

Indian Macro: Nine Lives, Nine Financial Insights



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India Macro Report
July 2026

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Executive Summary

The Indian economy has been growing at a robust rate, and by most conventional metrics it appears resilient as of now in the face of several geo-economic headwinds. Real GDP growth, flirting with 8% according to official estimates, keeps India in the top tier of the world's fastest-growing economies. After a prolonged period of banking and private sector stresses, namely, the twin balance sheet crisis years, corporate balance sheets have recovered, and the banking system has cleared a decade's worth of bad loans. Additionally, having borne the brunt of demonetization, a global pandemic, and waves of geopolitical disruptions, the Indian economy—notwithstanding well-documented questions about the veracity of official growth estimates—is certainly not stagnant. 'Nine Lives' in the title of this report, implying resilience is thus duly attributable to the Indian economy remaining on a growth trajectory.

Resilience, to be sure, is not the same as invulnerability, and growth simply read in the aggregate can obscure risks that may become visible when the macroeconomy is examined carefully across several cuts. That is what this report seeks to do. Using multiple financial data sources, be it concerning capital flows, banking and credit, trade, public finance, sectoral flows of funds, or capital markets, it essentially follows the money to advance 'nine financial insights' of macroeconomic importance. Each read separately, highlights specific pressure points that headline aggregate numbers simply cannot. When considered together, they point to three broad structural findings with attendant vulnerabilities, which warrant sustained attention, and most importantly, effective policy responses.

I. A structural demand shortfall

One consistent finding from across multiple entries is that aggregate demand is weak, and that all three domestic demand engines, namely, personal consumption, private investment, and government spending are constrained. Private non-financial corporations have repaired their balance sheets, but by shedding liabilities rather than by growing assets. The result is a smaller corporate India balance sheet without any revival of a new investment cycle. Gross fixed capital formation, as a result, has held steady post-pandemic but has not accelerated. Financial conditions at the same time are quite permissive with banks well capitalized, a lower interest rate environment than a decade ago, and ample liquidity. The constraint, thus, is not financial but one of demand. Firms invest when they expect demand to justify capacity expansion, but no such adjustment in expectations seems underway. Household consumption is holding up, but credit uptake by households is also rising. Household sector liabilities, most of which are loans, amounted to 34% of GDP in FY2018-19 but were 41% in FY2023-24 (until when we have robust data.) It is highly likely that credit is increasingly substituting for meaningful real wage growth.

The credit system is further mirroring this dynamic as bank lending to large industry has fallen consistently while personal (household) credit has deepened. Among the productive sectors of the economy, it is mainly the services trade segment that is showing consistent demand for credit. This is in-line with India's services trade doing well with an expanding surplus, post-pandemic. More recently, starting in the third quarter of FY2025-26, there are some green-shoots also visible in credit uptake by small and medium size firms, suggesting a possible revival of small-scale investments. The overall pattern of credit, though, is simply reflecting the subdued demand structure of the economy, and given that financial conditions are favourable, one thing is clear, that credit supply is not a constraint.

Government expenditure, the one component of aggregate demand most directly under policy control, has compressed post-pandemic. The central government's primary deficit, a measure of its active fiscal

outlay net of interest obligations, fell from 5.7% of GDP in the pandemic year FY2020-21 to 0.80% in FY2025-26 – a period of just five years. This post-pandemic fiscal consolidation by the central government has been achieved by cutting revenue expenditure on wages, subsidies, and grants; not capital investment, which in fact has risen modestly. Overall, the consolidation following the pandemic expansion appears to have come much too early, before any acceleration in private investments that it was implicitly meant to trigger. However, now that the RBI is again easing financial conditions by cutting the repo rate and injecting surplus liquidity, government borrowing costs too are declining and the yield curve is moving down. Given the persistence of sluggish aggregate demand and relatively subdued inflationary pressures, there may be greater scope for a more expansionary fiscal stance than is often assumed. The Fiscal Responsibility and Budget Management (FRBM) framework, particularly following the recommendations of the N.K. Singh Committee, emphasizes fiscal sustainability and debt reduction, recommending a medium-term debt anchor of 60% of GDP alongside a fiscal deficit target of 3% of GDP. These rules were designed in part to preserve macroeconomic stability and provide fiscal space to respond to future shocks.

This said, the persistently low inflation and weak private investment may indicate that the economy is operating below potential, reducing the immediate risks that additional public spending would generate excessive inflationary pressures. In such circumstances, a carefully calibrated fiscal expansion, may be justified. The case for such an expansion would rest not simply on supporting demand, but on ensuring that additional borrowing is directed towards productive public investment. Greater spending on both material infrastructure and non-material public goods—including health, education, research, administrative capacity, and the green transition—could strengthen the economy’s productive capacity while also crowding in private investment over the medium term. Given the government’s strong political mandate, the principal challenge may therefore lie less in the availability of fiscal space than in prevailing views about the appropriate role of fiscal policy and perhaps some scepticism about the capacity to take these expenditures effectively.

II. Increasing financialization of the Indian economy

A second structural finding of significance is the increased financialization of the Indian economy. There is no one definition of economic financialization and the academic literature on it is vibrantly vast and growing. A useful conception of it is that of a post-industrial *process* of structural change, such that traditional sources for deriving income and accumulating capital—that is, industrial production and trade in goods and services—are increasingly displaced by heightened pecuniary activities, involving the production and trade of financial securities across globally integrated financial markets. As such, financialization is conceptually proximate to high per capita income countries, the archetype being the American and British economies. The financialization of the Indian economy—a low per capita income dual economy that has not undergone industrialization as yet—is therefore both notable and intriguing. Not just from a research perspective, but more so as a system-wide lens to use when analysing this vast economy. Be it at the household level or at level of how the Indian state funds itself, we now notice a marked change that is indicative of increasing financialization.

A positive development of this is that Indian households are now far more integrated with the formal financial system than before. Notwithstanding a known skewed distribution, the household sector’s net financial worth in the aggregate has also increased, rising from 74.7% of GDP in FY2011-12 to 87.8% by FY2023-24. Notably, the share of investment fund units in the household sector’s asset portfolio more than doubled during the same period, due mainly to the Systematic Investment Plan (SIP) revolution. Bank deposits remain the dominant asset class for households but have been losing portfolio

share as savings are increasingly channelled via investment funds into financial markets, especially, equities. Household net-worth as a result is starting to be more on a mark-to-market basis than before. The financialization process for households also has geographical dimensions. SIP registrations, for instance, grew 3.1x in smaller cities over four years from FY2020-25 compared to 2.3x in bigger cities.

Household leverage at the same time is growing too. Annual incurrence of loans surged from under 4.5% of GDP before FY2022–23 to 6.2% by FY2023–24. More recently, in addition to increased uptake of personal loans, households have also increased their borrowing against gold jewellery. For lower income households, inclusion into the formal financial system can open up access to regulated channels of credit. This is surely better than unregulated access to predatory loan sharks. Furthermore, increased household borrowing in the presence of tepid real wage growth also often works to sustain personal consumption, providing even a short burst of economic expansion. However, this cannot be sustained for long as rising debt soon becomes onerous and raises the risk of an eventual downturn that can be particularly severe for highly levered households, especially, those making leveraged investments. Another discernible outcome of households financializing has also been that domestic institutional investors funded by SIP flows have managed to absorb sustained foreign institutional investor (FII) outflows. Indian equity markets as a result have not adjusted sharply downward in what has been a prolonged risk-off period for FIIs post-pandemic. That said, a market correction is underway now and is likely to test the limits of this domestic market support mechanism underpinned by households.

At the institutional level, the financial system has been restructured in ways that bring both opportunity and new risk. Other financial corporations, namely, mutual funds, insurance companies, pension funds, now hold more assets than the banking system and have become the dominant creditors of the Indian state, holding 40.6% of general government debt by FY2023-24. India's inclusion in the JPMorgan EM Government Bond Index since FY2024-25, and the introduction of incentives for foreign investments in rupee-denominated government securities may further deepen the government bond market. Moving towards a deeper bond market and a diversified creditor base of domestic and foreign investors is a positive development. Overall, though, increasing financialization of the Indian economy, marked by deeper integration of households and private institutions with capital markets must be regulated effectively as macro-financial stability is also now increasingly linked to financial market conditions. For instance, a sharp correction in equities markets can raise redemption pressures on investment funds by households, just as a sharp rise in government bond yields can trigger markdowns for asset managers. Increasing economic financialization, if regulated lightly, worsens such macro downside risks severely.

III. External vulnerabilities in a disrupted world

The third finding is that India's external position is not necessarily weak but holds specific vulnerabilities that are all too often overlooked in conventional analyses of its persistent current account deficit that arises mainly from running a persistent trade deficit. A highly underappreciated yet important structural pillar of India's external balances is remittances. At USD 138 billion in 2024, the highest in the world by a wide margin, remittances have on average covered more than the entirety of India's trade deficit since mid-2013. Unlike foreign direct investment (FDI) and foreign portfolio investment (FPI) flows, remittances are transfers, not claims. Hence, they do not generate future liability outflows and also do not ebb uncontrollably in risk-off periods, as has been the case with FDI/FPI flows recently.

To be clear, FDI and FPI flows are important for financing India's current account deficit and for countervailing the structural downward pressure that exists on the rupee as a result of it. However, since remittances in most periods cover the trade deficit to begin with, the current account deficit that FDI/FPI flows finance is substantially smaller than if remittances would be any less. At approximately

3% of GDP, remittances also generate more demand for the rupee in currency markets than FDI and FPI flows do, thereby cushioning the rupee more than is often recognized. In risk-off periods when these financial flows ebb, it is precisely India's remittance cushion that holds back an external adjustment that would otherwise be sharper. In short, remittances need to be front and centre in any analysis of India's external account, and not an after-thought.

With regards to international trade, a somewhat counterintuitive finding is that India is less integrated with the rest of the world in terms of trade than the early 2010s. Trade openness is now lower than its FY2012-15 levels despite a post-pandemic recovery. This is simply a reminder that India's growth model is domestic demand-led, not export-led, and that its external account dynamics are therefore better analysed by the composition of what it trades and with whom, rather than by volume alone. It is also worth remembering that India's persistent trade deficit arises from its goods trade deficit since in its services trade, it runs a surplus that is in fact expanding now, rising from 3.3% to 5.4% of GDP over the post-pandemic years.

Interestingly, the goods trade deficit is not primarily an oil problem, for oil accounts for only 25% of the goods import bill. The deficit is increasingly driven by non-oil imports, notably of goods such as electronics and machinery. This in turn is only indicative of India's under-developed manufacturing base that simultaneously necessitates importing goods that should be produced domestically while also not exporting the same in globally competitive markets. Closing this domestic manufacturing capacity gap, at least a fair bit, will also create several thousand jobs that are much needed now. To do so, requires a bold industrial policy that is formulated inclusively, is at-scale for India's needs, comes with a multi-year execution plan that is effectively communicated with the citizenry, and is implemented with all institutional zeal. Lastly, India's trade remains heavily concentrated in the US and China. The former is the largest destination for India's goods and services exports as well as the largest source for its services imports, while the latter is the largest source for goods imports. Such high levels of concentration, in an era of geopolitical volatility, now carries with it growing downside risks. Diversification, therefore, is not just an economic preference anymore, it is a strategic necessity, and the recent free trade agreement with the largest trading bloc, namely, the European Union appears to be a step in the right direction.

In Sum

India's economy is large, growing, and until now, resilient. Corporate balance sheets are the healthiest they have been in a long time, the banking system appears clean, the SIP revolution has drawn millions of households into formal channels of finance, the services surplus is growing, and strong remittances continue to anchor the external account. That said, economies can appear to be on solid ground until the ground shifts. Case in point being the American economy that appeared to be so until the global financial crisis unfolded. Hence, the nine financial insights documented in this report also highlight some macro risks for the Indian economy that demand serious policy responses. A structural demand shortfall in which no single engine of aggregate demand is adequately firing on all cylinders demands a fiscal policy response. For a low per capita income country like India, the process of financialization has severe implications for household wealth and macro-financial stability. Effective regulation of 'high finance' is thus key. Finally, in an emerging new world order, wherein, hitherto rules of trade have seemingly been torn asunder, India's external trade remains highly concentrated in its bilateral relationships with the US and China. A geopolitically sharp trade policy, working in conjunction with a robust industrial policy to make India's goods, and not just its services, globally competitive is much needed for both economic and national security reasons now. None of these risks necessarily imply an impending moment of doom, but all of them do demand prompt policy action to mitigate them.

Acknowledgements

Thanks are due to Arjun Jayadev and Ravi Vadapally for the initial idea behind this report and for their continued support through its development. All errors or omissions remain the responsibility of the authors.

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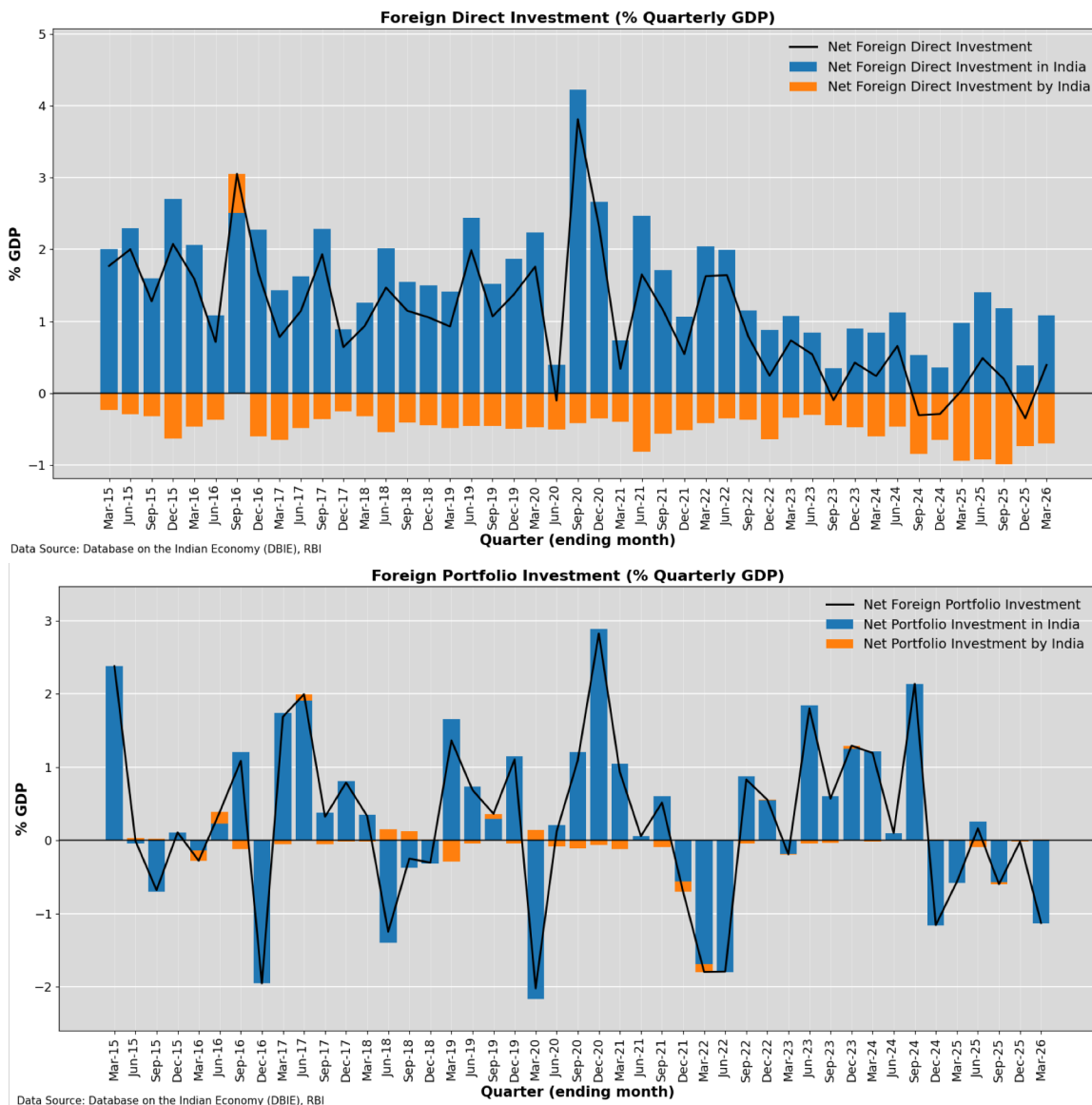
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1. Remittances are the understated anchor of India's external balances and the rupee¹

The Indian rupee (INR) lost nearly 12% of its value against the US Dollar (USD) in the year following June 2025. Several analysts have pointed to the consistent decline in net foreign direct investment (FDI) and net foreign portfolio investment (FPI) flows as a key driver. Notably, these flows began ebbing much before the current war in west Asia (see, figs. 1.1 and 1.2). A declining trend in net FDI began around Q2 FY2021-22, predating also the launch of ChatGPT – an early marker of global investment flow reversals to the US. Similarly, net FPI has trended downward too since Q4 FY2023-24.



Figures 1.1 and 1.2: Net FDI and Net FPI flows as % GDP

¹ A version of this was published in the Hindu newspaper on 2nd June 2026, under the title “Remittances anchor the rupee, India’s external balances.”

FDI and FPI flows, recorded in the financial account (FA), are surely important for both financing India's current account (CA) deficit as well as keeping the INR from depreciating as dramatically as it has in the recent past. However, there is often an overemphasis by analysts on FA flows (FDI/FPI) at the cost of other important flows for India, namely, remittances. These, as discussed here, in fact do much of the heavy lifting on both counts. Not accounting for remittances alongside FA flows in our analyses in fact risks being ignorant of a major external vulnerability that exists for India: the ebbing of its huge remittance flows. Accounting for both, as done here, offers a fuller understanding of India's external dynamics and pressures on the rupee.

It is commonly understood that downward (depreciation) pressure is structurally inherent upon the rupee because of India's persistent CA deficit (CAD), stemming mainly from its persistent trade deficit. India consistently runs up a large deficit and a relatively smaller surplus in its goods and services trade respectively, thereby yielding a persistent trade deficit (fig. 1.3, blue bars). The trade balance being a major component in the CA thus leads to India's persistent CAD (fig. 1.3, black line). Since financing this deficit in turn implies a consistent net excess demand for foreign exchange, there exists structural downward pressure on the INR. In short, the persistent nature of India's trade deficit makes INR depreciation inherent to its growth model. Consequently, buoyant, net positive FDI/FPI flows, the logic goes, are crucial to finance the CAD and also to countervail the downward pressure on the INR as demand for it then rises in currency markets. Declining net FDI/FPI flows, conversely, lead to INR depreciating faster.

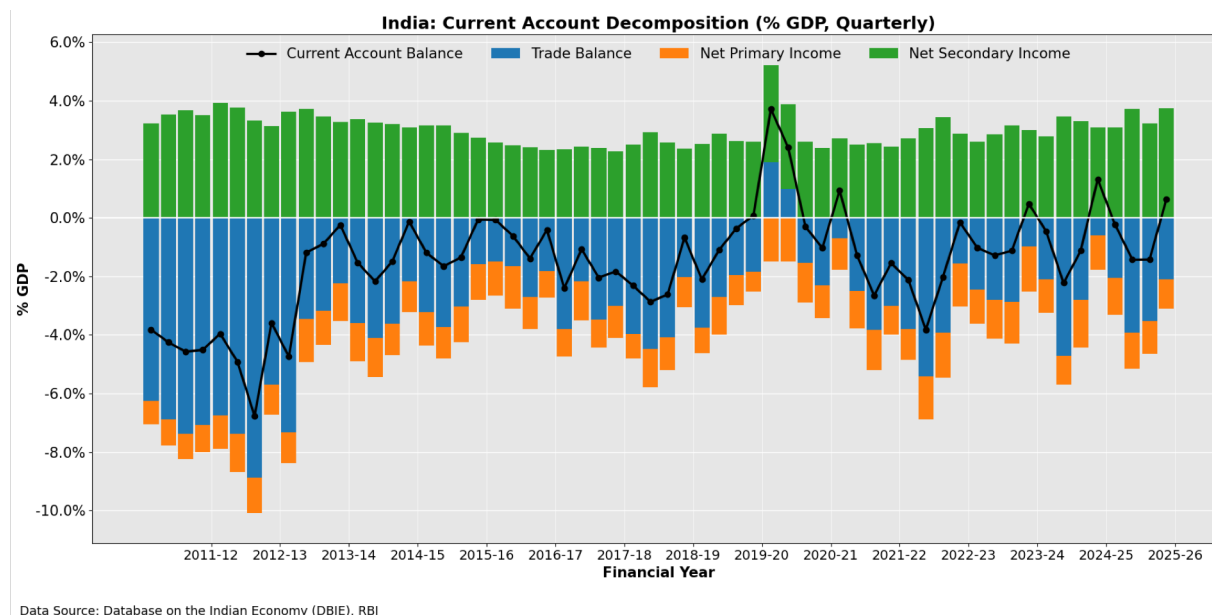


Figure 1.3: Current account decomposition as % GDP

Such explanations largely emphasizing the importance of FDI/FPI flows for financing the CAD and supporting the INR are incomplete, for they do not give due credence to how remittances, recorded in the CA, in fact serve to anchor both. Briefly, the CA consists of three component flows, with the first two being persistent deficits. First, the trade deficit, as discussed. Second, net primary income (fig. 1.3, orange bars), which reflects the net negative balance of investment income (interest, dividends, capital gains, and profits) earned by Indian residents on foreign assets and those paid on India's external liabilities held by foreign counterparts. Third, net secondary income (green bars), which for India

comprises mainly of its high net positive remittances. In absolute terms, India attracts the highest remittances in the world by a wide margin (USD 138 billion in 2024 versus Mexico's USD 68 billion at a distant second). Importantly, these matter for its CAD and the INR for the following reasons.

First, and importantly, since mid-2013, remittances have *on average* financed more than the entirety (>100%) of India's trade deficit (pandemic and Trump's 'liberation day' disruptions notwithstanding). Figure 1.4 shows this by charting net remittances as percent trade deficit. As a result, the CAD that FA flows (FDI/FPI) finance is effectively a residual of the two persistent deficits in the CA, leftover after remittances have financed their bulk. Put differently, if not for India's high net remittances, its CAD would be much larger and financing demands on the FA correspondingly higher. Second, net remittances averaging about 3% of GDP remain much higher than net FDI/FPI flows and thus work to countervail the downward pressure on the INR much more. Third, unlike say FPI, remittances are not given to sudden stops, for they are largely driven by the income and savings decisions of the Indian diaspora and their respective familial needs in India, not global risk appetite or investor confidence. Fourth, unlike FDI/FPI, remittances are transfers not claims, so they do not generate future liability outflows. Fifth, remittances have low transaction costs, especially now with instant money transfer apps.

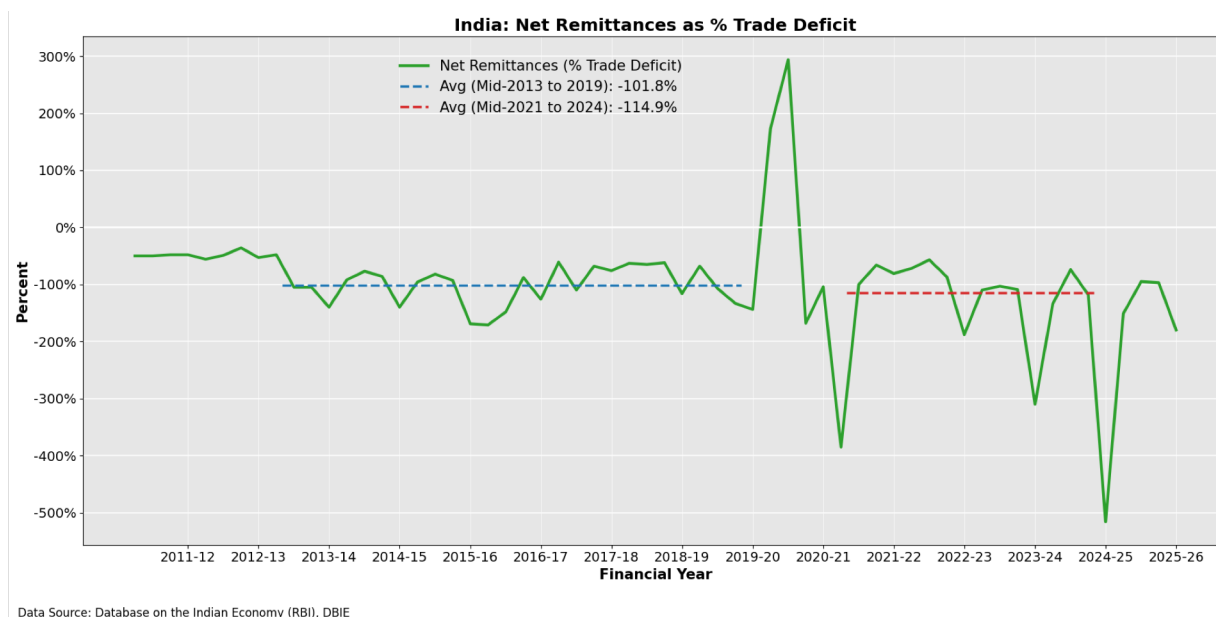


Figure 1.4: Net remittances as % trade deficit

Yet, despite their importance, analyses of remittances commonly pale in comparison to those of FDI/FPI flows. This is perhaps because India's unparalleled remittances are largely the result of small financial decisions by thousands of working-class Indians abroad who do not animate globalized elites in the same manner as talk of FDI/FPI does. That said, a lot rides on remittances, especially in 'risk-off' periods such as now when these FA flows by foreign investors have ebbed. This is because the more the rupee slips as a result, the more diaspora remitters are likely to wait till it bottoms out. At the same time, as global commodity prices rise, either due to events such as the war in west Asia or other supply shocks as during the pandemic, India's trade deficit stands to increase due to imports becoming dearer. As a result, a wide gap in the trade deficit's coverage from remittances can occur, which in turn will increase the CAD and its financing demands on the FA. Moreover, remittances being held back implies additional dampening of the countervailing demand for the INR in currency markets, thereby adding to the downward pressure on it.

To be sure, the rupee's recent slide appears to have been contained for now by the RBI's aggressive intervention in FX markets. This has involved using India's forex reserves that are notably not insignificant but are also not infinite either. With the rupee settling-in at just under 95 to the dollar for now, it also seems that diaspora remitters are conceiving this to be the bottom, for now. Hence, the most recent read from Q4 FY2025-26 shows remittances being really high (fig. 1.3, last green bar). In fact, as fig. 1.4 shows, remittances were so far in excess of the trade deficit that they even covered the net primary income deficit, delivering therefore a rare CA surplus for India in Q4 FY2025-26. To be sure, the CA will revert to being in deficit as it is a function of India's trade deficit, which in turn is a function of an under-developed manufacturing base that we cover in the next section. What is important for now, though, is recognizing the significance of remittances in anchoring India's external balances and the INR. This in turn demands that we account for them fully in our analysis, let alone formulate policy incentives to keep them from ebbing uncontrollably as FDI/FPI flows recently have.

2. India's goods trade deficit is less about oil than it is about an under-developed manufacturing base

The Indian economy, relative to the early 2010s, is now less integrated with the global economy. Contrary to common perceptions, a measure for trade integration, namely, trade openness—calculated as imports plus exports as percentage of GDP—is now lower than it was from FY2012–15. Despite a post-pandemic recovery, this is not necessarily surprising as India is a domestic demand-led economy, not an export-led one. Total trading volume therefore need not grow at the same pace as GDP.

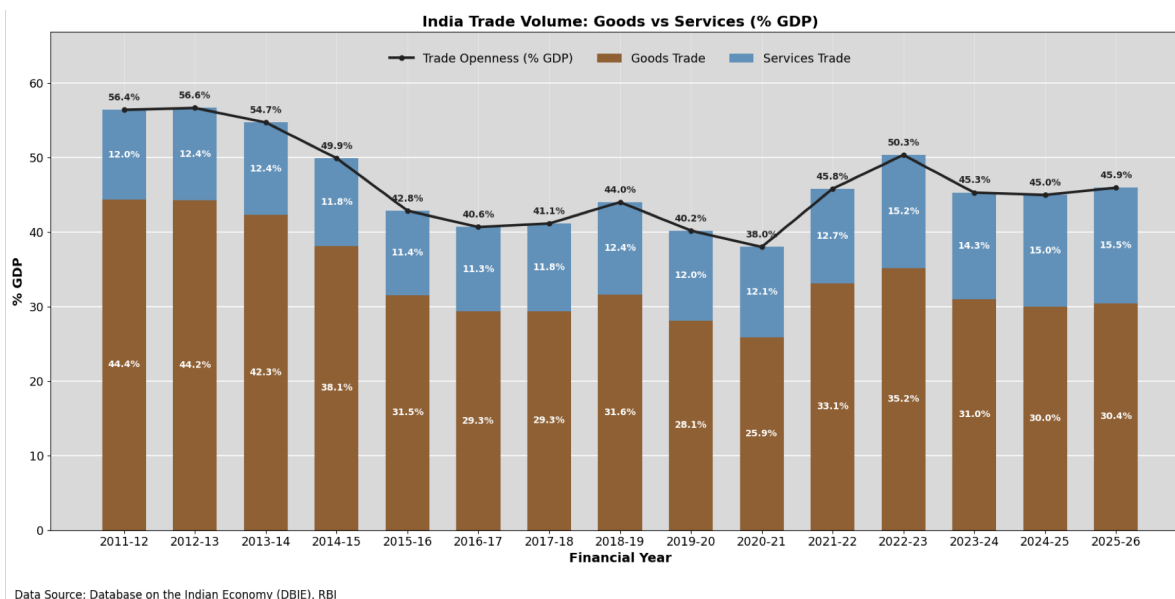


Figure 2.1: Trade openness (goods and services) as % GDP

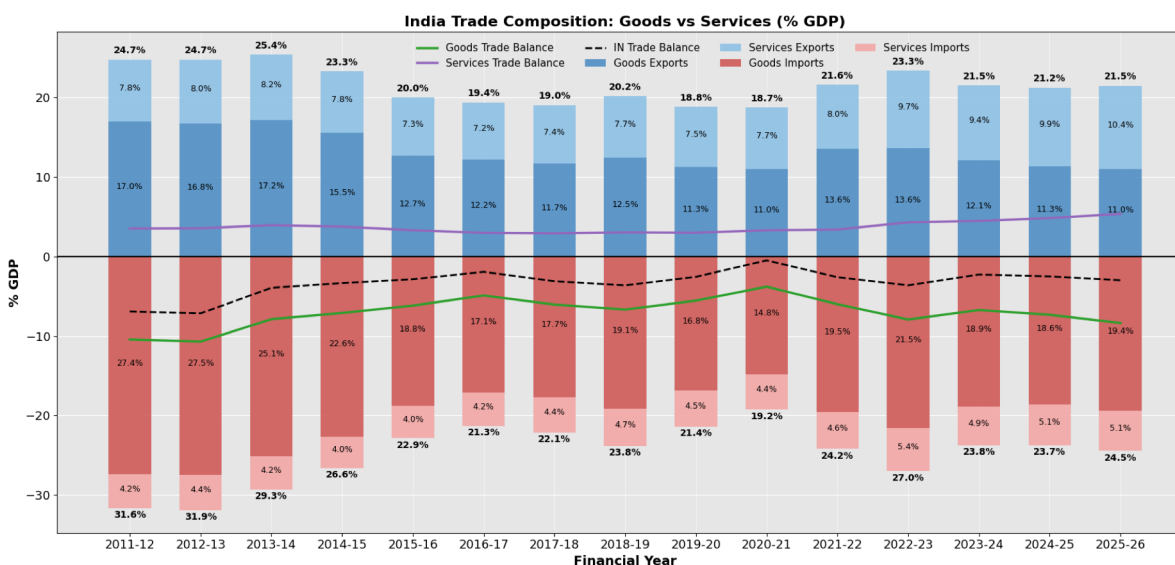


Figure 2.2: Trade balance (goods and services) as % GDP

The decomposition of India's trade openness (fig. 2.1, brown bars) further shows that the total volume of the goods trade (turnover) has tempered compared to the period FY2011-12 thru FY2014-15 but remains above the immediate pre-pandemic levels starting FY2015-16. Following the goods trade deficit alongside (fig. 2.2, green line below zero) shows that it moves in-step with the total goods trade volume, but in the opposite direction. Implying, therefore, that it is the rising import of goods (fig 2.2, dark rust bars below zero) that is driving India's overall goods trade and deficit, not necessarily goods exports that have been stagnant, and even declining recently (dark blue bars).

Another common perception is that India's goods imports are largely a function of its oil imports. India does import nearly 85% of its oil but this perception is only 1/4th true as oil imports account for only about 25% of the total goods import bill (fig. 2.3, dark blue bars below zero).

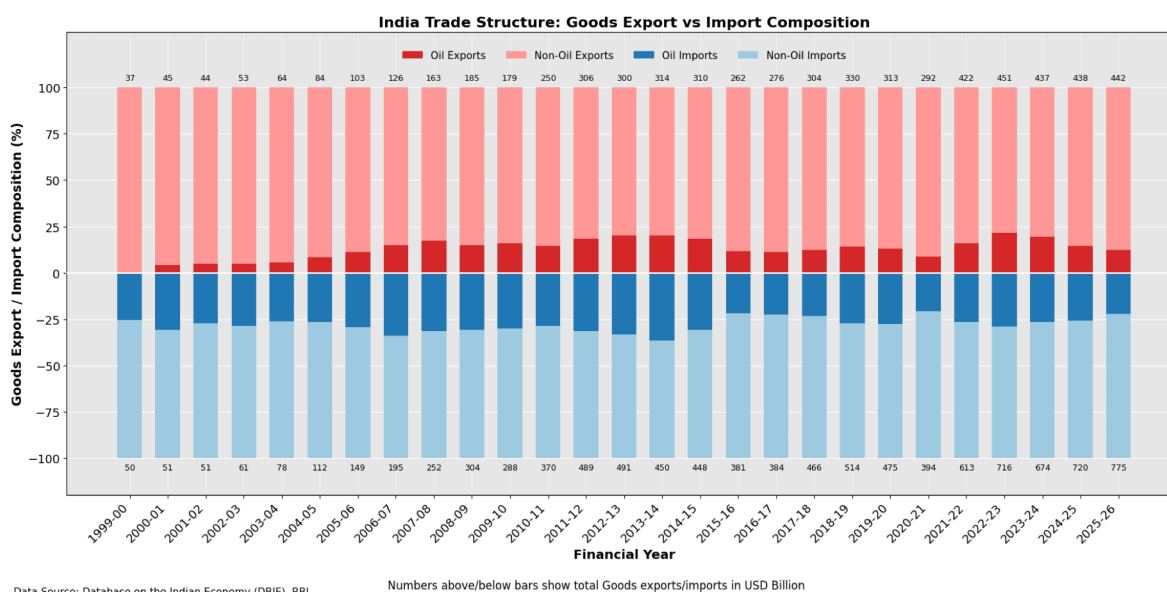


Figure 2.3: Goods trade compositional shares of oil versus non-oil goods

Furthermore, this share of oil imports has decreased slightly over time. To be sure, as figure 2.4 shows, oil imports (petroleum, crude and products marked as dark blue bars) constitute the dominant share within India's top 10 imported goods basket. Interestingly, electronic goods (light blue) have now displaced gold (orange) for the second spot, increasing their share within the top 10 imports basket from 10.4% in 2015 to 17.26% in 2025. Machinery, electrical and non-electrical imports (light orange) along with gold are competing for the third spot, with the former having a consistent share of about 9% in the top 10 goods imports. Gold's share (light blue), on the other hand, fluctuates even though its demand in India can be expected to remain due to cultural preferences, and its mass use as a store of value to hedge against inflation and uncertainty. Overall, the consistently rising share of non-commodity imports such as electronics and machinery in India's top 10 imported goods basket suggests that its goods deficit is getting tied to domestic industrial capacity constraints that are not a function of cyclical demand conditions per se.

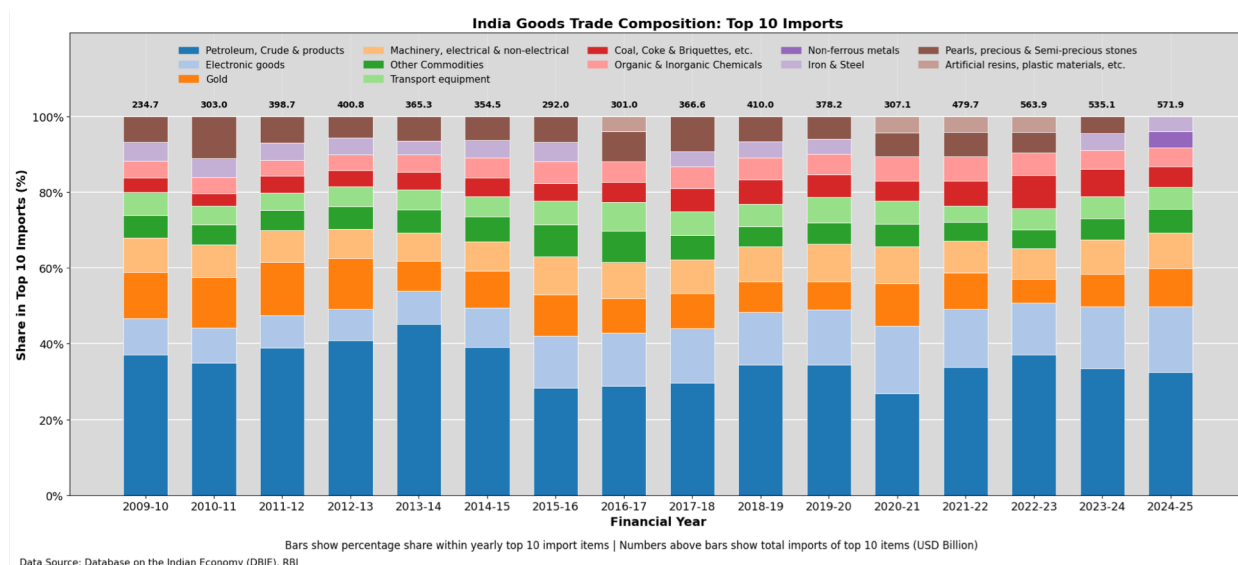


Figure 2.4: Top 10 goods imports, compositional shares

On the goods exports side, the launch since 2020 of several production linked incentive (PLI) schemes, meant to strengthen India's manufacturing base and exemplify the 'Make in India' ambition, appear to have modestly impacted the structure of goods export trade. Neither have geopolitical realignments, and national security concerns calling for a diversification away from China, for instance, impacted significantly. Compositionally, India's top 10 exported goods basket has remained the same since FY2009-10, though, compositional shares have surely changed.

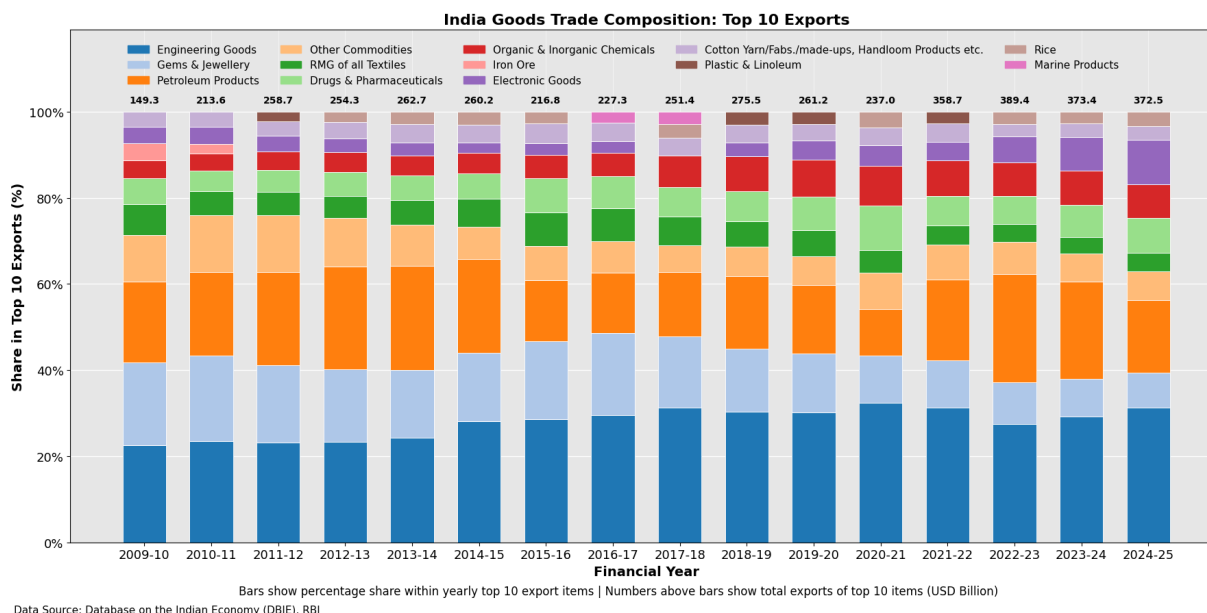
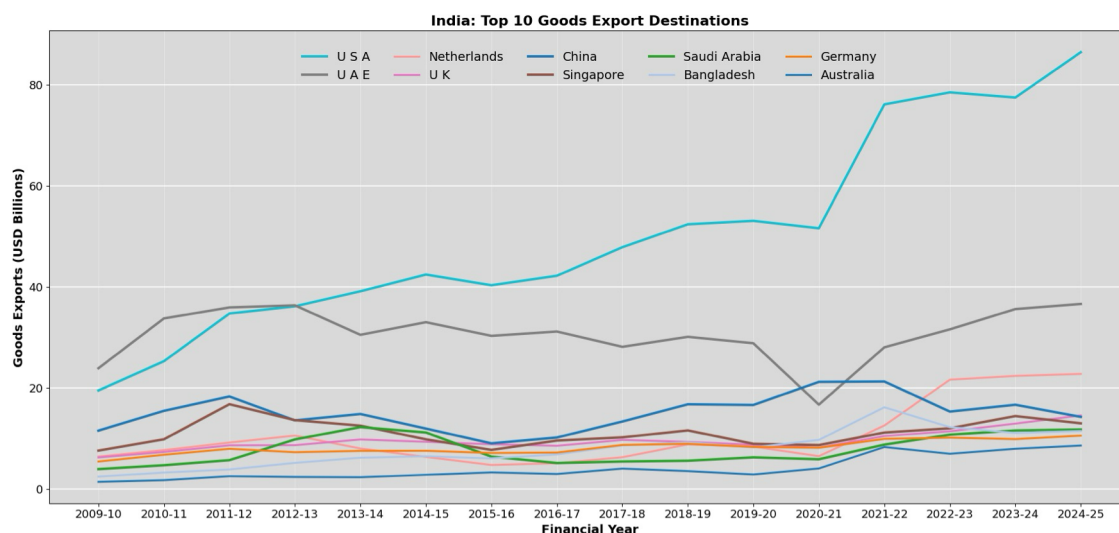


Figure 2.5: Top 10 goods exports, compositional shares

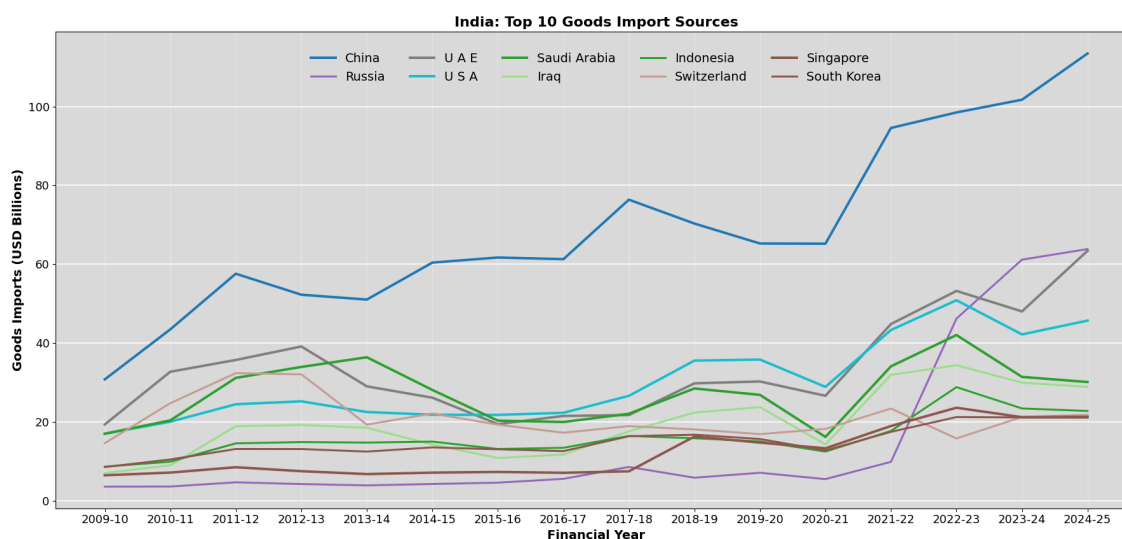
As figure 2.5 shows, out of thirteen categories, just three of engineering goods (dark blue bars), gems and jewellery (light blue) and petroleum products (orange; mainly imported crude refined and exported) have consistently composed nearly 60% of the top 10 exports basket. Barring four goods categories

competing for the most minor of the share in this basket, the remaining nine have also always been a part of it. Notably, electronic goods (purple) have seen their share rise dramatically, doubling in just five years from 4.48% in FY2019-20 to 10.36% in FY2024-25. This is likely due to an increase in exports of assembled electronic goods such as iPhones. This is a positive development even though India remains a good distance away from capturing a sizeable share of the global electronic goods value chain.

Finally, economic geography adds an interesting geopolitical dimension to India's goods trade. The US has become India's single largest goods export destination by a wide margin (fig. 2.6). In FY2024-25, India exported USD 86.5 billion worth of goods to the US, amounting to 19.8% of its total goods exports. By contrast, China is now the dominant source for India's imports by a wide margin (fig. 2.7). In FY2024-25, Indian imported USD 113.5 billion worth of goods from China, amounting to 15.8% of its total goods imports.



Data Source: Database on the Indian Economy (DBIE), RBI



Data Source: Database on the Indian Economy (DBIE), RBI

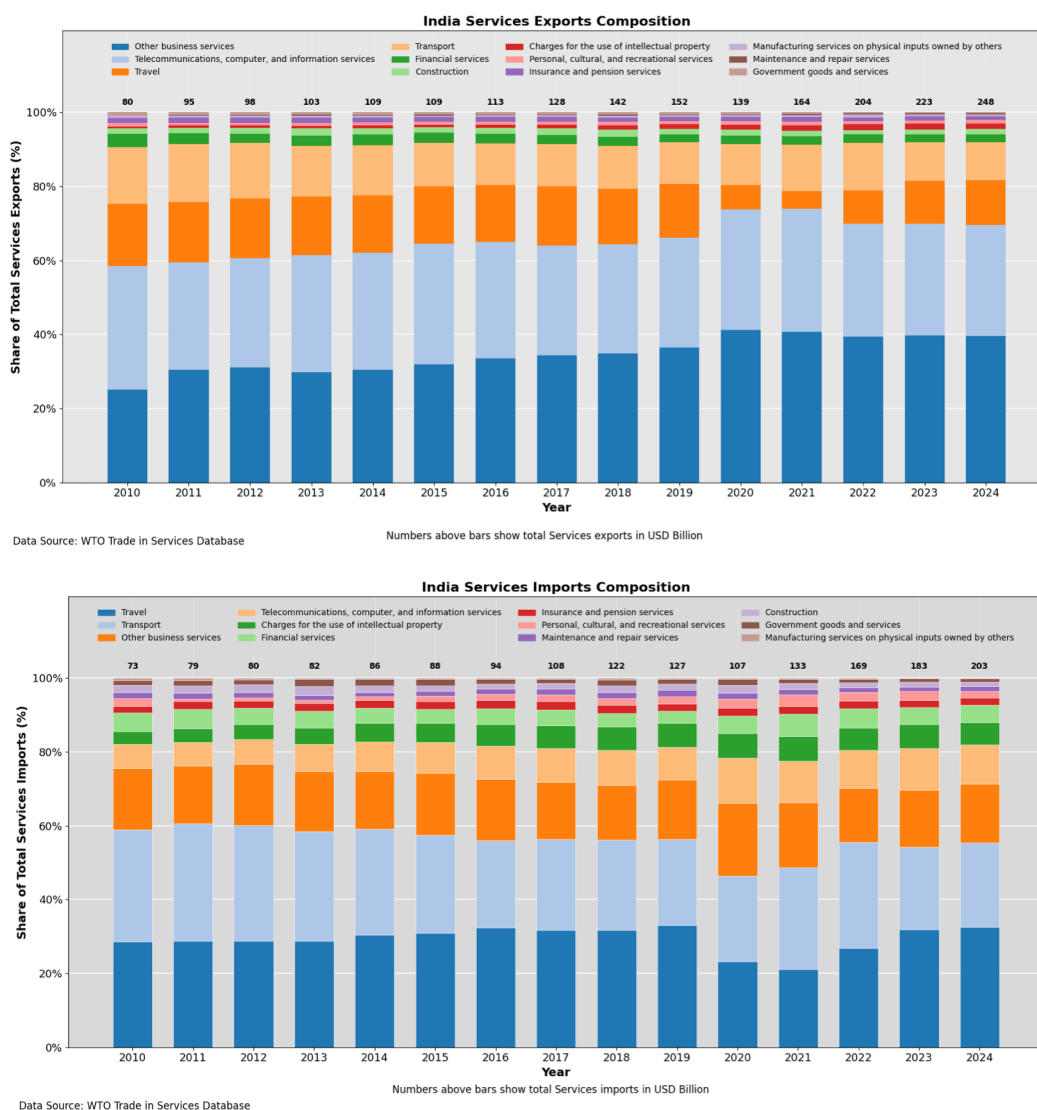
Figures 2.6 and 2.7: Top 10 goods export destinations and import sources

As such, in a world wherein trading rules now stand disrupted, a high degree of single-country concentration on both the export and import sides raises the risk of arbitrary and uncertain changes outside of India's control, which can dramatically worsen its goods trade deficit. India's persistent trade deficit is the result of it running a persistent goods trade deficit as it in fact runs a surplus in the services trade that we consider next. The goods trade deficit in turn being a function of rising imports of non-oil goods implies that it is only pertinent that India's domestic industrial base expands substantially, especially in high-value manufacturing.

If done right, in the sense of producing goods that compete globally, this can simultaneously compress India's import bill and expand its goods exports that have thus far been tepid. The electronic goods trade offers some hope. As shown here, electronic goods are both, one of the largest items on the import side, and also one of the thinnest but rapidly growing categories on the exports side. Effectively, the same domestic capability gap in high value electronics manufacturing is likely playing up on both side of the goods trade balance but differentially. In contrast to oil imports that are a structural constraint in India's goods trade, the under-developed manufacturing base by comparison need not be. In an emerging but unknown world of multi-bilateralism, developing a globally competitive manufacturing sector is now as much an urgent national security concern as it is an economic one.

3. India's services trade surplus is growing but with risks concentrated in the US trade relationship

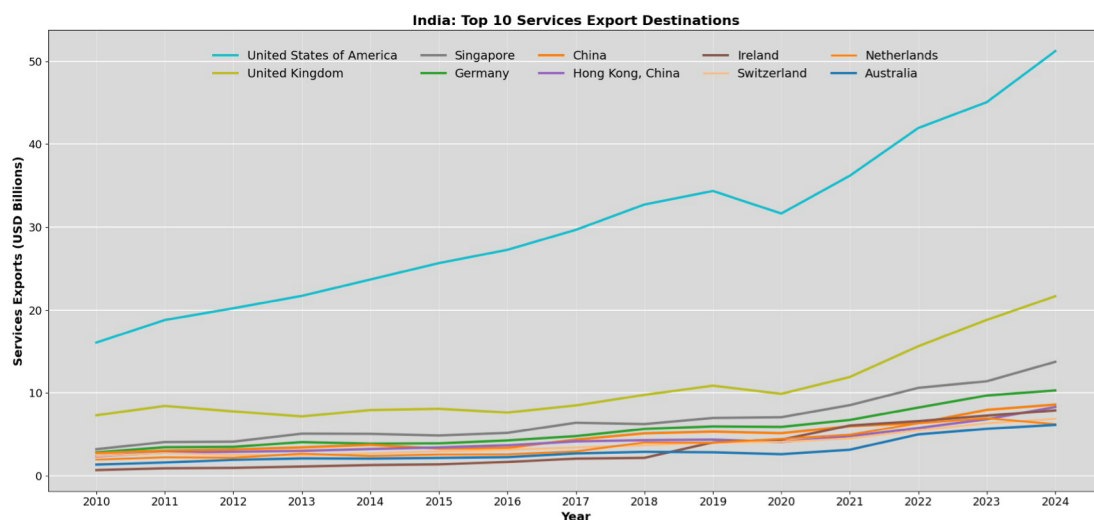
The aggregate trade composition charts in the previous section reflect contrasting dynamics in India's goods versus services trade (figs. 2.1 and 2.2). As opposed to running a persistent deficit in the goods trade, India runs a persistent surplus in services (fig. 2.2, violet line), which notably has been growing consistently post-pandemic. As is the services trade integration, with total service trade volumes too growing consistently post-pandemic from 12.1% of GDP in F2020-21 to 15.5% in FY2025-26 (fig. 2.1, blue bars). This is due to a rise in services exports during the period from 7.7% to 10.4% of GDP (fig. 2.2, light blue bars), which in turn has resulted in the services trade surplus growing from 3.3% to 5.4% of GDP (after a rather stable pre-pandemic run). In absolute terms, services exports more than doubled post-pandemic from USD 206 billion in FY2020-21 to USD 421.3 billion in FY2024-25, while imports grew 74% from USD 117.5 billion to USD 204.5 billion. In effect, the consistently positive and growing services trade surplus is an important and much needed counterweight to the goods trade deficit, without which, the overall trade and current account deficit, would be much larger.



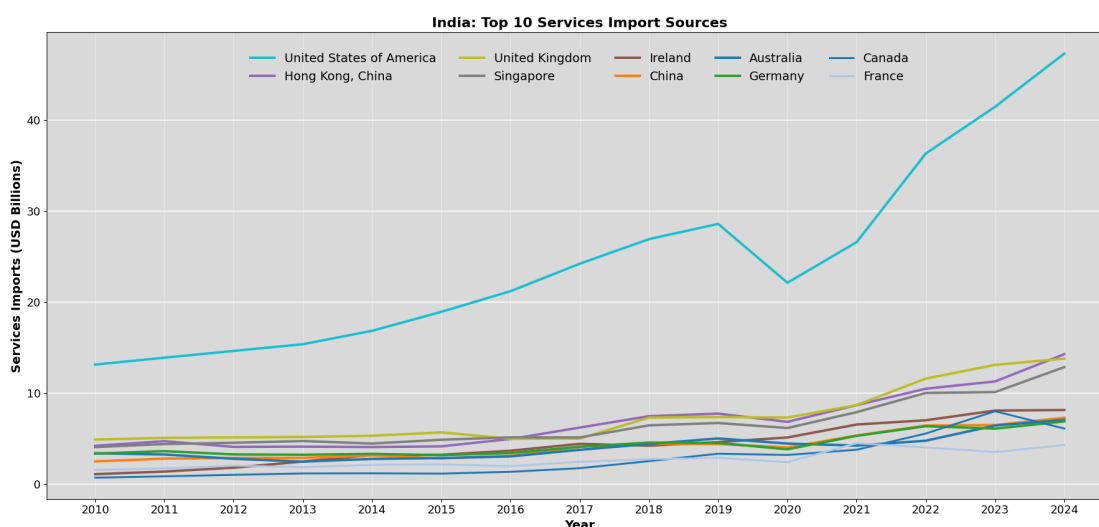
Figures 3.1 and 3.2: Top 10 services exports and imports, compositional shares

The composition of India's services trade is straightforward with the top 10 services export and import baskets (figs. 3.1 and 3.2) comprising the same categories. Four major categories of telecommunications, computer, and information (ICT) services; other business services (e.g., legal and business process management); travel; and transport have consistently held very similar top 10 shares, and together, these account for nearly 96-97% of the overall services trade turnover.

It is the geographic distribution (figs. 3.3 and 3.4) of India's services trade that is more interesting, for it makes the importance of the US relationship amply clear. By a wide margin, the US is the largest destination and source for India's services exports and imports respectively. The US trading relationship has deepened dramatically since 2010 as compared to other trading partners. This is primarily due to the increased integration of Indian ICT and 'other business services' firms within US corporate supply chains. The relationship runs both ways as, for instance, it is common for Indian tech firms to export their professional services to clients in the US by importing technological infrastructure from the US itself. Following the US, comes the UK at a distant second, with Indian services exports exceeding British imports by a factor of 1.8 in FY2023-24 (until when data is available).



Data Source: WTO Trade in Services Database



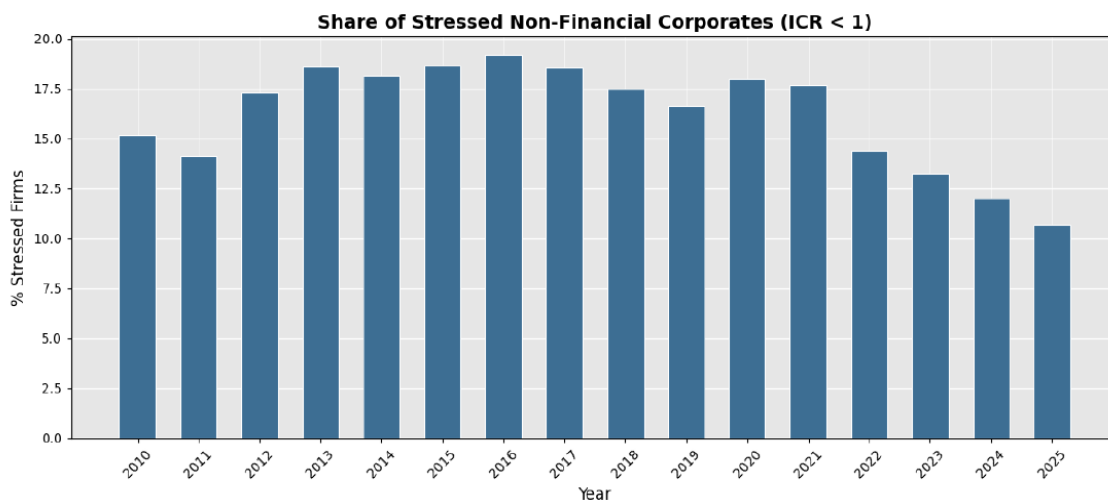
Data Source: WTO Trade in Services Database

Figure 3.3 and 3.4: Top 10 services export destinations and import sources

The centrality of the US further comes into sharp relief once we recall from the previous section that the US is also the largest destination for India's goods exports. Again, these being (geo)political times, such centrality of the US in India's trade is also a structural vulnerability. A shift in US trade policy (e.g., onerous tariffs), changing domestic demand conditions, or unfavourable changes in US immigration law are just some of the potential risks to India's overall trade and current account balance. To these, we must also now add the risk of AI driven automation. Specifically of coding, testing, and back-office tasks that form the backbone of India's services trade surplus, but which are precisely the areas where agentic AI systems are just about beginning to perform at scale. If the trend accelerates, the services surplus can compress even independently of any policy decision. In short, while India's trade relations with the world's largest importer, the US, have positively deepened, a disproportionately high concentration in it has also raised downside risks significantly. Diversifying India's trade portfolio is certainly in order, and in this regard, a recent positive development is the signing of the free trade deal with world's biggest trading bloc, namely, the European Union.

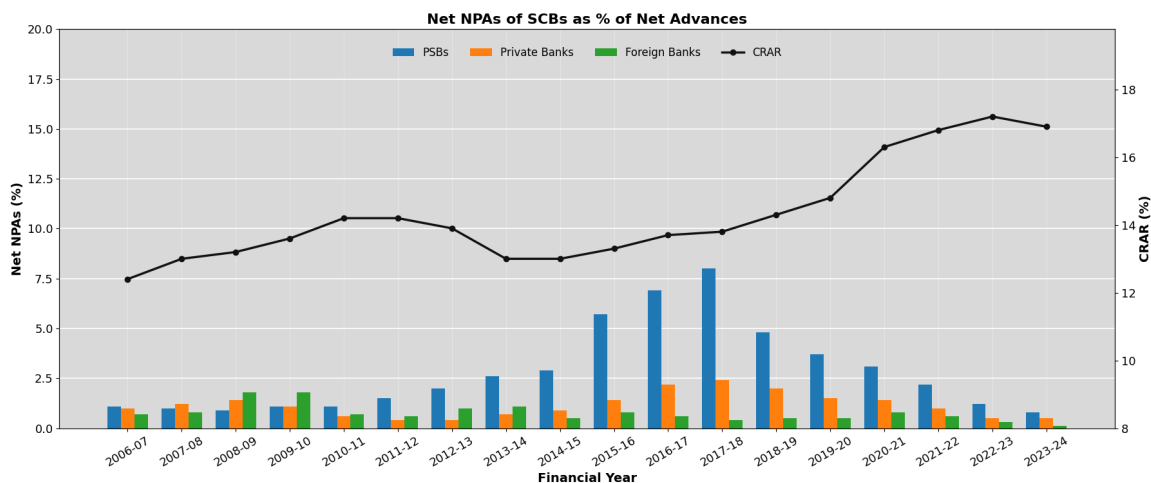
4. Corporate India has deleveraged, but investments remain sluggish even as financial conditions are permissive

Corporate India has been on a financial repair journey for more than a decade since the twin balance sheet crisis began around FY2014-15. This seems to have paid off as the share of distressed firms—those whose debt service payments exceed their operating earnings (i.e., interest coverage ratio < 1)—has fallen from a peak of nearly 19% in 2016 to approximately 10.5% in 2025 (fig. 4.1). This is now even lower than 15% in 2010. Simultaneously, net non-performing assets (NPAs) of scheduled commercial banks (SCBs), a mirror image of distress in the non-financial corporations (NFCs) sector, are also at historic lows, while capital adequacy of SCBs remains high at 17% of risk-weighted assets (fig. 4.2) By all accounts, corporate India and with that the banking system, is financially healthier now than at any point in the past decade, if not more. As a result, two pertinent and related questions arise. First, NFCs got financially healthier, how? Second, if they are so, are they investing?



Source: Calculated from Prowess Dataset on NFCs

Figure 4.1: Distress within the private non-financial corporations (NFCs) sector



Data Source: Database on the Indian Economy (DBIE), RBI

Figure 4.2: Banking sector stress measures (net NPAs and capital to risk-weighted assets ratio)

The financial balance sheet of private NFCs (fig. 4.3), created using the RBI's latest Flow of Funds (FoFs) data going until FY2023-24, is helpful in shedding some light on the first question. It reveals two distinct phases of financial repair by NFCs

- In the first phase from FY2013-14 to FY 2020-21, gross financial assets contracted by 11.3 percentage points from 95.6% to 84.3% of GDP, while gross liabilities grew relatively less by 4.3 percentage points from -129.3% to -133.6% of GDP. The financial net worth of private NFCs, as a result, deteriorated dramatically by 15.9 percentage points from -33.7% to -49.6% of GDP. The leverage ratio (liabilities relative to net worth) fell over this period from 3.84x to 2.69x; however, this cannot be conceived of as any form of genuine deleveraging. This is because financial net worth (leverage ratio's denominator) worsened in absolute terms not from liabilities growing sharply but from assets retracting significantly. The leverage ratio thus declined mechanically, reflecting in fact balance sheet stress and not deleveraging or repair per se.
- By contrast, in the second phase going from FY2020-21 to FY2023-24, the dynamic seems to have reversed itself. Gross financial assets continued contracting but gross liabilities now contracted far more. The former contracted by 17.5 percentage points to be at 66.8% of GDP by FY2023-24, while the latter contracted by 24.2 percentage points to be at 109.4% of GDP. The deterioration in financial net worth, as a result, got contained and in fact improved by 6.6 percentage points to be 43% of GDP. The leverage ratio improved further to 2.54x, but this time it was genuine deleveraging.

Importantly, then, corporate India recovered from the twin balance sheet crisis not by growing its way out of debt, which would have entailed assets growth from increased investments and cash flow. Instead, it shed its ways out of the crisis by contracting both sides of the balance sheet. This form of corporate austerity, so-to-speak, is apparent visually in fig. 4.3 as the financial footprint of NFCs in FY2023-24 is much smaller than it was in say FY2011-12.

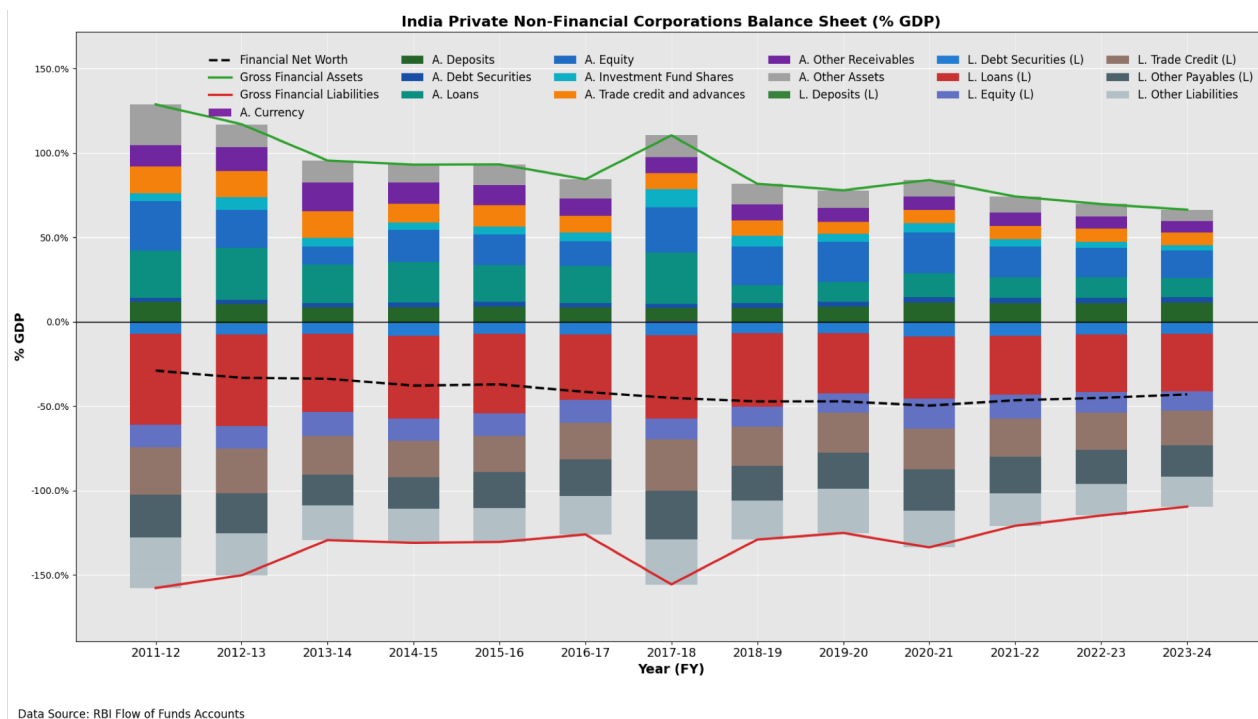


Figure 4.3: Private NFCs balance sheet

The RBI's Asset Quality Review (AQR) of FY2015–16, in response to the twin balance sheet crisis, can be thought of as one trigger for this balance sheet contraction. It forced SCBs to recognize NPAs and curtail extension of new credit, especially to distressed NFCs. As a result, net borrowing by the both private as well as public NFCs—a quasi-proxy for fixed investments—that was averaging at 6.1% of GDP until then, began declining in the years leading up to the pandemic year FY2020–21, when it hit a low of 2% (fig. 4.4, red bars). It has certainly recovered post-pandemic, but at a lower average rate of 3.9% of GDP over the three years from FY2021–24.

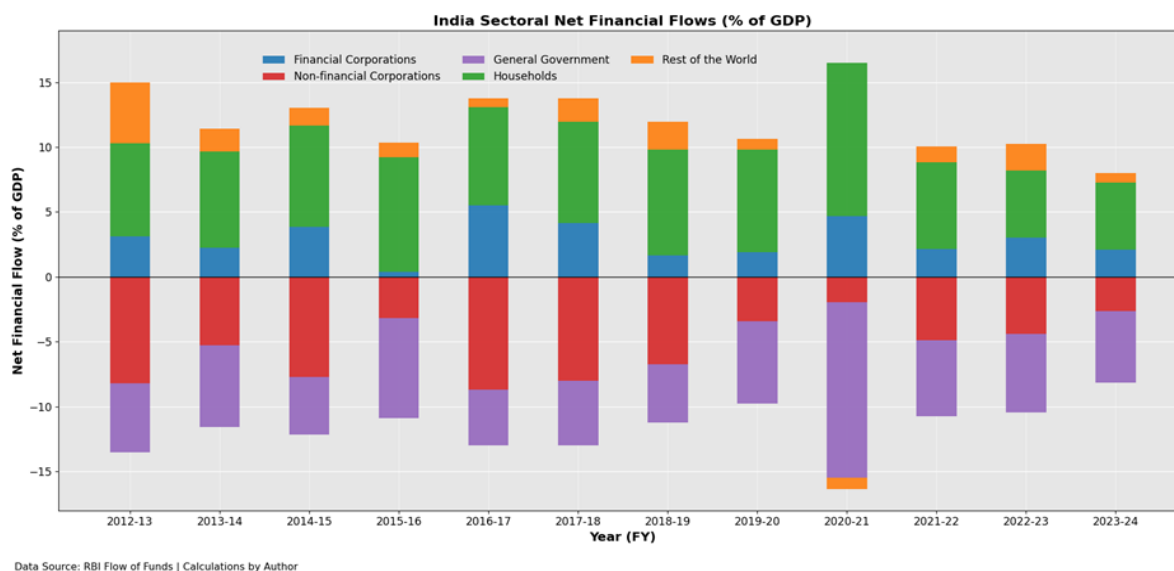


Figure 4.4: Sectoral net financial flows

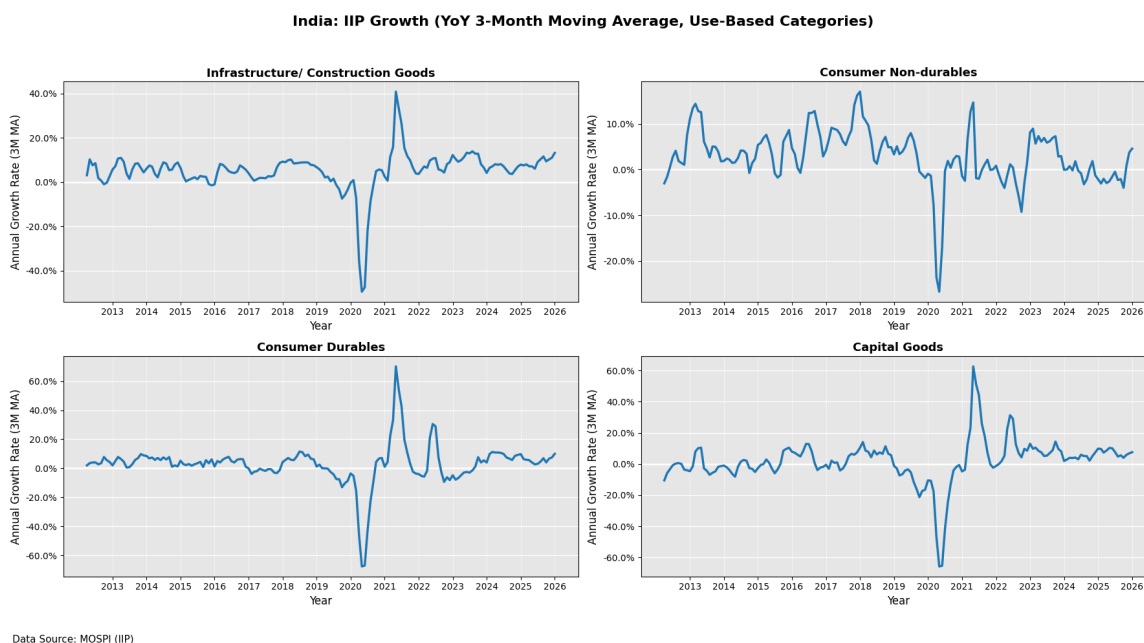
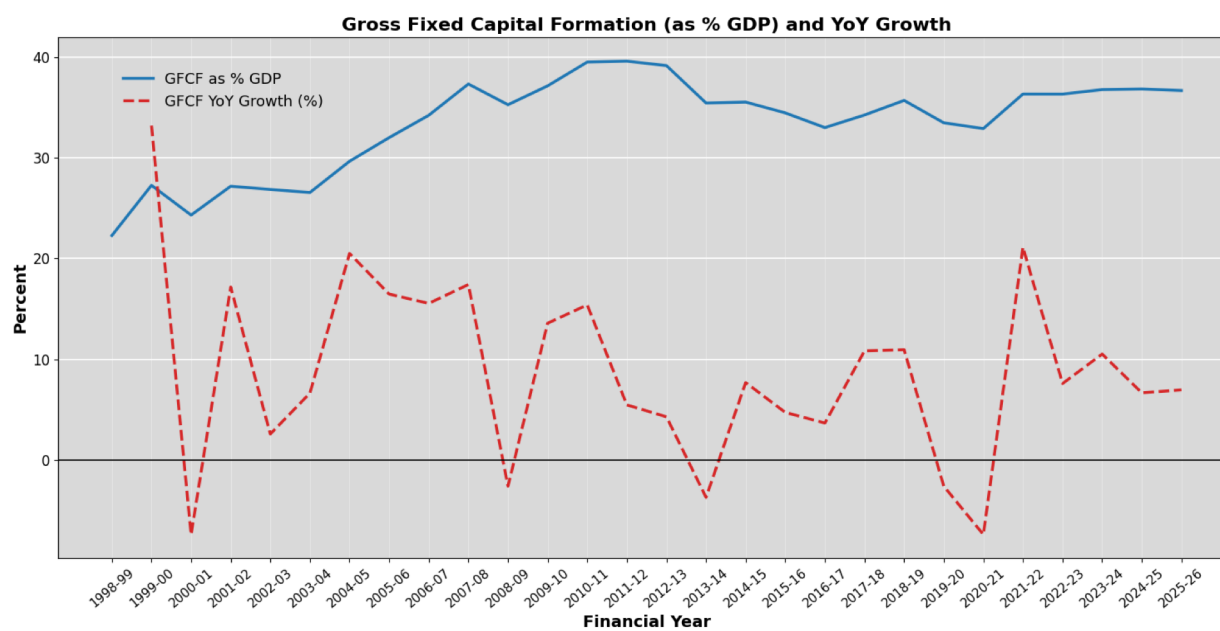


Figure 4.5: Index of Industrial Production, select sectors

The Index of Industrial Production (IIP) data further helps triangulate what the FoFs data suggests about slowing investments (fig. 4.5). Briefly, the use-based IIP decomposition shows capital goods production, a direct though lagging indicator of investment intent in the industrial economy, recovering from its pandemic collapse but not accelerating in any way that would suggest the onset of a new investment cycle. Capital goods growth on a three-month moving average basis has been positive post-pandemic but rather tepid and volatile, especially compared to say infrastructure / construction goods growth that appears to be on an upward trend.

So, now to the second question, it appears that even after corporate India has recovered well and the crisis period is far gone in the rearview mirror, a spurring of private investments that can be expected to follow a prolonged period of deleveraging has happened only partially; residential and non-residential construction being the likely drivers. Put differently, corporate India has healed itself by deleveraging and has restored its financial credibility and stability. This is a positive development but one that comes at the cost of productive capacity not expanding. Importantly, there is no morality tale to be told for sure as restrained investments on part of firms is not necessarily irrational. This is because firms coming out of a period of distress can be cautious with their balance sheets and eschew committing to large-scale capital expenditures that are often irreversible and risk putting them back in distress.

That said, financial conditions are also far more favourable now than ever before. Not just that the banks are sitting well with low NPAs and adequate capital (fig. 4.2), but also interest rates are trending down while the banking system remains aflush with liquidity (see, figs. 5.3 and 7.3 in sections 5 and 7). Under such highly permissive financial conditions, firms can be expected to forego caution and accelerate private investments. Unfortunately, there appears to be very little evidence of this in the aggregate as gross fixed capital formation (GFCF), having recovered from its pandemic trough, has just held steady at around 36.5% of GDP (fig. 4.6). Contrast this with the acceleration from FY2003-04 to FY2012-13, and India's dampened private investment cycle becomes more apparent. Year-over-year (YoY) growth in GFCF has been positive but is not trending much higher than in the pre-pandemic years. So, even under permissive financial conditions, India's capex cycle shows no significant signs of re-acceleration.



Data Source: Database on the Indian Economy (DBIE), RBI

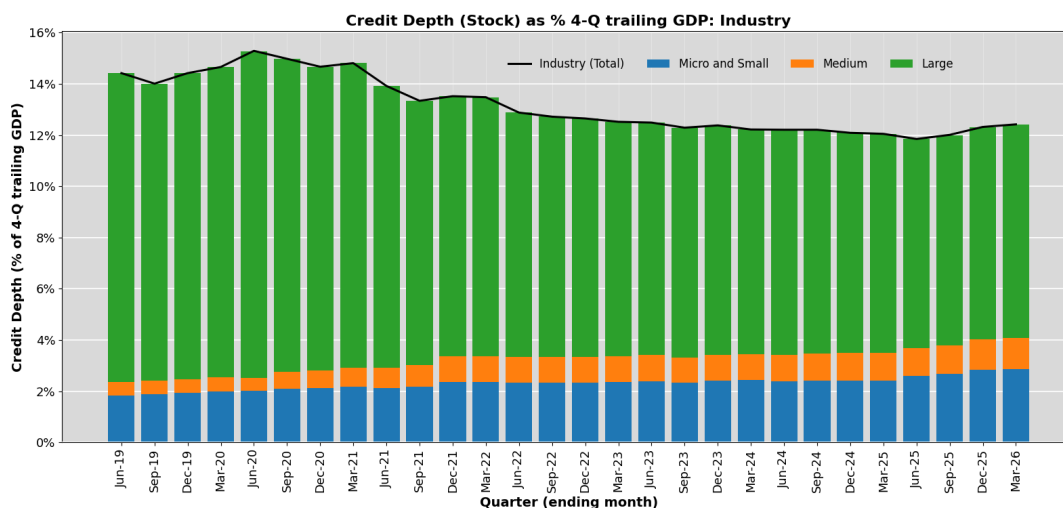
Figure 4.6: Gross Fixed Capital Formation as % GDP and % year-over-year growth

The likely explanation for a sluggish investment climate then lies on the demand, and not the financial side of investment decisions. Firm owners invest when they *expect* demand that justifies expanding capacity. However, at a time when household consumption, as discussed in section 6, is being ‘held up’ by credit supplanting income, there is likely no strong signal coming through for firm owners to adjust their expectations of future demand. At the same time, fiscal consolidation post-pandemic and subdued exports are further drawing from aggregate demand. India’s export share, as shown in figure 2.2, has averaged 21.8% of GDP over the post-pandemic years of FY2021-26. This is lower than even the 24.4% average from FY2010-14, when global demand following the Global Financial Crisis (GFC) of 2008-09 had contracted significantly. In effect, with a weak demand signal coming in from all three sources of aggregate demand, firms can rationally be expected to forego hard investments, preferring instead to remain liquid in safe assets, undertake financial investments, and/or stock buybacks. Under such circumstances, pushing further on the proverbial string of financial incentives, entailing further rate cuts, widening credit guarantees, expanding tax and other incentives such as PLI is likely to not move the needle on investments majorly. On the contrary, firms may not even be very receptive to financial incentives as the next section on credit expansion suggests. What would matter instead is for aggregate demand conditions to improve meaningfully and significantly. This can happen if demand for India’s exports accelerates significantly, the chances of which though are not that high in a de-globalizing world that entails countries turning inwards. Alternatively, it can happen by increased deficit spending, the case for which, as we cover in the section on government spending, is now much stronger than before.

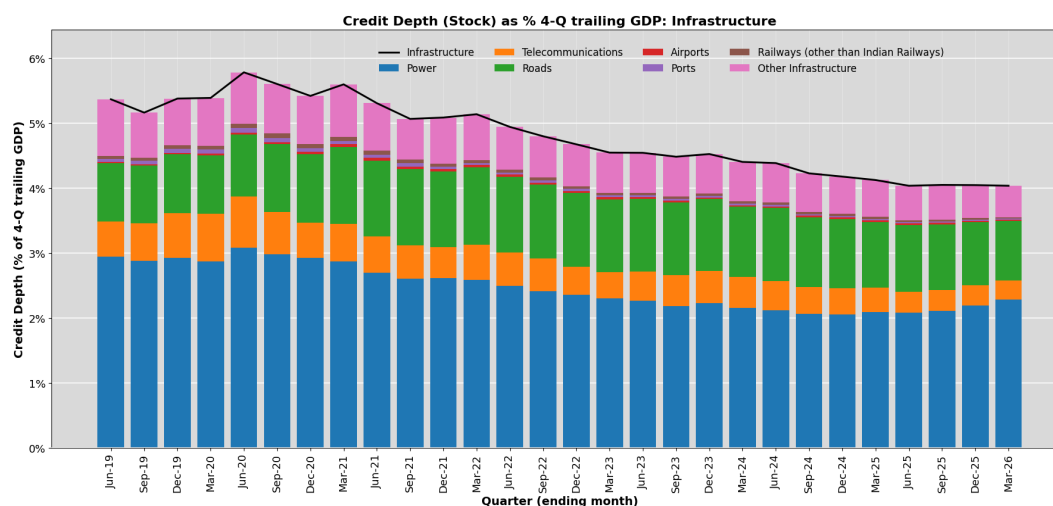
5. Banking sector credit patterns reflect weakness in demand

If extension of credit to NFCs decreases while it increases to other sectors such as households, a logical impulse is to probe if banks are allocating capital ‘efficiently’ and whether any ‘imbalance’ reflects some failure of financial intermediation that in turn may be hindering investments. We see such an imbalance in the data on sectoral allocation of credit by SCBs but find that sectoral credit patterns are likely only reinforcing the demand-constrained investment climate noted in the previous section.

Credit depth, that is total credit outstanding, has declined consistently in the industrial sector over the post-pandemic period through the second quarter of FY2025-26 (fig. 5.1). Compositionally, credit uptake by micro and small as well as medium size firms has risen slightly starting the third quarter, but demand from large firms continues to be tepid. Furthermore, within the industrial sector, the infrastructure segment too has witnessed credit depth declining consistently (fig. 5.2). This reinforces the flow of funds-based observation from the previous section, about the low demand for credit coming from NFCs, even as their balance sheets have recovered and financial conditions remain favourable.



Data Source: Database of the Indian Economy (DBIE), RBI



Data Source: Database of the Indian Economy (DBIE), RBI

Figure 5.1 and 5.2: Credit depth (total credit outstanding), industrial and infrastructure sectors respectively

Lending rates of SCBs by occupation (fig. 5.3) in fact show that the industrial borrowing rate is the second lowest, only to the financial sector, and is trending downward. The banking sector, at the same time, also remains aflush with liquidity (see, fig. 7.3 in section 7). Clearly, there seems to be no credit supply issue, but a demand issue resulting from spare capacity in the industrial sector.

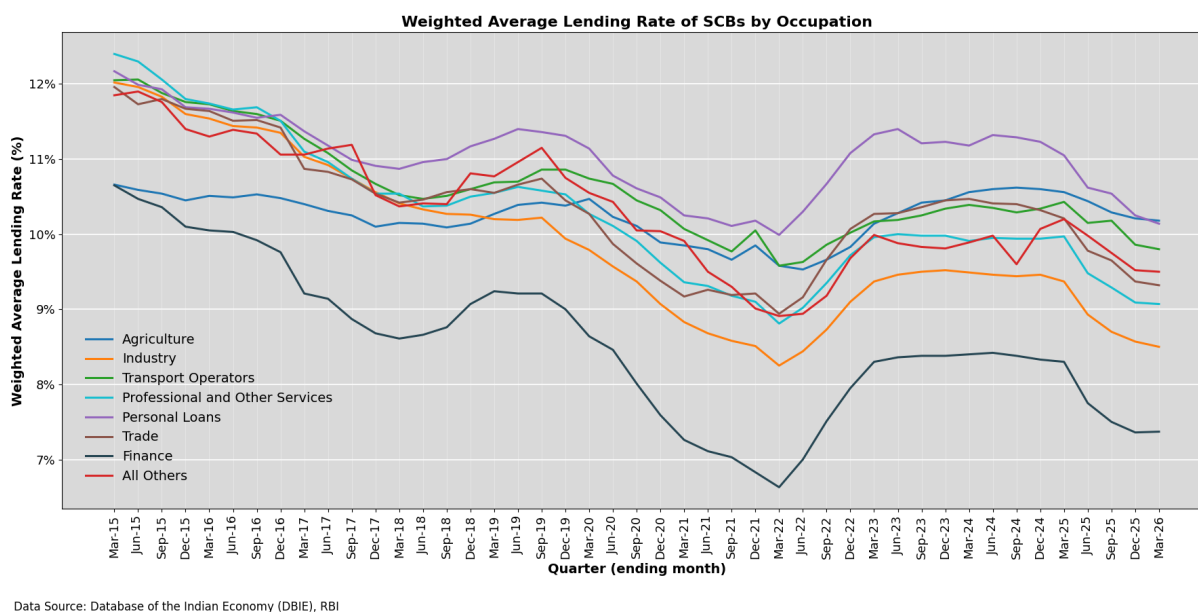


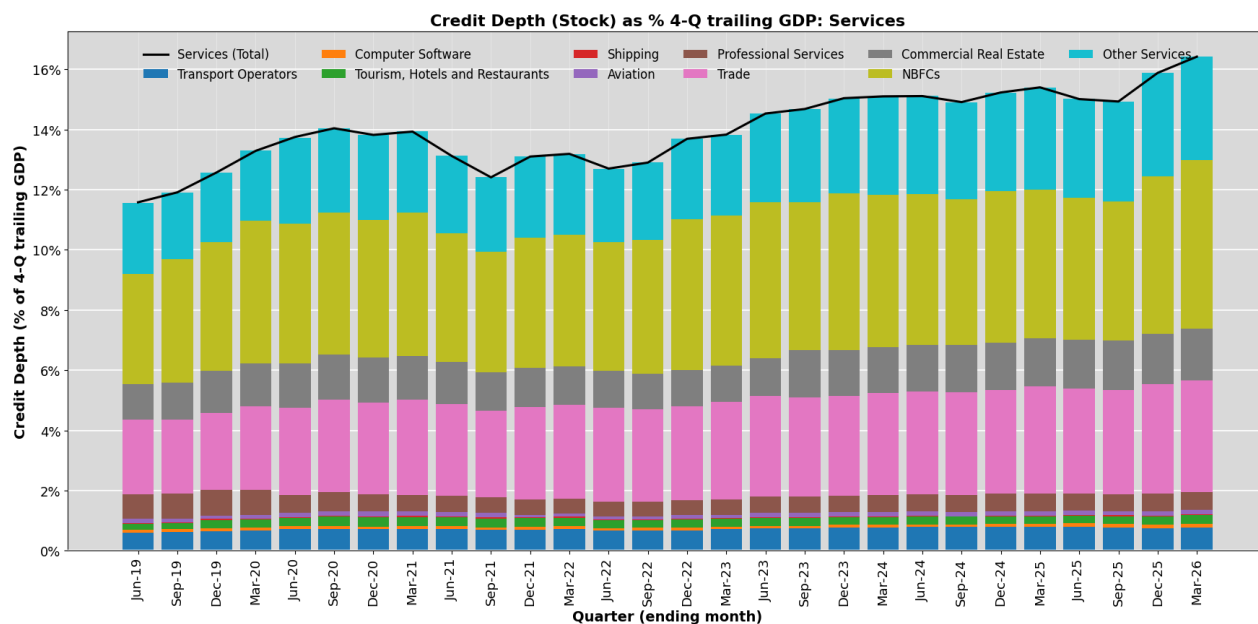
Figure 5.3: Lending rates of SCBs by occupation

The pattern of credit depth is more encouraging in the services sector (fig. 5.4), though this must be consumed with a pinch of salt. This is because the deepening of credit for the services sector, starting in the third quarter of FY2021-22, is driven significantly by an expanding financial intermediary, namely, the Non-banking Financial Companies (NBFC) sector (light green bars). Being non-depository institutions for the most part, NBFCs raise loanable funds—mainly debt—from capital markets as well as the formal banking sector (SCBs). Hence, their constitutive uptake of credit being on the rise indeed amounts to a deepening of credit in the services sector overall, but it is at best a coarse indicator for productive investments.² The same cannot be said for the services trade segment (pink bars), which too has seen substantial deepening of credit. This is certainly encouraging and aligns with the section on India’s services trade, wherein, we showed how services exports have grown significantly since 2022, resulting in a growing services trade surplus. This additionally reinforces the point made previously that credit uptake responds to sectoral demand, be it originating internally or externally as in this case.

Notably, the extension of credit to households has seemingly grown dramatically and continues to trend upward (fig. 5.5). Total quarterly personal credit depth has risen from an average of 13.5% of GDP in FY2019-20 to 18.4% in FY2025-26. Housing credit (orange) and other personal loans (light green bars) stand out as the two categories driving the deepening of credit for households. However, here too, some caution is warranted in discerning a trend. This is because upon closer examination, the largest single category of housing credit shows a single marked ‘step-up’ in the second quarter of FY2023-24 that then persists through the end of the sample period. This is *likely* explained by two concurrent factors: a possible periodic reclassification of credit between priority and non-priority sector housing

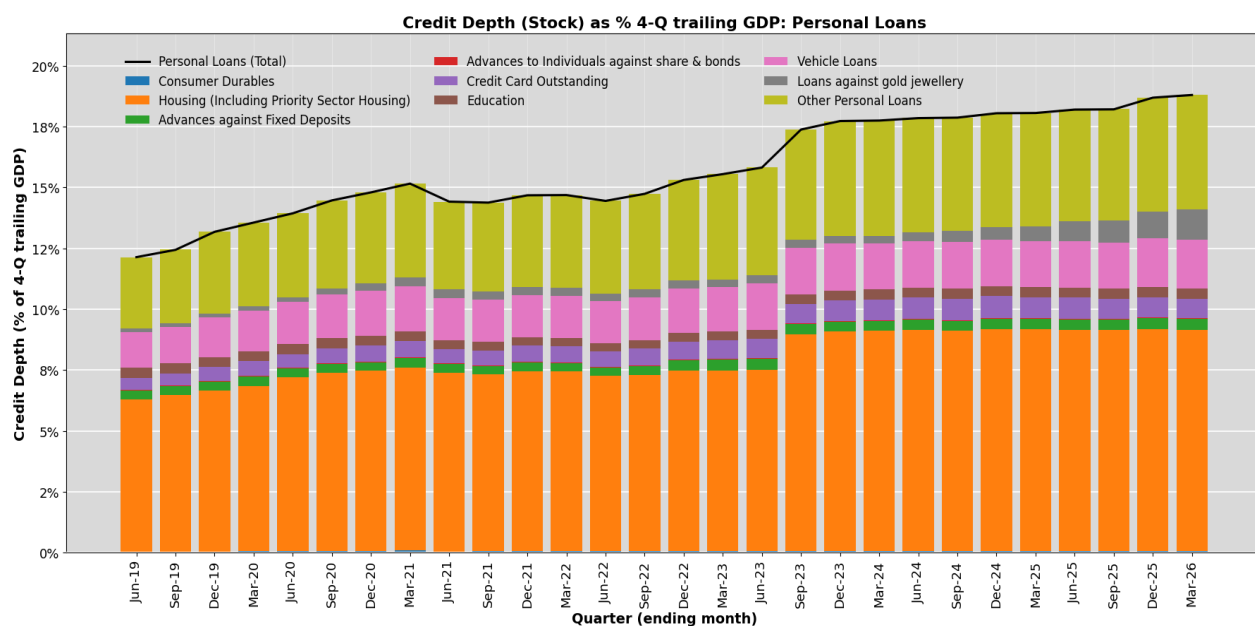
² Being highly financialized, NBFCs also invest heavily in other NBFCs and in various financial securities. Their growing significance is further considered in the section concerning the transformation of India’s financial system.

buckets, or more likely, the acquisition of HDFC's mortgage business that was structured as an NBFC by HDFC Bank that is an SCB. This acquisition went into effect July 1st, 2023, and the timing matches that of the step-up rather uncannily. So, once we account for this exogenous change, housing credit remains the largest category but the upward trend in overall household credit depth becomes less so.



Data Source: Database of the Indian Economy (DBIE), RBI

Figure 5.4: Credit depth (total credit outstanding), services sector



Data Source: Database of the Indian Economy (DBIE), RBI

Figure 5.5: Credit depth (total credit outstanding), household sector

The categories of other personal loans, and intriguingly, also of loans against gold jewellery (grey bars) that have shown some credit deepening. The former captures a mix of buy-now-pay-later consumer credit, top-up loans, and various forms of unsecured credit. These are known to have grown, highlighting the broad-based expansion of consumer credit, beyond the separate categories of credit cards (purple bars) and vehicle loans (pink bars). Interestingly, loans against gold jewellery—not monetary or any other form to be sure—have visibly grown since FY2024-25. This is likely due to rising gold prices that have enabled households to take on fresh loans against the same physical stock of collateral.

Given the foregoing, then, the important point is that households are expressing demand for credit. This, when considered again with the fact that household real incomes have not grown meaningfully, reinforces the point that increased household leverage is likely keeping up personal consumption. Moreover, what this analysis of credit patterns shows is that credit may lead only if the aggregate demand structure shifts such that private ‘animal spirits’ then move the needle on risk-taking and invest. In the absence of that, which unfortunately seems to be the case, credit patterns simply reflect the weakness in demand, but do not drive it.

6. Indian households are financializing through riskier investments and greater leverage

Households are the Indian economy's dominant creditors. Notwithstanding a severe distributional skew, household net financial worth in the aggregate rose steadily from 74.7% of GDP in FY2011-12 to 87.8% by FY2023-24, with gross financial assets touching 129% of GDP (fig. 6.1). The pandemic year, FY2020-21, produced the largest single-year jump in household net worth, spiking it to 100% of GDP as savings surged briefly and mainly for the upper decile of the income distribution (see, fig. 4.4 in section 4). The subsequent normalization has brought household surplus back down to trend, with net worth settling in 5.4 percentage points higher than pre-pandemic level of 82.4% of GDP in FY2019-20. Against this backdrop, two constitutive changes currently underway stand out and are worth examining in detail, the first more than the second. The first is a change in composition of households' asset portfolio and the second is about increasing leverage.

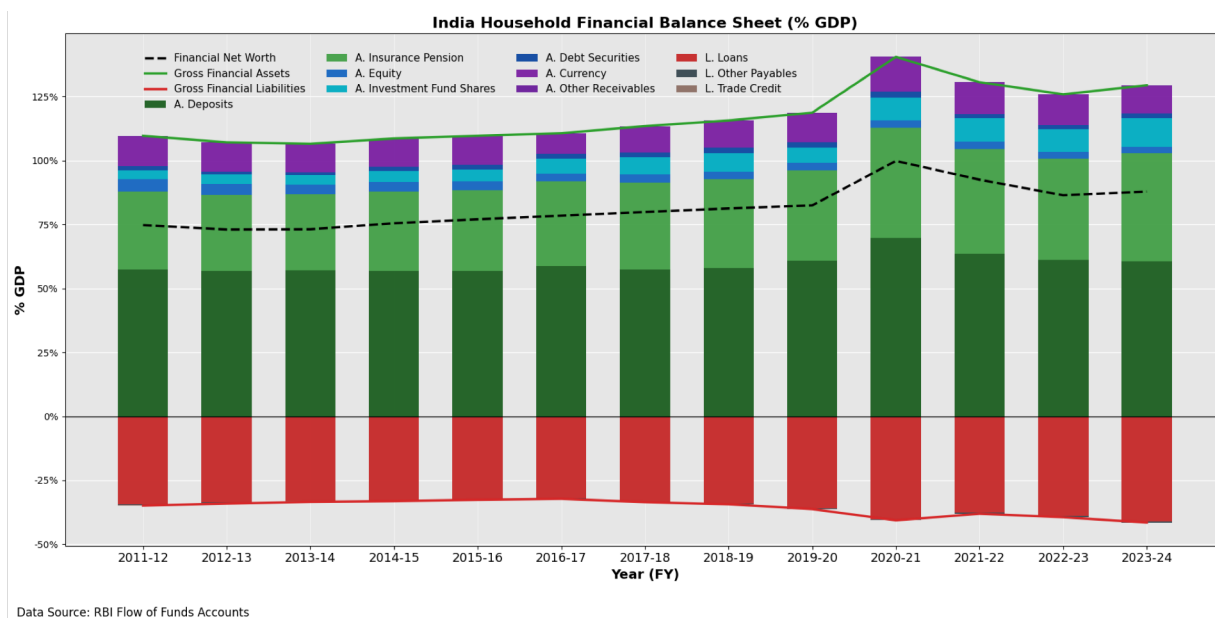


Figure 6.1: Household sector balance sheet

The first change is visually evident in both the household sector's balance sheet (fig. 6.1) and its asset portfolio composition (fig. 6.2). Focusing on the latter, we find that households more than doubled the share of investment fund units in their asset portfolio (light blue bars) between FY2015-16 when it was 4.1%, and FY2023-24 when it was 8.6%. A key driver behind this is the rise of Systematic Investment Plans (SIPs) that have enabled households to increasingly channel their savings into riskier assets (mainly equities) via mutual funds. We elaborate upon SIPs in the final section. For now, note that over the same period, bank deposits reduced their share in household assets by five percentage points to 46.8%. To be sure, bank deposits remain the largest asset class for households, but this shift, though seemingly small, is significant given that bank deposits' share typically hovered between 52 to 54%. More importantly, it signals a change in risk appetite of Indian households from being highly conservative in their asset allocations to being less so. Had it been a question of few years, the story would not be as clear. However, the consistently rising share of investment fund units in the household asset portfolio, due mainly to the rise of SIPs, tells us that households are increasingly willing to invest their savings in market-linked securities whose returns can be volatile and contingent upon market performance.

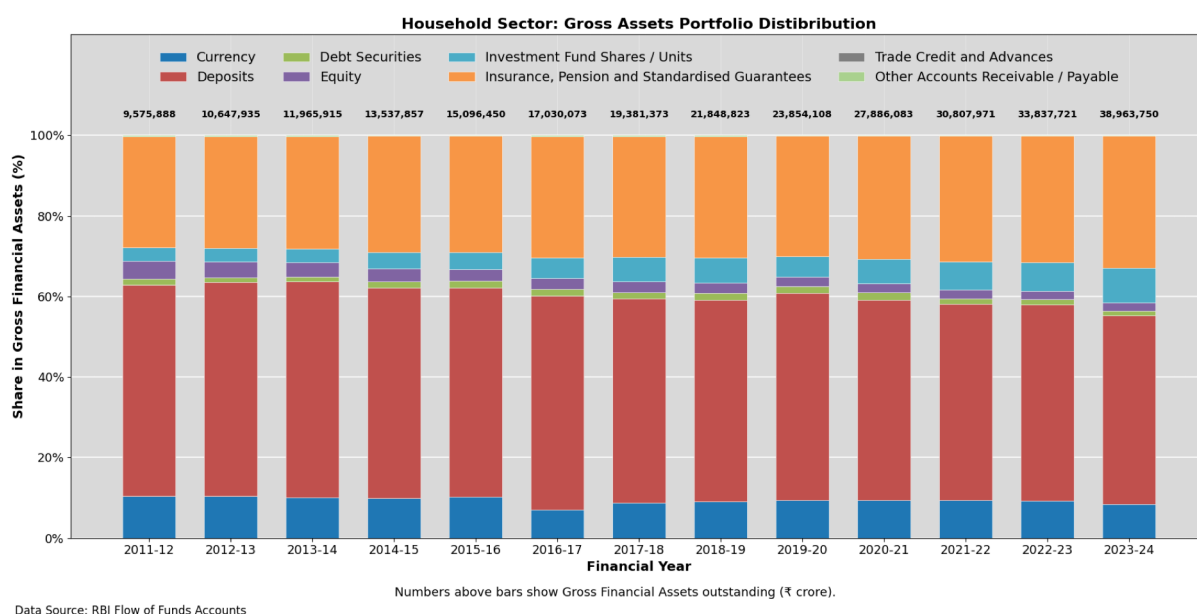
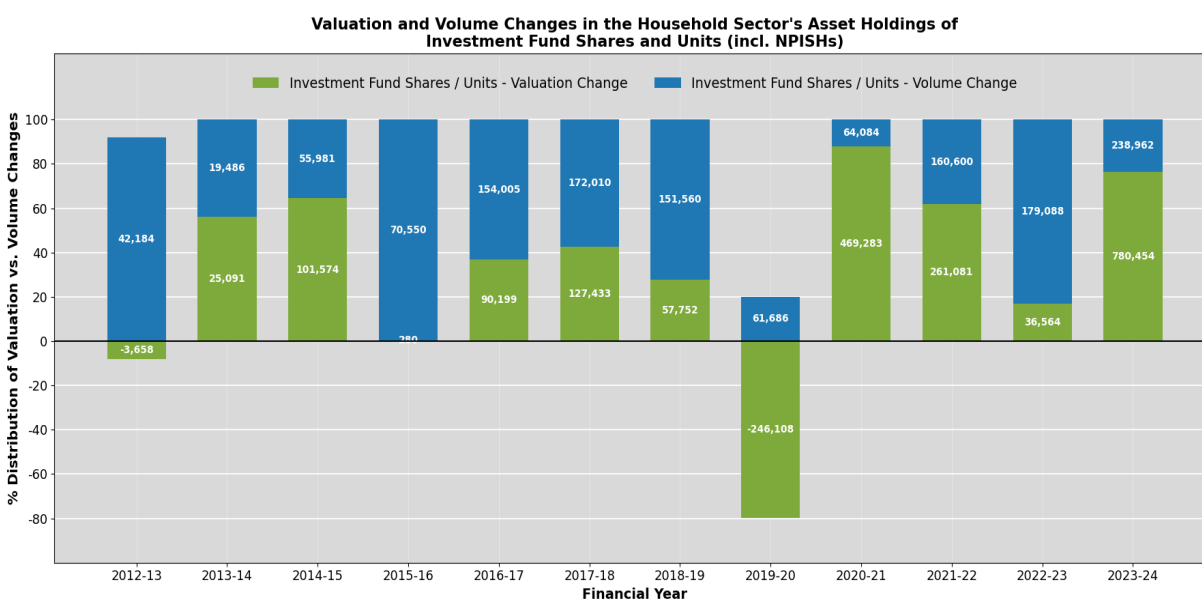


Figure 6.2: Household sector gross assets portfolio composition

The valuation and volume decomposition of household investment fund holdings makes analysing this shift a bit more interesting. Again, starting FY2015-16, we notice that nearly the entire change in investment fund holdings of households for that year was due to purchases of new units (fig. 6.3, blue bars). That is, mainly volume and not valuation effects were at play. And, in the three following years, FY2016-19, new unit purchases continued to contribute an average of 64% of the growth in value of household investment fund holdings, while the remaining contribution came from positive valuation effects. Then, interestingly, even during the pandemic year FY2019-20 when the market downturn destroyed 246,108 crores worth of value—wiping out 89.4% of the previous three years’ valuation gains—households continued purchasing new units worth 61,686 crores. Less, to be sure, but also not below 50% of previous years’ purchases. It could be argued that some were possibly ‘buying-the-dip.’ But if that were the case, then in the following year FY2020-21, we notice nearly the same amount of volume changes when the market returned, soaring back high such that valuation changes added a whopping 469,283 crores worth of value to household investment fund holdings. Finally, in all subsequent years until FY2023-24, new unit purchases increased consistently even as their contribution in some years such as FY2023-24 paled in comparison to those of valuation changes.

Point being that regardless of the vicissitudes of the stock market, Indian households continue investing in it via SIPs at a rate that is increasing with each passing year: new unit purchases in FY2023-24 amounted to 238,962 crores while just eight years back in FY2015-16 were at 70,500 crores. SIPs have been a game changer of sorts, for these decouple the investment decision from market timing as households need to commit once, and periodic contributions execute regardless of market conditions. For sure, with optionality built in, i.e., households can stop their periodic contributions, episodes like the current market downturn of 2026, if prolonged, is likely to be a test of whether Indian households’ relatively new and higher risk appetite has changed fundamentally or not.



Data Source: RBI Flow of Funds Accounts

Numbers inside bars denote valuation and volume changes in INR Crores.

Figure 6.3: Volume and valuation changes in household holdings of investment fund shares

The growth in assets must of course be read alongside what is happening on the liabilities side of the household sector balance sheet. This concerns the second change noted above, about increased household leverage. Briefly, as figure 6.1 shows, household liabilities that are nearly all loans, grew by seven percentage points in just five years: from 34% of GDP in FY2018-19 (pre-pandemic) to 41% in FY2023-24 (post-pandemic). The flow decomposition behind this growth reveals liability incurrence gathering pace starting FY2022-23. Prior to it, annual liability incurrence remained under 4.5% of GDP. However, starting FY2022-23, it surged to 5.9% and then to 6.2% in FY2023-24. Effectively, Indian households, presumably in the 80th – 85th percentile are borrowing more, likely due to no meaningful growth in real wages.

Rising household leverage can surely be read in two ways. An optimistic reading can be that it reflects increased confidence in debt serviceability, and more so, access to formal channels of (un)secured credit that was not the case before. Especially, for the masses at the lower rungs of the income distribution who too can get quick loans via apps (regardless of them being predatory loans or not). A more cautious reading though is that credit is likely substituting for income growth, financing consumption that current earnings are not sufficiently meeting. Worse, some households are borrowing to service existing debt. The two readings are not necessarily mutually exclusive. Access to formal channels of credit has indeed improved but so have real wages not grown significantly. We can therefore conclude that India's household balance sheet has become more deeply integrated with its formal financial system on both sides: more assets in market-linked securities and more liabilities incurrence via formal channels of credit. As such, income and wealth distribution notwithstanding, again, the household sector is indeed financializing. It is surely richer in the aggregate, but at the same time it is also more levered-up. Consequently, rising household leverage is concerning because its macroeconomic implications in the event of a significant economic downturn are rarely, if ever, linear.

7. The central government has consolidated enough, and the RBI's current easing cycle makes the case for increased deficit spending

The preceding entries have documented a consistent pattern of demand weakness in India's economy: corporate investment has remained sluggish despite repaired balance sheets and permissive financial conditions (section 4); credit patterns further reflect the demand shortfall (section 5); and households are likely sustaining consumption by increased borrowing in the absence of any meaningful real wage rise (section 6). What the preceding entries have not directly addressed, which this section seeks to do, is how fiscal consolidation in the post-pandemic years has contributed to the aggregate demand shortfall, and how the RBI's actions can indirectly prove to be enabling as well.

Government spending (G), constitutive of aggregate demand, is the component most controllable by policy.³ The primary deficit, that is, the fiscal deficit net of interest payments on total government debt outstanding, is a measure of the government's active fiscal stance. Interest payments are not a policy choice per se as these are legally binding obligations whose (non-)payments affect a sovereign's credit worthiness. Primary deficit, by contrast, captures what the government is actively choosing or having to spend over and above its non-borrowed revenue receipts (mainly direct and indirect taxes). A declining trend in the primary deficit relative to GDP suggests a contraction in government spending, namely fiscal consolidation, which by extension implies a declining contribution of the government to aggregate demand.

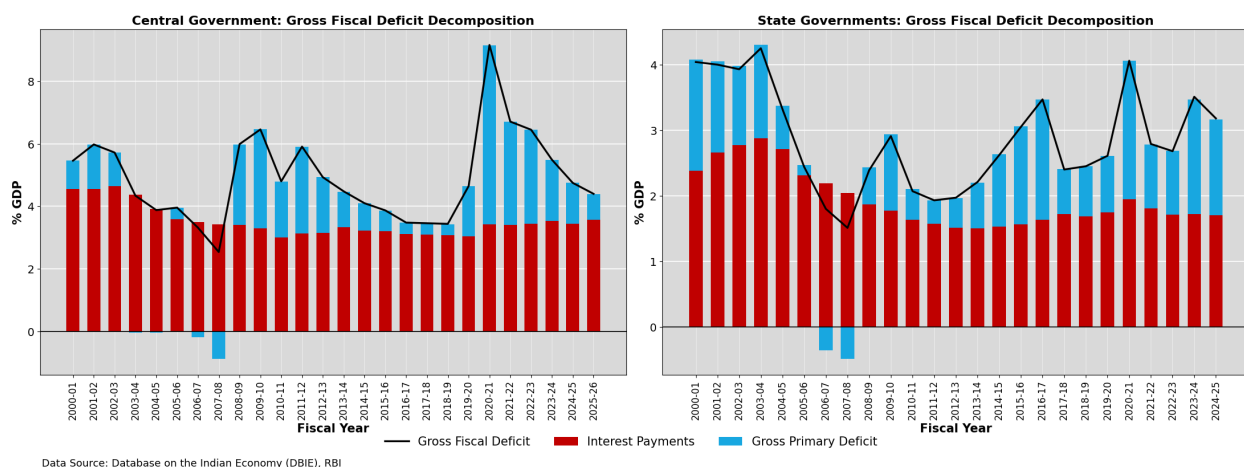


Figure 7.1: Central and State Governments Gross Fiscal Deficit Decomposition, Gross Primary Deficit and Interest Payments

The two fiscal deficit decomposition charts (fig. 7.1) reveal an interesting asymmetry in the primary deficits (blue bars) of the central and state governments. The central government's primary deficit was under 1% of GDP and nearing near zero through the pre-pandemic years of FY2014-15 to FY2018-19. As such, the centre was barely undertaking any active fiscal expansion above its interest obligations during the twin balance sheet crisis years. The pandemic-related fiscal expansion resulted in the primary deficit rising again, sharply, over FY2019-20 and FY2020-21. What is really noteworthy, though, is the post-pandemic compression of the primary deficit, which too has been rather sharp: declining from its peak of 5.7% of GDP in FY2020-21 to 0.80% in FY2205-26 – a period of just five years.

³ This is commonly understood by means of the expenditure approach equation for calculating GDP that equals aggregate demand as: $Y = C + I + G + X - M$.

The central government's primary deficit pattern, in particular, reveals how India responds to crises. Be it the short global slump in the early 2000s due to the dotcom bust, the global financial crisis of 2008-09, or the global pandemic, the primary deficit responds by expanding and then compressing back down immediately as the crisis recedes. Providing a counter-cyclical impulse to aggregate demand in moments of crisis, till recovery takes hold with the private sector picking back up, is indeed the role of the government. In principle at least. However, as discussed in section 4, private investments remain tepid. This in turn suggests that the withdrawal of fiscal support, post-pandemic, came much too soon that it did not really fulfil its purpose of providing a sustained counter-cyclical demand signal. As such, the sharp decline in the central government's primary deficit can be conceived of as a factor contributing significantly to the Indian economy's demand-constrained state currently.

The primary deficit pattern of state governments, by contrast, tells a different story. Their primary deficit at 1.75% of GDP in FY2024-25 (until when data is available for states) has followed a more consistently positive path, both post-pandemic and also pre-pandemic, starting FY2012-13. Note, though, that the primary deficit of states exists by virtue of them being short-strapped for revenue to begin with, and not because they seek to provide a sustained counter-cyclical response to any crisis. Therefore, the fiscal consolidation story is almost entirely a central government phenomenon and one that appears to have been undertaken much too soon and rapidly. Indeed, the gross fiscal deficit of the central government is down to 4.4% (fig. 7.1), trending towards the Fiscal Responsibility and Budget Management (FRBM) act's directed target of keeping it at 3% or lower, so as to cap the debt-to-GDP ratio at 60% of GDP. The cost of this, though, has been borne by aggregate demand, which being sub-par has likely forestalled any significant adjustments in expectations of private actors for a new investment cycle to take-off.

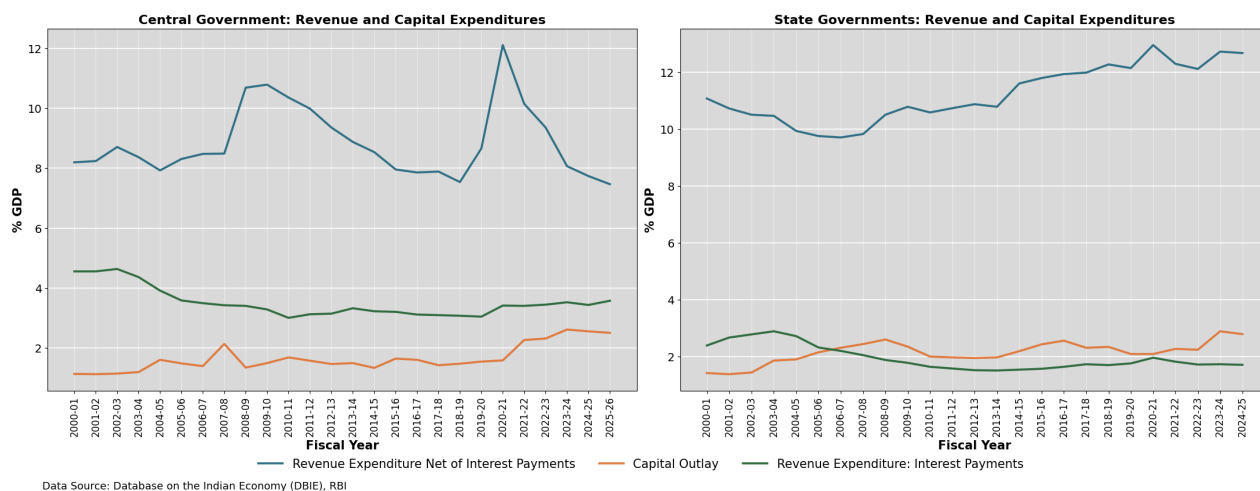


Figure 7.2: Revenue and capital expenditures, % GDP

A counterpoint to this reading can be that a declining primary deficit to GDP ratio after all does not imply that government spending is contracting in absolute terms. Government spending is still growing, just more slowly than the economy is, thereby, lowering the ratio mechanically. Some may even argue that the government perhaps does not need to borrow and spend as much when the economy is growing at a high rate—that the Indian economy is—than when it is not. Simply put, there is a non-linearity to government spending relative to GDP growth, hence, the decline in the central government's primary deficit ratio is justified and not necessarily drawing down aggregate demand. Government expenditure composition charts are of help here (fig. 7.2).

For the central government, the post-pandemic consolidation has come entirely through contraction of current revenue expenditure net of interest payments (blue line). It has declined from its peak of 12.1% of GDP in the pandemic year FY2020-21 to being 7.5% in FY2025-26, which is lower than even pre-pandemic levels. By contrast, capital outlay (orange line), capturing government-led fixed capital formation that matters significantly for holing up aggregate demand, has in fact risen over the same period from 1.6% to 2.5% of GDP. Though still low for a growing economy like India, this is nevertheless a positive recent development as pre-pandemic rates hovered lower between 1.5-2.0%. Also, interest rate payments (green) have remained stable throughout at roughly 3-3.5% of GDP.

The central government's fiscal consolidation is thus being achieved by cutting revenue account expenditures on wages, subsidies and grants; not by cutting back on capital investments or restructuring its debt service payments. However, since these government expenditure categories also quite directly support income and thus consumption of other institutional sectors, particularly households, it is highly unlikely that the sharp post-pandemic fiscal consolidation is having any positive effects on aggregate demand. Or even that there is not much need for such expenditures anymore as the economy is surely growing. All of this further comes into sharp relief once we also recall from section 6 above that the household sector has also increased its borrowing over the same period.

The picture for state governments is contrasting again with revenue expenditure net of interest payments rising consistently. In FY2024-25, it was estimated to be at 12.7% of GDP, while capital outlay at 2.8% of GDP has only risen marginally. The four charts in figures 7.1 and 7.2 when read together present a picture of fiscal consolidation that is a bit more nuanced than what headline deficit numbers alone convey. The central government is consolidating primarily by contracting revenue account expenditures while states do not appear to be doing so.

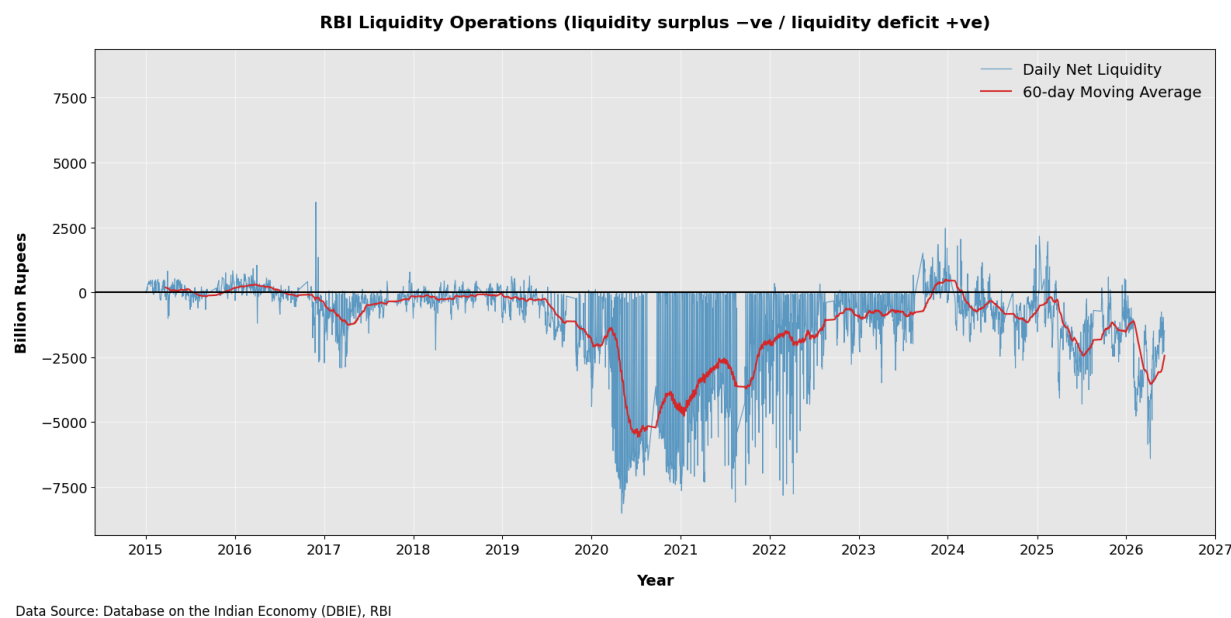


Figure 7.3: Banking sector liquidity (negative values imply higher liquidity)

In the context of the central government's fiscal consolidation, the RBI's stance of maintaining surplus liquidity through a good part of the post-pandemic period has also played an enabling role, albeit indirectly, in keeping the cost, i.e., interest rate, on new government borrowing low. Importantly, a period of low borrowing costs can also work to make the overall debt burden less onerous, for as older

debt matures and is rolled over at lower rates, the growth in interest payments on an incrementally growing stock of debt is likely to decelerate (as opposed to periods of tighter liquidity conditions that would entail higher rates). To further understand the macroeconomic relevance of this current post-pandemic period of surplus liquidity, it helps to briefly analyse the RBI's liquidity operations over three sub-periods or phases.

In the first phase, lasting approximately three years from FY2019–20 to FY2021–22, the RBI kept a high liquidity stance, visible as the persistently deep negative values in figure 7.3 (negative values imply surplus liquidity). Since the primary mechanism to inject such liquidity involves RBI's open market operations (OMOs) of purchasing G-Secs, this resulted in lowering long-term bond yields while the overnight repo rate too was lowered. A snapshot of the yield curve from this period, for example, from 1st July 2020 (fig 9.5, blue), gives it away clearly: the long end is at 6.5% while the front-end that most closely follows the repo rate is at 3.25%. As such, new G-Secs issued during this period to fund the pandemic-related primary deficit increase in figure 7.1 or to roll over maturing debt, got done in a highly accommodative interest rate environment.

In the second phase, approximating another three years from FY2022–25, the RBI reversed course by sharply raising the repo rate 225 basis points to 6.25% in a span of just seven months from April to October 2022 (fig. 7.4, green line). Moreover, the RBI's FX interventions during this period—especially over the two years FY2023–25 that held the INR rather steady between 82–86 to the dollar—added to the tightening as rupee liquidity got exchanged for dollar reserves. The tightening of liquidity corresponding during this second phase is clearly visible in figure 7.3. To be sure, the RBI's decision to raise the repo rate and tighten liquidity conditions was primarily a function of global inflationary pressures, resulting from prolonged supply chain disruptions. Inflationary pressures also moved the US Federal Reserve to begin raising the overnight federal funds rate starting early 2022.

Finally, in the third and ongoing phase, starting the last quarter of FY2024–25 (January 2025), the RBI has reversed course again as inflationary pressures have significantly abated now. It began by lowering the repo rate by 25 basis points from 6.5% that it had been at for two years, and which currently stands at 5.25% (fig. 7.4). The corresponding increase in liquidity starting 2025 is again visible in fig. 7.3. As is the slight tightening recently due to the RBI's aggressive FX interventions to contain the INR's fall.

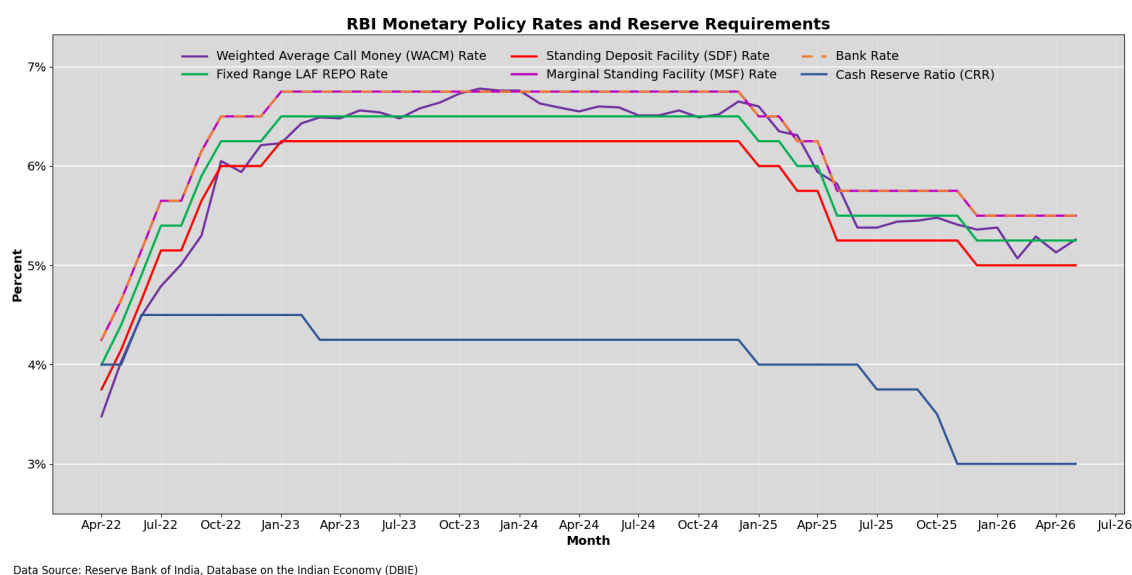


Figure 7.4: RBI monetary policy rates constituting the Liquidity Adjustment Facility (LAF) corridor

Snapshots of the yield curve from various points in time, across the three phases, further show the effect of the RBI's liquidity operations on the bond market. Notably, as the RBI began raising interest rates, and liquidity tightened towards positive values in fig. 7.3, the yield curve, for example, from 31st October 2022 (fig. 7.5, red curve), shifted dramatically upward. Comparing it to the one from the depths of the first phase of high surplus liquidity (blue), the belly of this second phase curve flattened sharply as medium-term borrowing costs, pricing in uncertainty from accelerating global inflation, rose to match those of longer borrowing tenors. Now, in the third phase, the yield curve (green) has shifted back down. Indeed, it is higher than where it was a year back (orange), but below the curve from a month ago (purple). This implies that government borrowing costs now are seemingly easing back into highly accommodative territory, which in turn matters for fiscal policy.

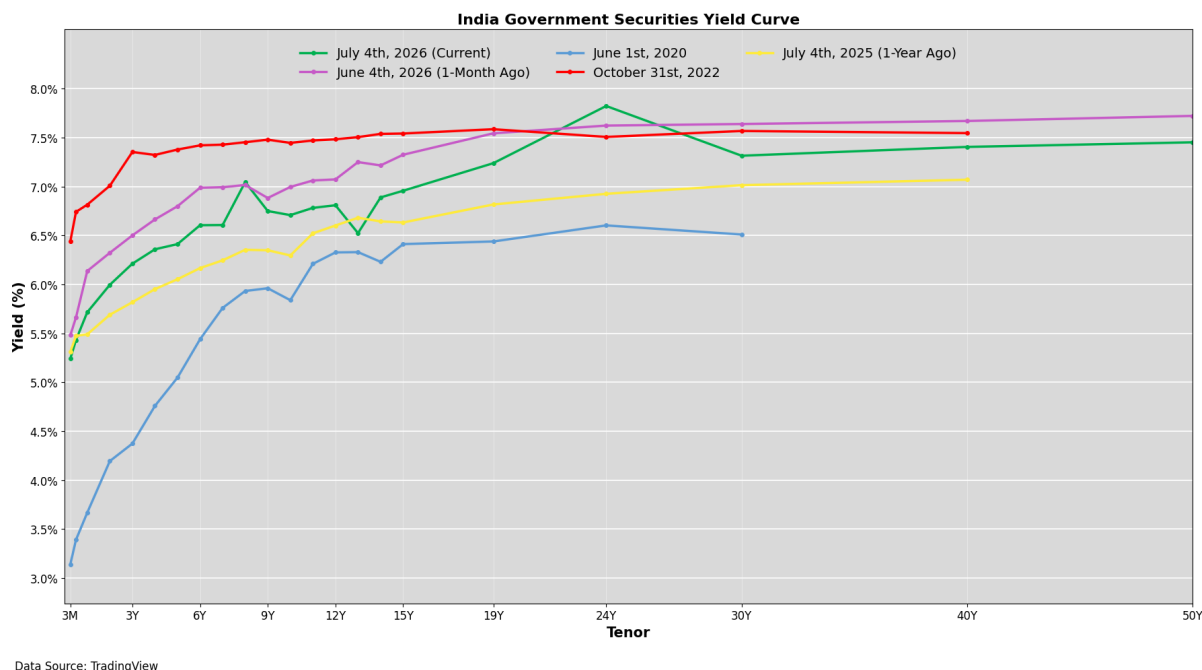


Figure 7.5: Indian G-Secs: Yield Curve Snapshots, various dates

Against the backdrop of a likely premature fiscal consolidation that has been carried out post-pandemic, the case for it continuing is weaker now in light of tepid investments on the one hand and low government borrowing costs on the other. Put differently, the government has done a good amount of fiscal consolidation already, and conditions are now ripe for it to boost aggregate demand by increasing deficit spending. To be sure, the recent rise in central government capital outlay, as discussed above in reference to figure 7.2, suggests a positive step in the right direction. However, not only is it a modest increase, but it also remains to be seen if it will be sustained, let alone accelerated. Overall, and in closing, it seems rather clear that more concerted government spending is the need of the hour to crowd-in private investments and raise 'animal spirits' across the board. This is not outside of the Indian state's potential, but it does require formulating a strategically serious industrial policy that is both audacious and not constrained by self-imposed limits on debt, and thereby, deficit spending.

8. Who funds the Indian state? The answer has changed and reveals deepening financialization of the Indian economy

The answer to ‘who funds the Indian state’ was clear prior to liberation: nationalized banks, directed by a high 40% statutory liquidity ratio (SLR) requirement absorbed government debt, comprising primarily of government securities (G-Secs) and some loans. Government deficit was thus funded via a form of financial repression in which the banking system had no meaningful choice but to be the dominant creditor. This model has been disrupted and transformed both by a reduction in the SLR to 18%, and notably, the rise of Other Financial Corporations (OFCs) as the dominant holders of government debt. OFCs include but are not limited to mutual funds, investment arms of insurance firms, pension funds, NBFCs, and other non-depository financial institutions.

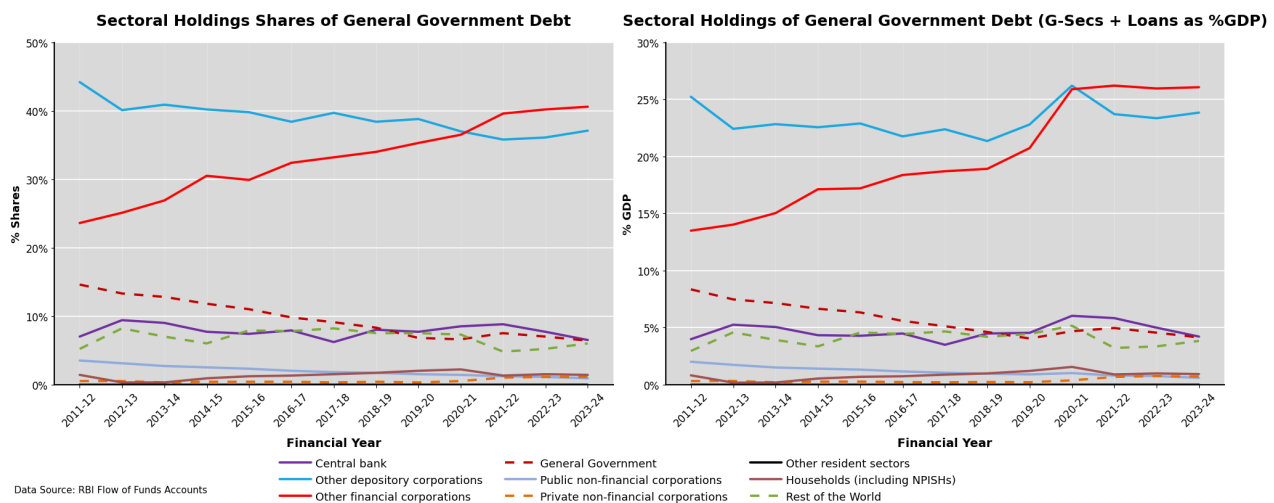


Figure 8.1: Sectoral holdings of government debt, distributional shares and relative value

Based on the flow of funds (FoFs) data, by FY2023-24, OFCs held 40.6% of general government debt, i.e., centre plus state government debt, amounting to 26.1% of GDP, up from 23.6% and 13.5% respectively in FY2011-12 (fig. 8.1). Other Depository Corporations (mainly SCBs), by contrast, held 37.1% of government debt amounting to 23.8% of GDP in FY2023-24, down from 44.2% and 25.2% respectively in FY2011-12. While the pandemic year FY2020-21 marks the moment that OFCs surpassed ODCs as the dominant creditor of the government, their rise has been ongoing for much longer. A good amount of this reversal can be attributed to insurance sector regulations that require investment portfolios of insurance premiums to hold a high percentage of G-Secs. More importantly, however, other specific OFCs, namely, mutual funds have likely contributed far more to this reversal, owing mainly to the growing popularity of retail Systematic Investment Plans (SIPs).

The demand for SIPs has grown significantly as Indian households have increasingly channelled their savings via them into mutual funds, away from traditional bank deposits. We elaborate upon this in a separate section below, which explains the rise of SIPs. For now, it is also relevant to note that excess savings accruing to the upper decile of the income distribution during the pandemic, further added to the demand for SIPs. Mutual funds, as a result, have gone on to invest bigger amounts into G-Secs as the government bond market is the deepest and most liquid fixed income market in India. The corporate bond market, by contrast, remains rather shallow. So, G-Secs being the de facto safe asset class, has resulted in them absorbing the growth in mutual fund portfolios. In short, SIP-channelled household savings now constitute an indirect chain of intermediation that finances the fiscal deficit.

Interestingly, contrary to a common perception, the rest of the world (RoW), specifically, is not a major creditor category for the Indian government. To be sure, Indian G-Secs are now part of JP Morgan's EM Government Bond Index since FY2024-25, which has enhanced their credibility. Furthermore, new incentive schemes, such as the RBI's fully accessible route (FAR) launched in 2020, allowing foreign portfolio investors and NRIs to invest in specific G-Secs without major restrictions and retention requirements has resulted in some recent uptake of Indian G-Secs abroad (fig. 8.2, red bars). But, given that in FY2023-24 the RoW's share of Indian government debt stood at a mere 6.0% amounting to just 3.8% of GDP (fig. 8.1), the impact of these recent changes remains low.

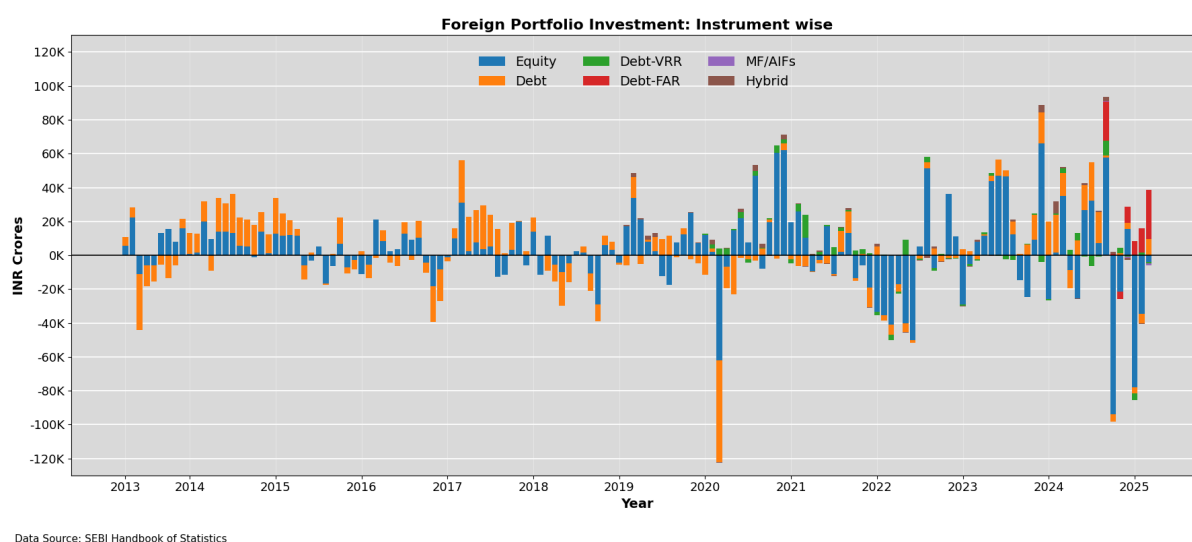
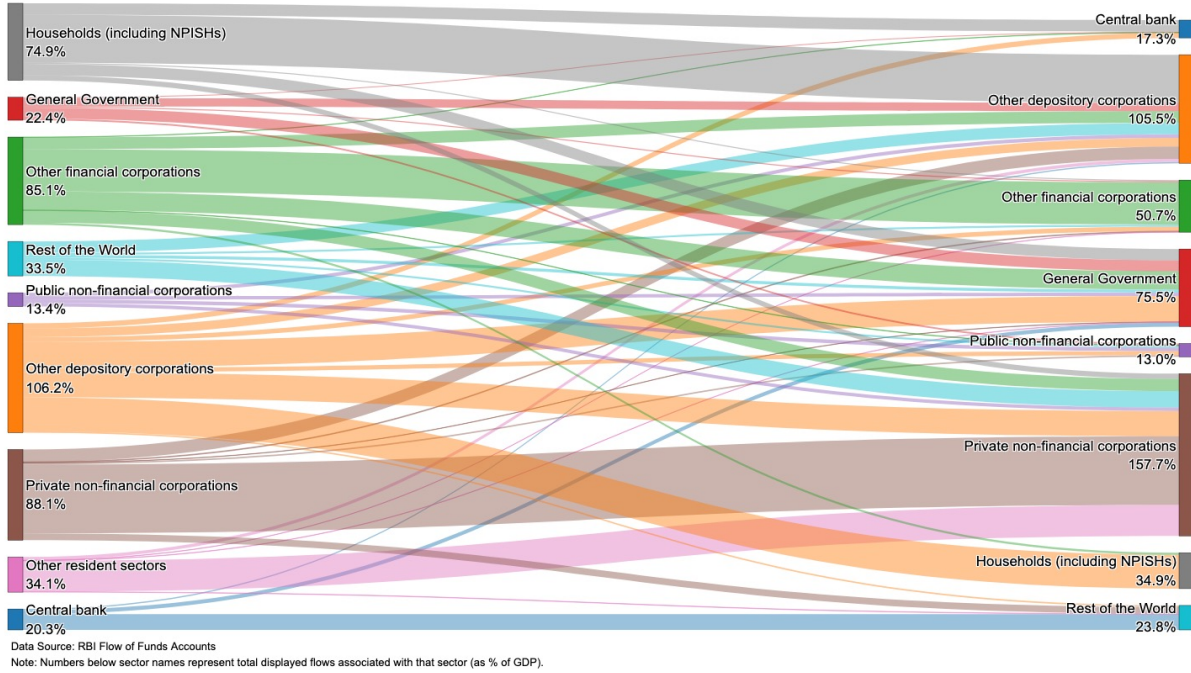


Figure 8.2: Foreign portfolio investments by instrument

Interestingly, the rise of domestic OFCs is reflective of deepening capital markets, which also makes India an intriguing case of heightened financialization at low per capita income. The growing importance of OFCs is also not restricted to their now dominant role in funding the Indian state. It in fact highlights an ongoing transformation of the financial system itself. Charted as Sankey diagrams (figs. 6.3 and 6.4), two snapshots from FY2011-12 and FY2023-24, using the latest FoFs data on cross-sectoral asset holdings are *illustrative* of this transformation that is increasingly centred on OFCs.⁴ In FY2011-12, India's financial system was undoubtedly bank-centred. ODCs held the largest amount of assets worth 106.2% of GDP while OFC assets were a distant second, 21.1 percentage points lower and amounting to 85.1% of GDP. Fast forward to FY2023-24 and the transformation is clear: ODC sector assets contracted by 16.8 percentage points to 89.4% of GDP while those of OFCs grew by 27.4 percentage points to be the largest, worth 112.5% of GDP.

⁴ These charts are illustrative in nature as there are certain crossholdings that cannot be visualized due to limitations in the underlying FoFs data structure. The limitation mainly concerns indirect assets holdings. For instance, the cross-sectoral asset holding data does not fully capture the connection between households and OFCs, and so these diagrams do not fully reflect the point made above about SIPS increasing channeling household savings to OFCs.

Financial Outstanding: Sector-wise Flow of Funds, 2011-12 (Normalised by GDP)



Financial Outstanding: Sector-wise Flow of Funds, 2023-24 (Normalised by GDP)

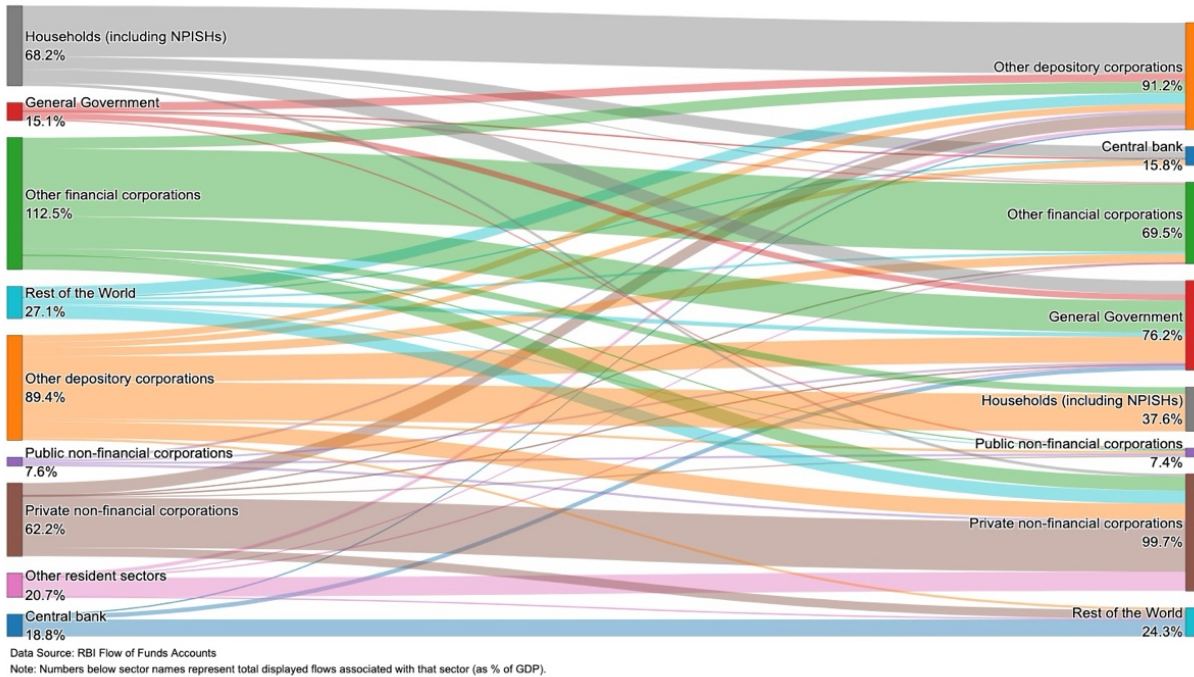


Figure 8.3 and 8.4: Cross-sectoral assets holdings (from who to whom), FY2011-12 and FY 2023-24

There are, as the saying goes, no free lunches. The rise of OFCs comes with cross-cutting implications of potential economic benefits but also added risks. For the government, a more diversified and growing creditor base across OFCs, ODCs, households, and possibly even the RoW potentially holding INR denominated G-Secs at some point in the future, only deepens the market for government debt, and by extension, government backed safe financial assets. Given varying risk appetites and investment horizons, the yield curve can also potentially become more informative as a result, and longer tenor bonds more attractive. This would be a net positive.

At the same time, however, the financial system's fragility is likely to increase as liquidity and solvency risks for the non-banking complex of OFCs (mutual funds, insurance companies, and pension funds) become increasingly tied to the performance of G-Secs in a way that has not been the case thus far. For instance, a sharp rise in G-Sec yields, whether from perceptions of fiscal deterioration or monetary tightening, runs the risk of sudden markdowns of OFC assets that can raise redemption pressures. It helps to note that SIPs of a typical household generally do not have lock-in periods. So, redemption pressures from households can surely escalate. Furthermore, with a burgeoning market of mutual funds, especially those offering quasi-closed end financial products such as Exchange Traded Funds (ETFs), rising redemption pressures can in turn contribute significantly to overall capital market volatility.

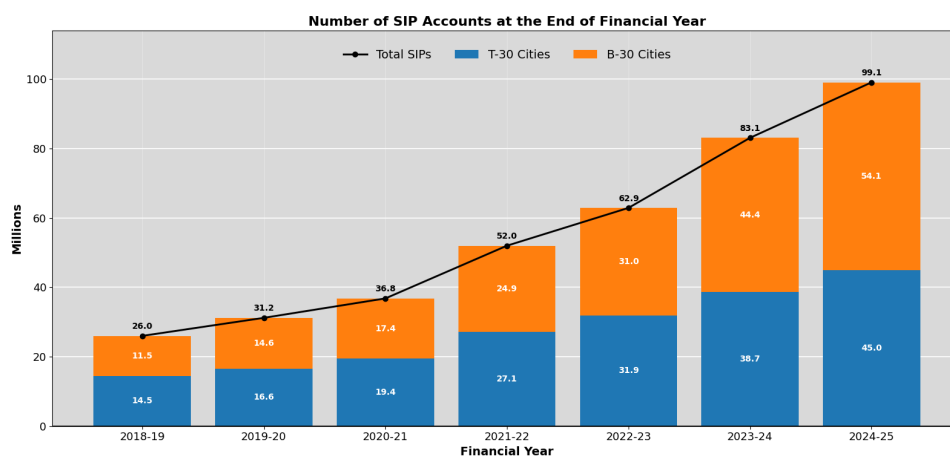
More important is the fact that rising bond yields may spawn dynamics that can wipe out holders of government debt. This is not hypothetical but very real. For instance, when the British government under Liz Truss announced tax cuts in September 2022, gilt yields spiked, thereby, marking down the value of long-duration gilt holdings, especially of pension funds. This in turn triggered a near-systemic liquidity crisis, with some pension funds even nearing insolvency, which necessitated emergency intervention by the Bank of England. Not to mention the fact that this ill-fated decision cost Liz Truss her prime-ministership, made infamous by a stunt artist live-streaming a ball of lettuce outlasting her. Likewise, in the US, Silicon Valley Bank's collapse in March 2023 came about due to a highly unbalanced portfolio with disproportionately high holdings of long-term US Treasuries. But, as the long-end of the US yield curve began rising in response to rising interest rates, such asset-holdings lost value; notionally to be sure but nevertheless eliminating the bank's capital on a mark-to-market basis. Even though notional, once these losses were made public, an unsustainable run on the bank ensued, bringing it to an end. So, in both cases, the trigger was the same: a rise in sovereign bond yields with the effect running through the balance sheets of institutions that had significant holdings of government securities.

India's OFC complex, with its growing and regulation mandated holdings of G-Secs is not immune to this dynamic. To be sure, the Indian OFC sector is highly regulated, and its asset composition remains well balanced. But the overall transformation in OFCs becoming the dominant funders of the Indian state, and having the entire financial system centred on them, implies that financial stability is now also more contingent on asset market conditions. Especially, on perceptions and expectations that are often difficult to control just via government policies.

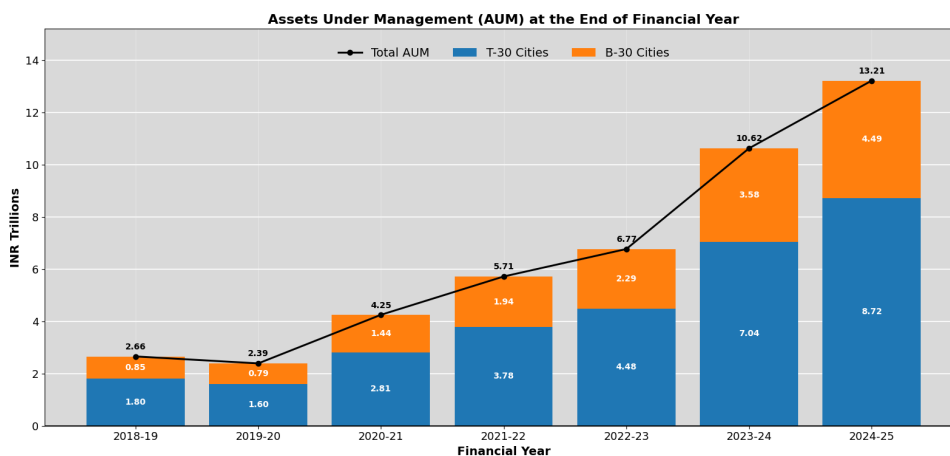
9. Indian equities are becoming less sensitive to foreign portfolio flows but more sensitive to domestic households

India's equity markets for the longest time were highly responsive and sensitive to foreign portfolio flows. When FPIs sold (risk-off), the market typically fell; when they bought (risk-on), it typically rallied. Domestic institutional investors (DIIs) were present but at a much smaller scale. This sensitivity to FPI flows is now significantly less due to the rise of DIIs channelling household savings via SIPs. This positively alters how the Indian financial system responds to risk-off episodes when global portfolio capital ebbs. At the same time, it also creates a different sensitivity in place of the old one.

Let us first consider why the demand for SIPs has grown in popularity recently. An important reason for their growth is the expansion into 'beyond top 30' cities, namely, B-30 cities. This was the result of both regulatory, technological, and product changes in the mutual fund market. Mutual fund investments, previously, were concentrated in the top 30 (T-30) cities. Major metro areas such as Mumbai, Delhi, Bangalore, and a few others dominated due to the presence of an urban professional class who presumably understood the risks of investing in equities, and more importantly, had the disposable income to take on such risks. However, since FY2020-21, both SIP registrations and assets under management (AUM) in B-30 cities have grown rapidly (figs. 9.1 and 9.2).



Data Source: SEBI Handbook of Statistics



Data Source: SEBI Handbook of Statistics

Figure 9.1 and 9.2: SIP registrations and AUM distributions across T-30 and B-30 cities

Over four years from FY2020-25, SIP registrations grew 3.1x in B-30 cities compared to 2.3x in T-30 ones. By FY2022-23, the number of SIPs in B-30 cities had caught up to those in T-30 (31:31.9 million) for a near-equal distribution (31:31.9 million). But, by FY2024-25, B-30 registration numbers overshoot to be 20% more than those in T-30 cities. This in turn resulted in keeping the AUM distribution constant at 1.95x. That is, FY2024-25 AUM in T-30 cities were 1.95x of those in B-30 cities, and this was no different than in FY2020-21. As may be expected, AUM in T-30 cities is bound to be higher given higher disposable incomes. The larger point, then, is that had it not been for the significant growth in uptake of SIPs in B-30 cities, the AUM in T-30 cities would likely have been of much higher multiples. This geographic broadening means that SIP flows now reflect a wider and more diverse base of Indian households, not restricted to those with high disposable incomes alone. The consequence of this, as has been the case recently, is that the Indian equity market is now less sensitive to global risk-off episodes. Net FPI flows, as shown in figure 1.2 above, have been declining since Q4 FY2023-24. Yet, the recent downturn notwithstanding, equity markets did not corresponding fall all through since then, as both the Nifty 50 and Sensex indices, show (fig. 9.3).

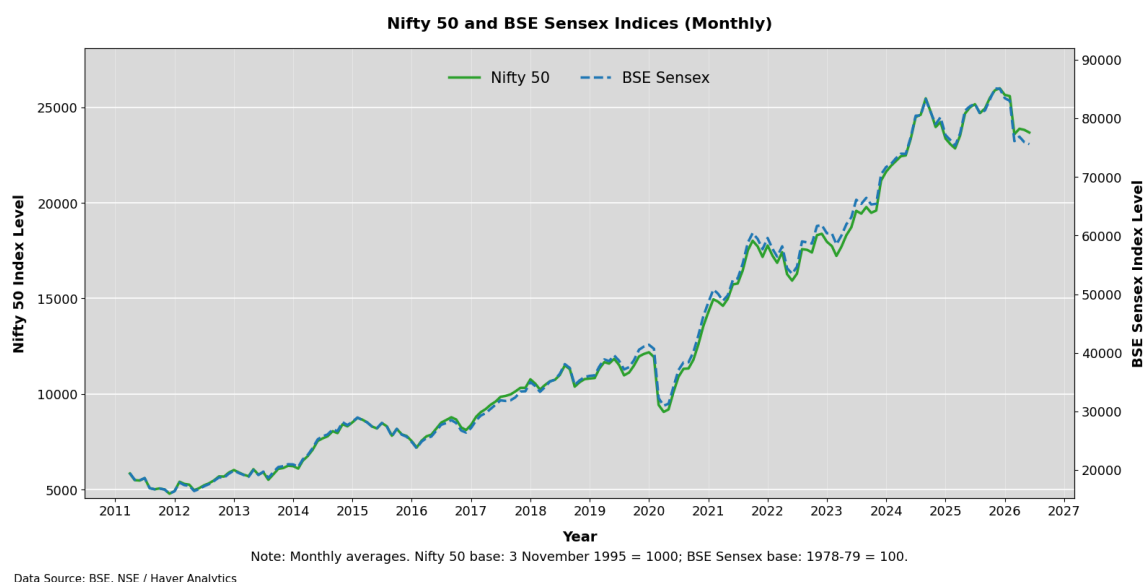


Figure 9.3: Nifty 50 and BSE Sensex Indices

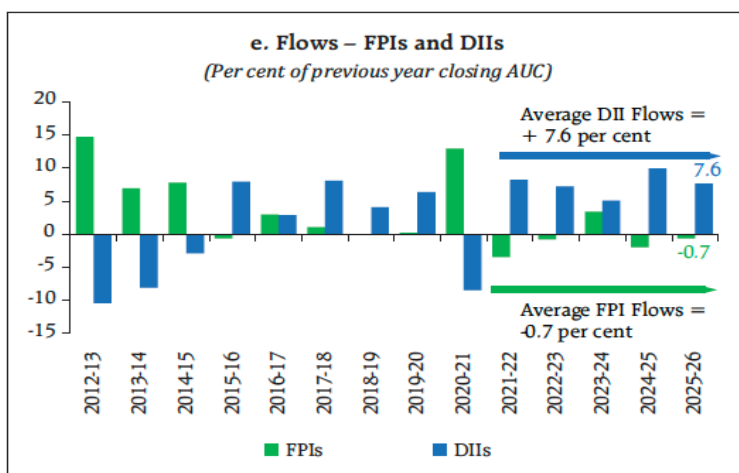


Figure 9.4: FPI versus DII flow changes (from RBI Financial Stability Report, December 2025)

Relatedly, a chart (fig. 9.4) from the RBI's *Financial Stability Report* released in December 2025 is also worth reproducing here. Considering it in conjunction with fig. 9.3 helps buttress this point further, for it shows how, as FPIs exited their positions from FY2021-22 to FY2025-26, at an average annual outflow rate of -0.7% of the previous year's assets under custody (AUC), DIIs stepped in with an average net inflow rate of 7.6%. As a result, equity markets, unlike previous risk-off episodes, held up during this period.

Interestingly, the post-pandemic resilience of the Indian stock market is commonly attributed to strong 'fundamentals' of the Indian economy. A more immediate explanation is the DII-led absorption of FPI exits, funded via buoyant indirect SIP investments of Indian households. Given the current rise in neo-nationalism, de-globalization, and geopolitical volatility in global capital flows, this domestic stabilization mechanism, so-to-speak, is potentially a positive development for the Indian economy. By the same token, though, a new and delicate balance will also need to be maintained. In that, SIPs-driven stability works only as long as household disposable incomes are rising, financial confidence is maintained, and the commitment to making scheduled investments continues. Nothing is necessarily given, and so a sharp market adjustment can well trigger redemptions from SIP funds, disrupt the household investment schedule, and unwind this domestic mechanism that seems to support India's equities markets now. The opposite is also dangerous. In that, a market that never corrects, risks breeding the kind of complacency that draws retail investors into leveraged positions. It is helpful to recall here that American households, upon similarly 'discovering' equities during the 'roaring' 1920s, transitioned into making highly leveraged investments that eventually led to the great crash of 1929 and a massive destruction of household wealth over the Great Depression that ensued through the 1930s. That may be an extreme example, but certainly worth considering for similarities in household behaviour when it comes to investing in riskier assets. The Indian equities markets have moved to now being sensitive to domestic household conditions of real income growth, consumer confidence, debt serviceability and leverage behaviour. Much remains to be seen, and perhaps, the ongoing correction in them will test how precisely this new domestic stabilization mechanism, undergirded by DIIs, fares.