EM benchmark, 2025



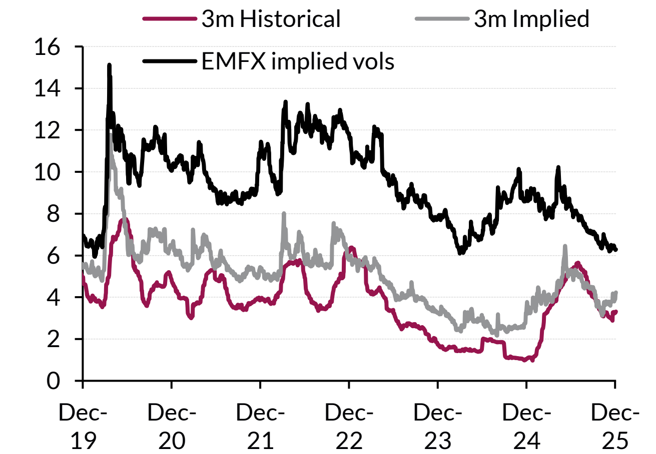
Source: Bloomberg, Axis Bank Research

The earnings downgrades triggered by economic growth disappointment in the last 12 months resulted in India's benchmark weights in EM funds falling from 20% to 16%. The resultant sell-off from passive funds linked to the benchmark and rotation from active funds into other markets (TW, Korea, China) were the major drivers of FII outflows in the last 15 months. As India's earnings trajectory stabilize (in US$ terms), we believe India can outperform global markets in 2026, which should boost India's weights in benchmark index, resulting in more passive inflows.

Mild, not wild depreciation remains the base case going ahead

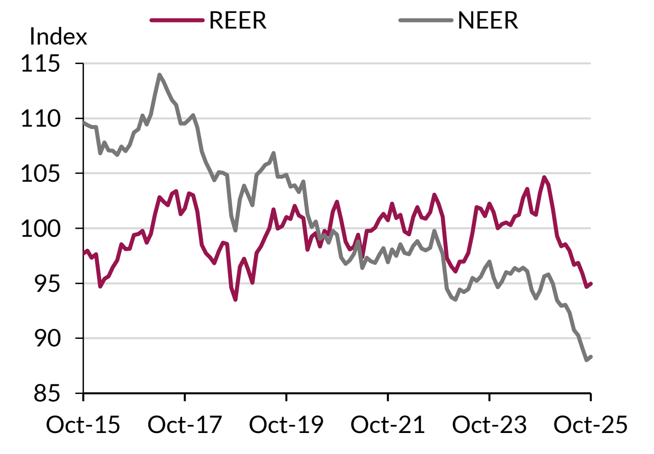
The Indian Rupee (INR) experienced a period of managed stability following its sharp depreciation in 2022, when it weakened by 11.4% amid aggressive US rate hikes and global risk repricing. The RBI shifted from a flexible approach to a more stabilised, crawl-like regime, actively intervening to limit INR volatility and maintain a narrow trading band. However, this strategy proved unsustainable, resulting in a significant drawdown of FX reserves—particularly during late 2024, when over $88 bn was deployed in just three months. As intervention limits were reached, the RBI was forced to allow the USDINR to break out of its band, leading to a rapid move past 90.

Exhibit 88 - Suppressed INR vols rose, but still low



Source: Bloomberg, Axis Bank Research

Exhibit 89 - REER has weakened to a 2018 low from a record high – will it stop here?



Source: BIS, Axis Bank Research

Looking ahead, the base case is for "mild, not wild" depreciation of the INR against the USD. The sharply weaker REER (now at its lowest since 2018), and ongoing reforms to improve the ease of doing business are supportive of sentiment and could incentivise fresh inflows over time. There is also the persistent overhang of the USD being devalued to improve US manufacturing competitiveness and cope with the US' widening negative Net International Investment Position. However, with a large overhang of forward shorts and persistent global headwinds, significant appreciation is unlikely. The RBI is expected to absorb excess inflows to rebuild reserves, and any shift back to a floating regime would only be gradual. The INR is projected at 90/USD by June 2026 and 92/USD by June 2027, with the pace of depreciation dependent on the evolution of capital flows and global risk appetite.

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