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Amid Global Uncertainty from Trump 2.0, India Gears Up with Policy Response to Boost Domestic Demand

- The second term of U.S. President Trump's administration (Trump 2.0) is expected to focus on pro-growth measures such as broad deregulation, boosting energy supply, and implementing a tax regime aimed at promoting investment, which could have positive spillover effects on the global economy.
- However, Trump's tariff policy is likely to bring heightened uncertainty and volatility. Tariffs will remain a key tool in trade negotiations, with potential impositions on countries like Canada, Mexico, and China.
- For India, U.S. trade policies under Trump 2.0 present both risks, like targeted tariffs and trade disruptions, and opportunities, particularly through potential trade agreements, lower energy prices, and the "China+1" strategy, which could position India as a key beneficiary of shifting global supply chains.
- While India will remain one of the fastest-growing major economies in 2025, it faces near-term growth challenges due to slower urban consumption, weaker exports, and sluggish private investment. Domestic policy responses, including fiscal and monetary measures, will be crucial for boosting growth amid global uncertainties.
- On fiscal policy, the upcoming Central Government budget is expected to show a better-than-expected FY25 budget deficit outcome and a slower pace of fiscal consolidation in FY26.
- The Central Government budget deficit for FY25 is expected to be ~ 4.8% of GDP, slightly below the budgeted 4.9%, due to underspending. The government is likely to target a deficit of ~4.5% for FY26.
- The FY26 budget may include tax relief for income taxpayers and enhanced allocations for welfare schemes to boost consumption.
- The FY26 budget is also expected to focus on capital spending to revive growth, with higher allocations for infrastructure, particularly railways and energy, and continued support for state-level CAPEX.
- The RBI's recent shift in its FX intervention strategy has led to a weaker rupee, which may support export competitiveness but also improve policy flexibility to support economic growth.
- CPI inflation eased to a four-month low of 5.2% YoY in December, driven by a decline in food inflation. Core inflation also eased, signalling sluggish demand conditions.
- With expectations for further easing in inflation in January, the RBI is likely to initiate a shallow policy rate cut cycle starting in February 2025 to support growth. The central bank may also announce additional liquidity measures to manage liquidity and ensure better transmission of anticipated policy rate change.

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Donald Trump returns for the second Presidential term, periods of heightened uncertainty likely

Donald Trump's inauguration as President of the United States (Trump 2.0) this week makes the US economic policy decisions even more central to the global economic outlook than they typically are. As discussed in recent *Economic Monthly Reports*, the United States entered 2025 poised to be a standout economic performer once again but with the prospect of greater volatility – policy, market and economic – than has prevailed in the prior couple of years.

Such greater volatility notwithstanding, our assessment remains that the Trump 2.0 policy mix is not easily categorized and is considerably more nuanced than seems to be recognized. President Trump's macro policy mix will be a heterodox one: it will combine pro-growth measures such as broad deregulation, efforts to boost energy supply and a tax regime geared toward promoting saving and investment. Yet, it will also include targeted industrial policy and tariffs/trade intervention. Since Mr. Trump's electoral victory, including the first few days of his new Administration, tariffs continue to garner the lion's share of attention, highlighted in part by financial markets' yo-yoing in response to various tariff and trade-related statements.

Trump 2.0's initial days have been marked by significantly greater policy focus (via Executive Orders) on the energy supply and deregulation front than trade. The US already is the world's largest producer of energy, and the Administration is seeking to boost energy production further by the equivalent of 3 million barrels of oil per day, which would equate to a roughly 8% rise in overall domestic energy supply (as measured by British thermal units). The hope is that such a boost to domestic energy output in turn lowers – or, at least, caps – energy costs for both consumers and businesses with beneficial economic effects. Moreover, artificial intelligence (AI) and data centres are extremely energy intensive and more plentiful energy supplies will be beneficial in sustaining the US's lead in those critical businesses.

Since the election, the president and his economic team also have been working with various Congressional officials on tax policy. Due to a quirk in US tax law, Trump 1.0's 2017 restructuring of the US tax system is set to expire at year-end. Absent legislation, tax rates would increase by a decent-sized amount, resulting in fiscal tightening. Given the competing interests and the narrow Republican majority in the House of Representatives, crafting new tax legislation is going to be an arduous process. But one that already is underway, which is a marked contrast to Trump 1.0 when such discussions and negotiations did not begin in earnest until roughly six months post inauguration.

To date – and, again, it is very early days – tariff-related news and headlines have been mostly ad hoc comments from Mr. Trump. Notably, these comments seem designed – at this point – as negotiating tools. Indeed, the floating of 25% tariffs on both Canada and Mexico effective (possibly) February 1 seems primarily designed to encourage those countries to stiffen security on their respective border with the US to help slow the flow of illegal immigrants into the US, a major Trump 2.0 policy goal. Similarly, the floating of a 10% tariff on Chinese imports effective (possibly) February 1 seems designed to try to push China to make greater efforts to control the flow of fentanyl into the US, another major Trump 2.0 policy goal.

China, Canada and Mexico are the three largest trading partners of the US, and the imposition of tariffs on those countries' exports to the US is more likely to be the by-product of carefully crafted policies, not the ad hoc pronouncements thrown out so far by Mr. Trump. Given Mr. Trump's impulsive tendencies, ad hoc tariff implementations against any of these three countries cannot be ruled out. But given his desire to restructure US trade in a meaningful manner, that only has the chance of being achieved via well thought out and durable policy changes (tariffs and otherwise) by the US and these three economies.

As we wrote in the election's aftermath, none of this is to imply that there will not be disruptions – perhaps good-sized ones – on the international front. President Trump campaigned on an aggressive policy agenda, his inaugural speech reinforced that aggressive agenda and many of the actions he has taken in his first few days in office indicate that he intends to follow through.

Our best assessment is that it will be two to three months before Trump 2.0 begins to consider implementing substantive policy initiatives on the international economic front. During this time, officials likely will be firming up plans and – having learned how to navigate the intricacies of the US legal and regulatory framework during Trump 1.0 – maximizing the likelihood that key policy initiatives can withstand any regulatory/legal challenge.

India economy outlook: policy response anticipated to address slowing economic growth

As per the IMF, the Indian economy is expected to remain one of the fastest growing economies globally with a projected growth of 6.5% in FY25 and FY26. This is despite signs of slower growth in FY25 due to a combination of disruptions related to general elections and weather, but also due to slower urban consumption spending, weaker export growth and lack of broad-based revival in private investment. After a sluggish H1-FY25, there are signs of economic activity picking up in recent months, with recovery in IIP, still robust PMI services level, rise in formal sector hiring, and

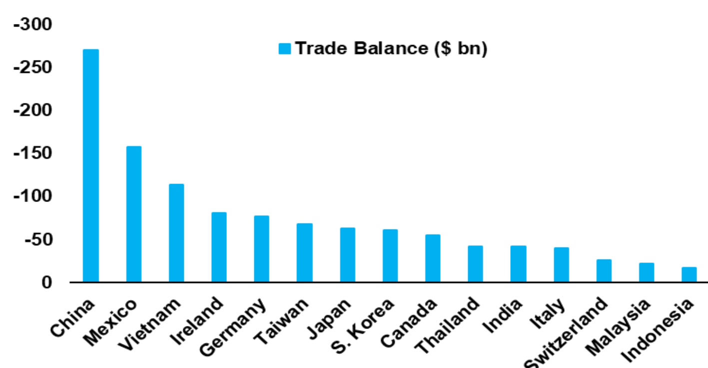
acceleration in Government CAPEX and increase in rural demand indicators (barring two-wheeler sales), as per the high-frequency data. However, exports, urban demand, and private investment remain sluggish. The external environment remains highly uncertain, particularly due to the US trade and the Fed's monetary policy outlook. As a result, we continue to see downside risks to our projection of 6.7% real GDP growth in FY25. In this context, domestic policy response remains critical to support domestic demand and address risks emerging from US policies. In the subsequent sections, we analyse India's fiscal and monetary policies outlook and also risks and opportunities from possible US policy developments.

U.S. policies under President Trump pose risks but also provide opportunities to India

U.S. policies under President Trump 2.0 are expected to undergo significant changes, accompanied by heightened uncertainty. These developments will have important implications for the global economy, including potential spillover effects on India, alongside potentially direct impacts from trade, immigration, and the U.S. Fed's policies.

The U.S. is India's second largest trading partner, accounting for 18.9% of India's exports and 6.4% of its imports, based on data for (April-Sept) FY25. Key exports from India to the U.S. include pharmaceuticals, telecom instruments, diamonds, and precious stones. India's major imports from the U.S. are petroleum & petroleum products, and coal, coke & briquettes. The U.S. is also a significant source of FDI into India and an important market for India's services exports, particularly in the IT sector.

US's goods trade deficit with India is relatively moderate



Source: US BEA

In 2024 (through November), the U.S. goods trade deficit with India stood at approximately $42 billion, making India the 11th largest contributor to the U.S. trade deficit, though this figure represents only 15% of the US trade deficit with China. As a result, India is less likely to face the broad-based tariffs that countries like China, Canada, and Mexico may encounter. However, India could still face targeted tariffs, particularly given its relatively high average tariff rates—17% on a simple average basis and 12% on a trade-weighted average basis, under Most Favoured Nation (MFN) status. Agricultural products, in particular, face higher tariffs compared to non-agricultural items.

India: Tariffs and Imports- Summary and duty ranges

Summary	Year	Total	Agricultural Products	Non-Agricultural
Simple Average Final Bound		50.8	113.1	36.0
MFN Applied				
Simple Average	2023	17.0	39.0	13.5
Trade-Weighted Average	2023	12.0	65.0	9.0
Imports in $bn	2022	712.3	37.4	674.9

Source: WTO

During his first term, President Trump imposed tariffs on steel and aluminium imports from India and terminated India's eligibility for the U.S. Generalized System of Preferences (GSP). As per the US Congressional Research Service, GSP accounted for 11% of U.S. merchandise imports from India, or $6.3 billion in 2018, covering products such as chemicals, auto parts, and tableware. Despite these setbacks, India's exports to the U.S. continued to grow after the initial impact, with India's share of U.S. imports increasing to 3.1% and exports to 2.4% by 2023, compared to 2.6% and 2.0% in 2017, respectively.

During his campaign, President Trump highlighted India as one of the countries imposing high tariffs. He proposed a flat 10% tariff on all goods entering the U.S., regardless of their country of origin, without targeting India directly. Trump's recent threat of a 100% tariff on BRICS nations appears to be aimed at dissuading these countries from seeking alternatives to the U.S. dollar. Since India is not pursuing such an agenda, this tariff is unlikely to materialize. The "America First Trade Policy" memorandum issued after Trump's inauguration outlined plans to negotiate bilateral or sector-specific trade agreements with select countries to secure market access for American businesses. This policy could benefit India by opening opportunities for trade deal negotiations, particularly for customs duties and product access. Close diplomatic relations between the US and India, particularly the strong rapport between US President Trump and India's PM Narendra Modi, should lead to a more amicable approach to addressing trade and sectoral issues. This does not rule out periods of high uncertainty and tensions before a deal could be reached.

In addition to direct impacts, the evolving U.S. policy agenda—both domestic and external—will pose risks while also creating opportunities for India. Under Trump 2.0, U.S. energy policy, combined with the potential de-escalation of geopolitical tensions in the Middle East and Ukraine-Russia, could help lower crude oil and other major commodity prices, benefiting India. Moreover, there is potential for strengthening India-U.S. defence and energy trade, which could further enhance bilateral relations.

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Any escalation in the U.S.-China trade war could present opportunities for India, particularly under the "China+1" strategy, which encourages businesses to diversify supply chains away from China. In the past, India did not significantly benefit from this shift, with Mexico and Vietnam emerging as major beneficiaries. However, India is now better positioned, thanks to various Production-Linked Incentive (PLI) schemes designed to attract foreign investment. Nonetheless, India will need to manage risks such as potential Chinese export dumping into India and other markets in the event of further U.S.-China tensions. Additionally, fluctuations in China's currency could impact India's export competitiveness. Moreover, an escalation of the U.S.-China trade war or the imposition of broad-based tariffs by the U.S. would have negative implications for global trade, which would, in turn, affect India's exports.

Lastly, the U.S. domestic policy agenda is expected to stimulate US economic growth, which would have positive spillover effects on the global economy, including India. Increased US investments in AI and IT sectors, along with financial sector deregulation, could benefit India's IT industry. While tighter US immigration policies and increased scrutiny of H-1B visas may raise costs for Indian IT firms, the impact is expected to be limited, as was the case during Trump's first term. A stronger U.S. economy could also reduce the scope for additional monetary easing by the U.S. Fed, supporting a stronger U.S. dollar. This, in turn, could put pressure on emerging market currencies, including India. However, India's economic fundamentals remain relatively strong, with high economic growth, moderate current account deficit and low external debt. Its fiscal and government debt position is relatively weaker, but a captive domestic market ensures adequate financing. Lastly, the RBI's (still) robust FX reserves, should cushion the impact of foreign capital outflow and currency volatility.

India's economic fundamentals are relatively strong compared to major peers

Indicator	Year	Brazil	China	India	Indonesia	South Africa	Türkiye
Real GDP YoY%	2024	3.7	4.8	6.5	5.0	0.8	2.8
	2025	2.2	4.6	6.5	5.1	1.5	2.6
CPI Inflation (avg), YoY%	2024	4.3	0.4	4.4	2.5	4.7	60.9
	2025	3.6	1.7	4.1	2.5	4.5	33.0
General Govt net lending/borrowing, % of GDP	2024	-6.9	-7.4	-7.8	-2.7	-6.2	-5.2
	2025	-7.3	-7.6	-7.6	-2.5	-6.3	-3.6
General Govt Debt, % of GDP	2024	87.6	90.1	83.1	40.5	75.0	25.2
	2025	92.0	93.8	82.6	40.7	77.4	26.0
Current A/C balance, % of GDP	2024	-1.7	1.4	-1.1	-1.0	-1.6	-2.2
	2025	-1.8	1.6	-1.3	-1.2	-1.9	-2.1
External Debt, % of GDP	2024	35.1	13.8	17.5	30.5	43.7	39.1
FX Reserves, $ bn	2024	329.7	3521.6	659.4	150.2	65.9	155.2

Source: IMF (January 2025 report for real GDP growth, and October'24 report for other data). For India, data and projections are presented on a fiscal year (FY) basis, with FY 2024/25 (starting in April 2024)) shown in the 2024 row. World Bank (External debt). FX Reserves are from the IMF, as per the latest month available in 2024.

Budget preview: slower fiscal consolidation expected as government to take steps to boost demand

The finance minister is scheduled to unveil the central government budget for the next fiscal year - FY26 and release the revised fiscal numbers for the current fiscal year on February 1st. For the current fiscal year, we expect the government to undershoot its fiscal deficit target owing to lower than budgeted spending, particularly capital spending, offsetting the shortfall in receipts arising from the poor progress of the divestment plan. In absolute terms, we expect the fiscal deficit to be lower by ~Rs. 0.72 lakh crores. As a % of GDP, the fiscal deficit is estimated at ~4.8% compared to the budgeted target of 4.9%. This is despite factoring in the lower GDP estimate for FY25. As per the first advanced estimate, the nominal GDP for FY25 is estimated to grow by 9.7% compared with the 10.5% assumed in the budget estimates.

During the first eight months of FY25 (April-November), the total receipts are tracking ~59% of the Budget Estimates (BE) and we expect it to undershoot the budgeted estimates slightly led by non-tax revenue and divestment receipts. The centre pegged non-tax revenue for FY25 at Rs 5.5 lakh crore with Rs 2.9 lakh crore from dividends and profit and Rs 2.1 lakh crore from other non-tax revenue. With RBI's bumper dividend transfer of Rs 2.1 lakh crores and the PSE's dividend also remaining robust, we expect dividends to overshoot the budgeted estimate. However, this will not be enough to offset the shortfall in other non-tax revenue arising on account of lower proceeds under economic services. Meanwhile, the saga of poor divestment performance has continued in FY25 with total non-debt capital receipts tracking at Rs 8.9K crores (out of which Rs 8.6 K crore is from divestment). We expect these receipts at ~Rs 25K crore in FY25 (including asset monetization) significantly undershooting the budgeted estimate of Rs 50K crore.

Meanwhile, the gross tax revenue grew by 10.7% in FYTD25 in line with the budget estimates. This was primarily led by personal income tax collections, whilst corporate tax acted as a laggard. Indeed, until November, personal income tax grew by an impressive 23.5% YoY, compared with a budgeted growth of 13.6% over FY24 provisional (for the full FY), while corporate taxes contracted by 0.5%, compared with a budgeted growth of 12.0%. Indirect taxes on the other hand grew by ~9.2% in FYTD compared to the budgeted increase of 8.2% led by other taxes and customs duties. GST collections, however, are tracking slightly lower at 9% (until December) compared to a budgeted growth of 11.0%. Overall, for the whole year, we estimate the shortfall in direct taxes to be covered by a favourable performance of indirect taxes.

The growth in expenditure is tracking lower than the budgeted estimate. Part of the reason for the lower spending is the general elections in Q1, which significantly disrupted the spending pattern. This is primarily led by capital expenditure, which declined by 12.3% in April-November vs the budgeted estimate of 17.1%. Further, the central government loans to the state governments also stood lower at Rs 90K crore vs the target of Rs 1.5 lakh crore. This likely will continue to remain an area of underutilization. Overall, we expect the capital expenditure to undershoot BE to the tune of Rs 1.3 lakh crore. Meanwhile, the pace of revenue expenditure was relatively strong at 7.8% in FYTD25 vs budgeted growth of 6.2%. This is primarily led by the subsidy expenditure, which is currently tracking at 15% in FYTD25 compared to a decline of 3% (full year) estimated in the budget. Meanwhile, interest payments are tracking slightly lower at 8.3% vs BE of 9.3%. We expect the subsidy expenditure to overshoot the BE and interest expenditure to undershoot the BE marginally. Overall, we expect the total revenue expenditure to be higher than the BE by ~ Rs. 20K crore after incorporating the first supplementary demand grants, which are mainly focused on revenue expenditure items, including PM KISAN, fertilizer subsidies, pension & retirement benefits, etc. In a nutshell, with higher revenue expenditure and lower capital expenditure, the total expenditure is expected to undershoot the BE to the tune of ~Rs. 1.1 lakh crore. With that, we expect the fiscal deficit to undershoot the targeted number by ~Rs 0.72 lakh crore.

FY26 budget to focus on consumption and capital expenditure to revive growth

The upcoming FY26 budget will be presented against the backdrop of slowing domestic growth due to slowing urban consumption and weaker investment spending. Therefore, the government is expected to deal with the dual objective of supporting growth while maintaining focus on the fiscal consolidation although bit at a slower pace. Accordingly, we expect the budget deficit for FY26 to be pegged at ~4.5% of GDP. To provide relief to the middle class and boost demand, the govt can tweak income tax rates/slabs. As per media reports, the government could provide considerable relief to salaried taxpayers with an annual income of up to Rs 20 lakh either by making an annual income up to Rs 10 lakh completely tax-free or introducing a new 25% tax slab for incomes between Rs 15 lakh and Rs 20 lakh. While this would be helpful, a more effective way to boost disposable income would be rationalization of the GST tax rates given that the income tax paying population is ~2%. The rural welfare scheme will continue to be in focus to boost rural consumption. This could take the form of higher allocation for MNREGA and an increase in income support under PM Kisan Samman Nidhi. There will be a focus on job creation and skilling, through allocation for schemes announced in FY25 and possibly expanding their scope. Expansion of PLI schemes to labour intensive sectors and select MSME segments could also be announced.

Capital spending is expected to be one of the key themes once again for FY26 given the lack of meaningful pick-up in private investment amidst a challenging global environment along with deceleration in the pace of domestic consumption. Higher allocation for Infrastructure, especially Railways and Energy, is expected though allocation for Road and Defence could be rationalized. To revive spending by the states, the government is expected to continue the interest-free loans to states and may even increase the allocation slightly. However, given a portion of these loans are performance-linked and the current year's disbursement

Fiscal Metrics	INR Lakh Crores				% of GDP			
	FY23 A	FY24 A	FY25 BE	FY25 E	FY23 A	FY24 A	FY25 BE	FY25 E
Revenue Receipts	23.8	27.3	31.3	31.2	8.8	9.2	9.6	9.6
Net Tax Revenues	21.0	23.3	25.8	25.8	7.8	7.9	7.9	8.0
Gross Tax Revenues	30.5	34.6	38.4	38.5	11.3	11.7	11.8	11.9
Direct Tax	16.6	19.6	22.1	21.7	6.2	6.6	6.8	6.7
Corporate Tax	8.3	9.1	10.2	9.3	3.1	3.1	3.1	2.9
Income Tax	8.3	10.4	11.9	12.5	3.1	3.5	3.6	3.9
Indirect Tax	14.0	15.1	16.3	16.7	5.2	5.1	5.0	5.2
Customs	2.1	2.3	2.4	2.5	0.8	0.8	0.7	0.8
Union Excise Duty	3.2	3.1	3.2	3.0	1.2	1.0	1.0	0.9
GST	8.5	9.6	10.6	10.5	3.2	3.2	3.3	3.2
Less States Share	9.5	11.3	12.5	12.7	3.5	3.8	3.8	3.9
Non-Tax Revenues	2.9	4.0	5.5	5.3	1.1	1.4	1.7	1.6
Dividend from PSE	0.6	0.5	0.6	0.6	0.2	0.2	0.2	0.2
Dividend from RBI & PSU	0.4	1.0	2.3	2.3	0.1	0.4	0.7	0.7
Non-Debt Capital Receipts	0.7	0.6	0.8	0.5	0.3	0.2	0.2	0.2
Disinvestments & Others	0.5	0.3	0.5	0.3	0.2	0.1	0.2	0.1
Total Receipts	**24.6**	**27.9**	**32.1**	**31.7**	**9.1**	**9.4**	**9.8**	**9.8**
Total Expenditure	**41.9**	**44.4**	**48.2**	**47.1**	**15.6**	**15.0**	**14.8**	**14.5**
Revenue Expenditure	34.5	34.9	37.1	37.3	12.8	11.8	11.4	11.5
Interest Payments	9.3	10.6	11.6	11.5	3.4	3.6	3.6	3.6
Subsidy	5.3	4.4	4.3	4.6	2.0	1.5	1.3	1.4
Capital Expenditure	7.4	9.5	11.1	9.8	2.7	3.2	3.4	3.0
Fiscal Deficit	**17.4**	**16.5**	**16.1**	**15.4**	6.4	5.6	4.9	4.8

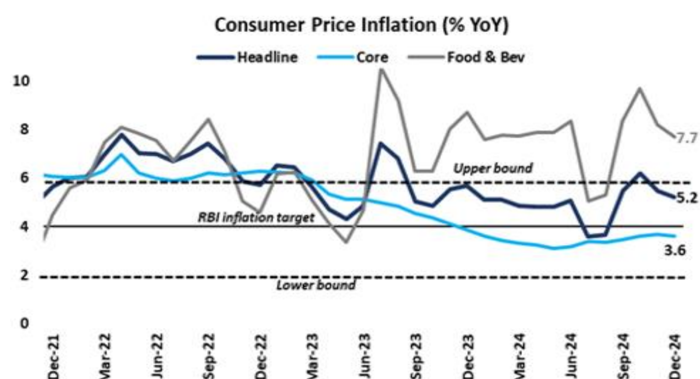
Source: CMIE, Budget documents, DMI estimates; Note: E - DMI Estimates, BE - Budget Estimates, A - Actuals.

has been slow, the centre is likely to relax some of these conditions going ahead. The government is likely to continue the support provided to MSMEs in the form of enhancing credit availability and could announce steps to reduce tax/improve ease of doing business. It could also rationalize customs duties and provide support to boost exports.

RBI policy preview: policy rate cut expected in February 2025, with additional liquidity measures

CPI inflation eased to a four-month low of 5.2% YoY in December, down from 5.5% YoY in November. This marked the sharpest sequential decline in 15 months, primarily driven by the largest sequential drop in food inflation over the same period. On a yearly basis, food and beverages inflation fell to 7.7% YoY in December from 8.2% YoY in November. This decline was largely attributed to a seasonal correction in vegetable prices, alongside a reduction in the prices of cereals and pulses. Core inflation also eased from 3.67% in November to 3.61% in December, signalling sluggish demand conditions. Importantly, the decline in core inflation was more pronounced in core goods compared to core services, reflecting the continued weakness in demand for goods. Notably, the feared pass-through of high food inflation to core inflation has not materialized so far. For Q3-FY25, the CPI headline inflation averaged 5.6%, marginally below the RBI's projection of 5.7%.

Inflation falls to a four-month low, led by food inflation



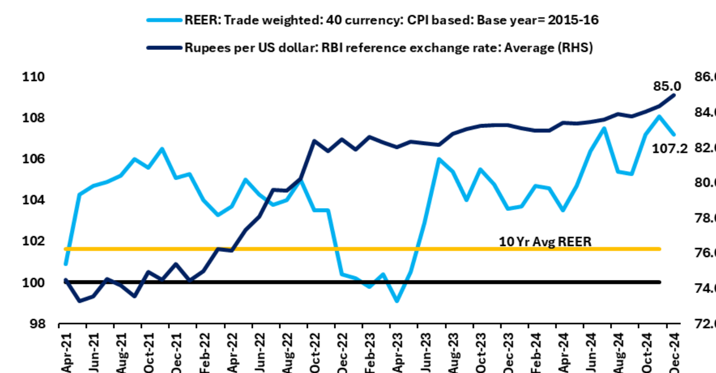
Source: CMIE

High-frequency data for January 2025 suggests that vegetable prices are continuing to trend lower. However, this positive trend in food inflation could be partially offset by a rise in edible oil prices due to customs duty hikes. Core inflation is likely to remain contained in the near term before gradually rising. Accordingly, we expect inflation to dip below 5% in January, barring any unforeseen disruptions in the inflationary trajectory.

The RBI is currently facing a difficult policy choice: it must keep controlling inflationary pressures while simultaneously addressing the economic slowdown. With CPI inflation on a downward trajectory, there is a need for a policy response to counter mounting growth concerns—especially considering that monetary policy operates with a lag. However, the RBI's policy flexibility is constrained by a highly uncertain global environment, particularly with respect to the US trade policy and the US Federal Reserve's monetary policy. The hardening of US yields and the strengthening of the US dollar have already led to foreign capital outflows from emerging markets and the weakening of their currencies, including India. This creates a policy "trilemma" (also known as the "impossible trinity") for the RBI, as it cannot simultaneously ease monetary policy and intervene heavily in the foreign exchange market and have an open capital account.

For several quarters, the RBI has maintained a tight leash on the exchange rate, intervening heavily during periods of foreign capital outflows, which in turn has drained domestic systemic liquidity. Despite the 50-basis-point (bps) cut in the Cash Reserve Ratio (CRR) in December 2024, the systemic liquidity deficit has widened to an average of Rs 1.8 lakh crore in January 2025 (data till 22nd Jan), up from Rs 0.6 lakh crore in December 2024. Consequently, the weighted average call rate hovered above the policy rate, tightening monetary conditions and impeding economic activity.

Rupee's recent depreciation could reduce currency (REER) overvaluation



Source: CMIE

Policy considerations must weigh both the short-term and long-term consequences of the RBI's FX strategy. While the yield differential (between US and India G-Sec yields) can drive the movements in foreign capital flows and, consequently, in exchange rates in the short term, India attracts a larger share of foreign capital inflows into the stock market and long-term FDI—both of which are growth-oriented. Therefore, measures to support growth could attract foreign capital into India. Furthermore, large exchange rate market interventions have led to a sharp fall in FX reserves (by US$ 65 billion in the past three months to US$ 626 billion by 10th January 2025) and caused the rupee's loss of competitiveness. In Real Effective Exchange Rate (REER) terms, the rupee is still overvalued by 7% by December. This could result in a larger trade deficit in the

future, as exports lose competitiveness and imports become cheaper. In external trade markets, the loss of market opportunities is harder to recover from, given intense global competition.

As policymaking involves balancing often conflicting objectives, the RBI should ease monetary policy to support growth, while allowing for at least depreciation of the rupee aligned to peers. This may imply short-term pain on the exchange rate front but could encourage growth-oriented foreign capital inflows and prevent the loss of external trade opportunities. Further, this strategy would lower the negative impact on domestic liquidity and growth, while preserving FX reserves for potential major shocks.

Under the RBI's new governor, there appears to be a shift in the RBI's FX intervention strategy. Since December 2024, the RBI has started loosening its grip on the rupee, allowing for a faster pace of depreciation. As a result, the INR has depreciated by 0.8% in December 2024 and 1.4% in January 2025 (so far), breaching the 86.6 level on multiple days against the US dollar. While the depreciation of the rupee is likely to exert upward pressure on inflation through higher import costs, the exchange rate pass-through may not occur immediately or to its full extent, given sluggish domestic demand conditions. As FX volatility is expected to remain high in the coming months, the RBI is likely to judiciously use its FX reserves for intervention going ahead, while allowing the rupee to move more in line with its peers. This approach should improve the RBI's policy flexibility to pursue measures that support economic growth. The external environment, especially US trade policy, will remain a critical source of policy uncertainty, which the RBI will need to navigate carefully in the coming months.

Going ahead, the RBI will need to place greater emphasis on managing domestic liquidity while balancing the need to protect export competitiveness and support economic growth. We believe that the RBI is likely to initiate a shallow policy rate cut cycle starting in February 2025. At the same time, it will need to address the systemic liquidity deficit to prevent unintended tightening of monetary conditions and ensure better transmission of any policy rate cuts. From mid-January 2025, the RBI began conducting daily Variable Rate Repo (VRR) auctions to help lower money market rates from elevated levels, but it does not provide durable liquidity to the system. Given the seasonal liquidity demand in Q4, the RBI will need to infuse durable liquidity through measures such as additional CRR cuts, Open Market Operations (OMO), longer-tenor VRR auctions, or USDINR buy-sell swaps.

Market Update

Bond Market: Indian bond market experienced a volatile start to the new calendar year. After moderating in December, the 10-year benchmark yields rose to 6.85% in the first half of January, rising by roughly 9 bps from the end of December. This was led by multiple factors, the predominant one being the rise in US treasury yields amidst strong US economic data reinforcing expectations of higher interest rates for longer. Higher crude oil prices also exerted upward pressure on yields. However, as US Treasury yields declined following softer inflation data, Indian 10-year yields mirrored this trend, falling by 13 bps to 6.72% as of January 22nd. Looking ahead, the yields are expected to be supported by a lower fiscal deficit compared to the target, policy rate cut, and likely infusion of durable liquidity by the RBI. However, the potential US policy developments could lead to higher volatility.

Equity Market: Indian equity markets, which recovered in the first half of December, turned negative following hawkish commentary from the US Federal Reserve, causing a ~2% decline in the NIFTY50 within three days after the Fed's policy meeting. Despite this, FPI flows remained marginally positive in December. In January, subdued corporate results and a reversal of FPI flows, driven by rising US Treasury yields and a strengthening dollar, further impacted the market (2.1% correction so far). With potential US policy uncertainties and the ongoing impact of rising US interest rates, Indian equity markets are likely to remain volatile.

Currency Market: In the currency market, the Indian Rupee continued to weaken, depreciating by 0.8% in December to trade at an average of Rs 85.0/US$. The rupee's decline was driven by a strengthening dollar and foreign capital outflows. The depreciation was further exacerbated by US Fed policy and year-end dollar demand from importers. Despite this depreciation, the Indian rupee remained overvalued as per the REER metric. The rupee's depreciation continued into January with the rupee breaching the 86.6 level on multiple days, as a strong dollar, and rising crude prices and continued foreign capital outflow weighed on the rupee. The pace of depreciation has also increased recently due to RBI's lack of aggressive intervention in the foreign exchange market. With the rupee still overvalued and expectations of global policy changes leading to strengthening of the dollar, further depreciation in the rupee is likely.

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