

CSIE Report

India's Macroeconomy: Growth, Resilience, and Vulnerabilities



Puneet Bhasin | Anshuman Singh

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India's Macroeconomy: Growth, Resilience, and Vulnerabilities

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Executive Summary

**1****India remains resilient, but headline growth masks vulnerabilities.**

Strong growth, healthier corporate balance sheets, and a sound banking system provide a solid foundation, but closer analysis reveals some simmering pressures.

**2****Domestic demand is tepid.**

Consumption, private investment, and government spending are all not firing strongly. Private investment appears constrained by weak demand, while rising household credit may be supporting consumption.

**3****Financialisation is likely running ahead of the productive economy.**

Household participation in financial markets has expanded rapidly but so has borrowing. This creates new vulnerabilities as household wealth and macroeconomic stability become more exposed to financial-market shocks.

**4****The external sector has both a cushion and a vulnerability.**

Strong remittances provide stability, but India remains dependent on manufactured imports and has highly concentrated trade relationships with the US and China.

**5****Policy should strengthen resilience before vulnerabilities become crises.**

This means supporting demand and productive investment, regulating financial markets effectively, and pursuing an industrial and trade strategy that makes Indian goods as globally competitive as its services.

Introduction

Over the last decade, the Indian economy has been growing at a robust rate by most conventional macroeconomic metrics. Real GDP growth has hovered around 7-8 percent according to official estimates inflation is subdued and financial balance sheets are not stressed. Having weathered demonetisation, the twin balance sheet crisis, a global pandemic, and waves of geopolitical disruptions, the Indian economy appears reasonably healthy and stable.

Stability, to be sure, is not the same as invulnerability. Aggregate growth can hide vulnerabilities that become clear when we look more closely at the economy. This report does exactly that. Drawing on financial data on trade, capital flows, banking and credit, public finance, sectoral flows of funds, and capital markets, it ‘follows the money’ to develop nine financial insights. Each highlights a pressure point that headline growth numbers can miss. Taken together, they point to three broad structural vulnerabilities that need attention, despite an otherwise reasonably healthy macroeconomic picture.

We can group these vulnerabilities into three types: a structural demand shortfall, financialization that is likely running ahead of the productive base of the economy, and external sector concerns. We outline these in turn.

I. A structural demand shortfall

One consistent finding from the entries in this report is that aggregate demand has been relatively weak. All three domestic demand engines: personal consumption, private investment, and government spending have not been robust.

Perhaps of greatest concern is private investment. Granted, non-financial corporations have had to repair their balance sheets due to a debt overhang and stringent conditions since 2015. For the most part, this has been accomplished through shedding liabilities and an overall contraction in corporate India’s balance sheet. Now, however, financial conditions are quite permissive with banks well capitalised, 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 appears to be taking place. Indeed, the latest Q1 FY2026-27 GDP release shows an encouraging uptick in gross fixed capital formation, but it is too early to conclude that a revival in India’s private investment cycle is underway.

Second, household consumption remains robust, but there are concerns that these are increasingly being driven by debt. Credit uptake by households is also rising. Household sector liabilities, most of which are loans, amounted to 34 percent of GDP in FY2018-19 but were 41 percent in FY2023-24. Coupled with the consistent finding that real wage growth has been tepid (Tripathi, Jayadev and Shravan, 2026; Das and Drèze, 2024), it is possible that this is a case of credit substituting for meaningful real wage

growth and thereby potentially increasing financial fragility.¹ Bank lending to large industry has fallen consistently while personal credit has deepened, indicating increased household credit uptake.

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 percent of GDP in the pandemic year FY2020-21 to 0.8 percent in FY2025-26. This post-pandemic fiscal consolidation by the central government has been achieved by cutting revenue expenditure on wages, subsidies, and grants; while making modest capital investments.

II. Increasing financialisation of the Indian economy

A second structural finding of significance is the increased financialisation of the Indian economy. There is no single definition of economic financialisation but one useful conception of it is that of a post-industrial *process* of structural change, such that traditional sources of income and capital accumulation — industrial production and trade in goods and services — are increasingly overshadowed by financial activity: the creation and trading of financial assets in global markets. As one measure, India's GDP per capita ranks it at 146th in the world, but its stock market capitalisation to GDP is 14th in the world. Financialisation is usually associated with high-income economies such as the US and UK. Its growing importance in India is therefore both striking and important. India remains a relatively low-income, dual economy that has not yet fully industrialised. Yet financialisation is becoming increasingly visible across the economy — from how households manage their money to how the government finances itself. This makes financialisation an important lens through which to understand the changing Indian economy. The concern is not that financialisation is inherently bad, but that it is occurring in India before the economy has completed the more fundamental transition toward industrialisation and broad-based productivity growth. In a richer economy, financial markets can support productive investment by mobilising savings, allocating capital and managing risk. In India, however, growing financial activity may increasingly involve the trading and appreciation of existing financial and real assets rather than the creation of productive capacity, jobs and incomes. This can widen inequality, encourage household and corporate leverage, and make the economy more vulnerable to asset-price and financial shocks. More fundamentally, it risks masking a structural weakness: An economy can have rapidly expanding financial markets even while manufacturing, productive investment and employment remain relatively weak.

On the positive side Indian households are becoming far more integrated into the formal financial system. Household net financial wealth rose from 74.7 percent of GDP in FY2011-12 to 87.8 percent in FY2023-24, while the share of investment fund units in household portfolios more than doubled, driven largely by the SIP revolution. Bank deposits remain the dominant asset, but their share is declining as savings increasingly flow through investment funds and into financial markets, especially equities,

1 Tripathi, Avinash M, Arjun Jayadev and M K Shravan (2026): "Rural Growth and Distribution: Two Narratives from the PLFS, 2017–2023," Review of Agrarian Studies, Vol 16, No 1. Das, Arindam and Jean Drèze (2024): "The Problem of India's Stagnant Real Wages," Ideas for India, 26 July 2024.

making household wealth more sensitive to market movements. This financialisation is also spreading geographically: SIP registrations grew 3.1 times in smaller cities between FY2020-25, compared with 2.3 times in bigger cities. At the same time, household borrowing has increased sharply, with annual loan flows rising from below 4.5 percent of GDP before FY2022-23 to 6.2 percent in FY2023-24, including increased personal loans and borrowing against gold. Greater access to formal credit is clearly preferable to predatory informal lending, but with real wage growth remaining weak, rising household debt may be supporting consumption in ways that cannot be sustained. The concern is that households may increasingly be combining leverage with exposure to risky financial assets, leaving them vulnerable to a downturn in which falling incomes or asset prices could trigger a sharp and painful adjustment. A clear outcome of household financialisation is that domestic institutional investors, funded by SIP flows, have been able to absorb sustained foreign institutional investor (FII) outflows. As a result, Indian equity markets have avoided a sharp decline despite a prolonged post-pandemic risk-off period for FIIs. A market correction may now be underway, however, and this could test how far domestic household savings can continue to support the market. At the institutional level, the financial system has also changed significantly. Other financial corporations (mutual funds, insurance companies and pension funds) now hold more assets than the banking system and have become the dominant creditors of the Indian state, holding 40.6 percent of general government debt in FY2023-24. India's inclusion in the JPMorgan EM Government Bond Index from FY2024-25, along with incentives for foreign investment in rupee-denominated government securities, could deepen the bond market further. A deeper bond market and a more diversified creditor base are positive developments, but they also mean that macroeconomic stability is increasingly tied to financial market conditions. A sharp equity correction, for instance, could trigger household redemptions from investment funds, while a rise in government bond yields could generate losses for asset managers. As financialisation deepens, effective regulation and macro-financial oversight therefore become increasingly important to contain these risks.

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. It is clear that India has a stubborn current account deficit that arises mainly from running a persistent trade deficit. On the other hand, remittances at USD 138 billion in 2024, and the highest in the world by a wide margin, 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 are more stable.

India's external position has an important cushion in the form of remittances, but it also contains significant vulnerabilities. FDI and FPI flows are important for financing the current account deficit and supporting the rupee, yet remittances — around 3 percent of GDP — already cover much of the trade deficit and provide a more stable source of foreign exchange. This cushion becomes particularly important during risk-off periods, when FDI and FPI flows can weaken sharply. The vulnerability is therefore not simply the size of the current account deficit, but India's dependence on relatively volatile capital flows at a time when its trade structure remains weak. Indeed, trade openness is now below its FY2012-15 levels despite

the post-pandemic recovery, reinforcing the fact that India's growth remains primarily domestic-demand driven rather than export led. At the same time, the persistent goods trade deficit is increasingly driven by non-oil imports: Oil accounts for only 25 percent of the goods import bill, while imports of electronics, machinery and other manufactured goods have risen. This reflects the weakness of India's manufacturing base—India imports many goods it does not yet produce competitively at scale, while also struggling to export them. The resulting external vulnerability is compounded by trade concentration: The US is the largest destination for India's goods and services exports and a major source of services imports, while China is the largest source of goods imports. In an increasingly volatile geopolitical environment, this concentration creates additional risks. Strengthening domestic manufacturing, diversifying export markets and building more resilient trade relationships are therefore not simply growth strategies; they are important elements of India's external and macroeconomic stability.

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. But economies can appear to be on solid ground until the ground shifts—the American economy before the global financial crisis being a case in point. The nine financial insights in this report therefore point to three areas of macroeconomic vulnerability that warrant serious policy attention. First, a structural demand shortfall: No single engine of aggregate demand is firing strongly enough, and the weakness of demand is increasingly a constraint on private investment. This calls for an active policy response, particularly in a relatively low per capita income economy like India. Second, financialisation is likely advancing faster than the productive base of the economy, bringing millions of households and institutions into financial markets but also making household wealth and macroeconomic stability more exposed to financial market conditions. Effective regulation of “high finance” is therefore critical. Third, external vulnerabilities are becoming more important in a changing global order. India's trade remains highly concentrated in its relationships with the US and China, while its persistent goods trade deficit reflects, in part, the weakness of its manufacturing base. A geopolitically astute trade policy, combined with a robust industrial policy to make Indian goods—not just services—globally competitive, is increasingly important for both economic and national security. None of these vulnerabilities implies an impending crisis or “moment of doom.” But together they suggest that resilience should not be taken for granted, and that prompt policy action is needed to strengthen the foundations of India's growth before vulnerabilities become crises.

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Section A:

A Structural Demand Shortfall

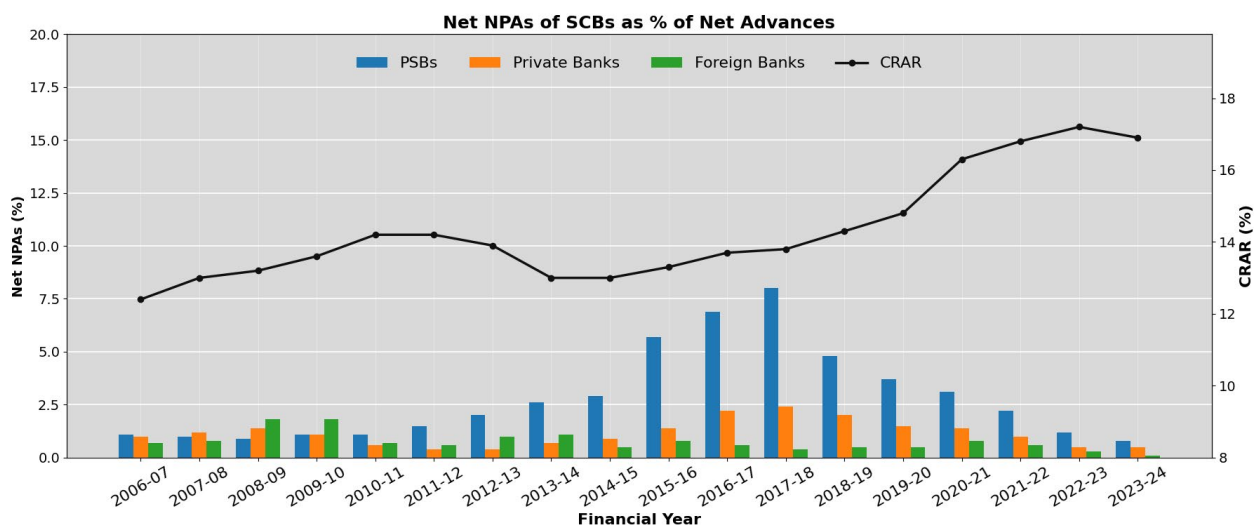
1. Corporate India has deleveraged, but investments remain sluggish even as financial conditions are permissive

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 percent in 2016 to approximately 10.5 percent in 2025 (Fig. 1.1). This is now even lower than 15 percent 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 percent of risk-weighted assets (Fig. 1.2) 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 1.1: Distress within the private non-financial corporations (NFCs) sector



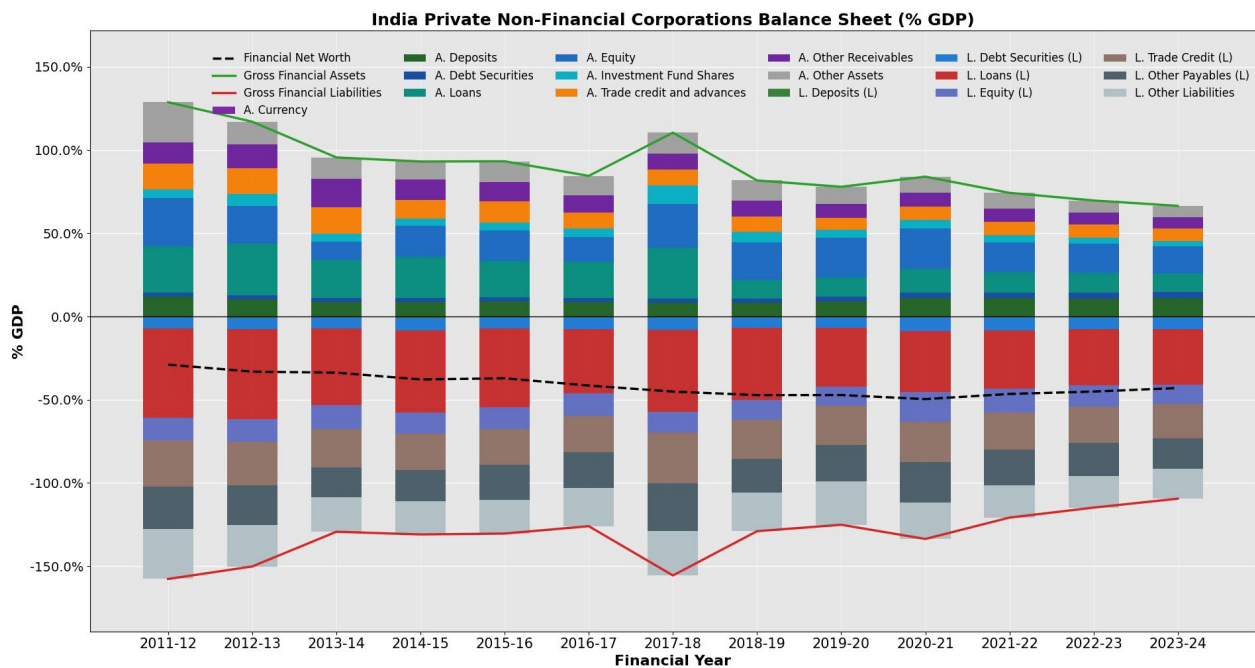
Data Source: Database on the Indian Economy (DBIE), RBI

Figure 1.2: Banking sector stress measures (net NPAs and capital to risk-weighted assets ratio)

The financial balance sheet of private NFCs (Fig. 1.3), 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 percent to 84.3 percent of GDP, while gross liabilities grew relatively less by 4.3 percentage points from -129.3 percent to -133.6 percent of GDP. The financial net worth of private NFCs, as a result, deteriorated dramatically by 15.9 percentage points from -33.7 percent to -49.6 percent 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 percent of GDP by FY2023-24, while the latter contracted by 24.2 percentage points to be at 109.4 percent 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 percent of GDP. The leverage ratio improved further to 2.54x, but this time it was genuine deleveraging.

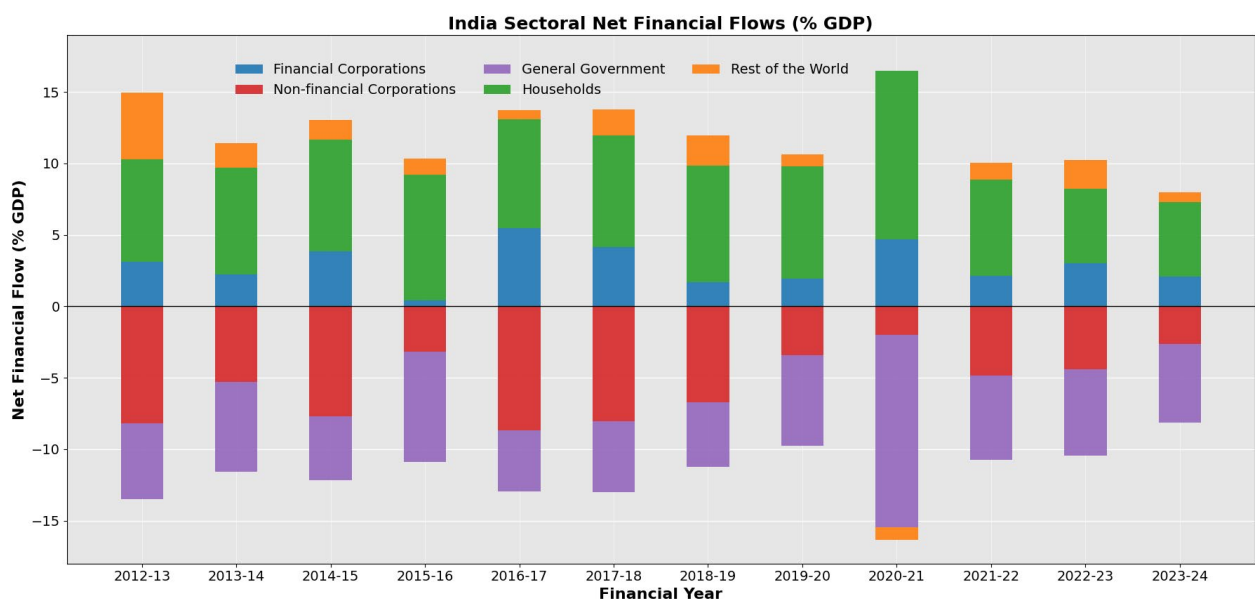
Importantly, then, corporate India recovered from the twin balance sheet crisis not by growing its way out of debt, which would have entailed assets growth from increased investments and cash flow. Instead, it shed its way out of the crisis by contracting both sides of the balance sheet. This form of corporate austerity, so-to-speak, is apparent visually in Fig. 1.3 as the financial footprint of NFCs in FY2023-24 is much smaller than it was in say FY2011-12.



Data Source: RBI Flow of Funds Accounts

Figure 1.3: Private NFCs balance sheet

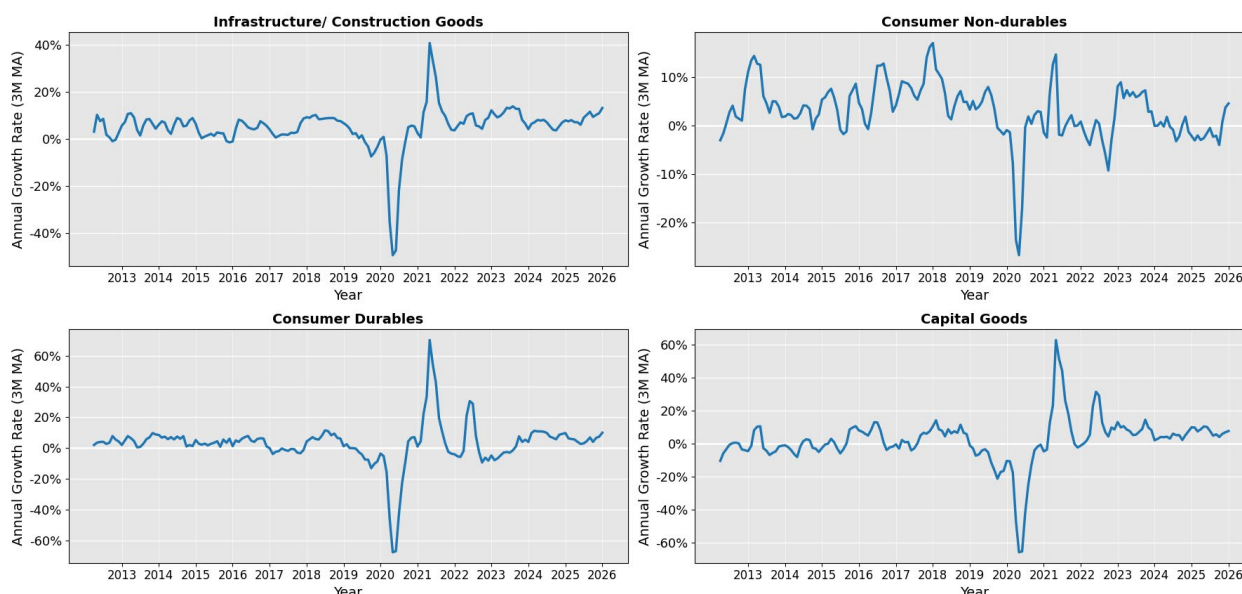
The RBI's Asset Quality Review (AQR) of FY2015–16, in response to the twin balance sheet crisis, can be thought of as one trigger for this balance sheet contraction. It forced SCBs to recognise NPAs and curtail extension of new credit, especially to distressed NFCs. As a result, net borrowing by the both private as well as public NFCs—a quasi-proxy for fixed investments—that was averaging at 6.1 percent of GDP until then, began declining in the years leading up to the pandemic year FY2020-21, when it hit a low of 2 percent (Fig. 1.4, red bars). It has certainly recovered post-pandemic, but at a lower average rate of 3.9 percent of GDP over the three years from FY2021–24.



Data Source: RBI Flow of Funds Accounts

Figure 1.4: Sectoral net financial flows

India: IIP Growth (YoY 3-Month Moving Average, Use-Based Categories)



Data Source: MOSPI (IIP)

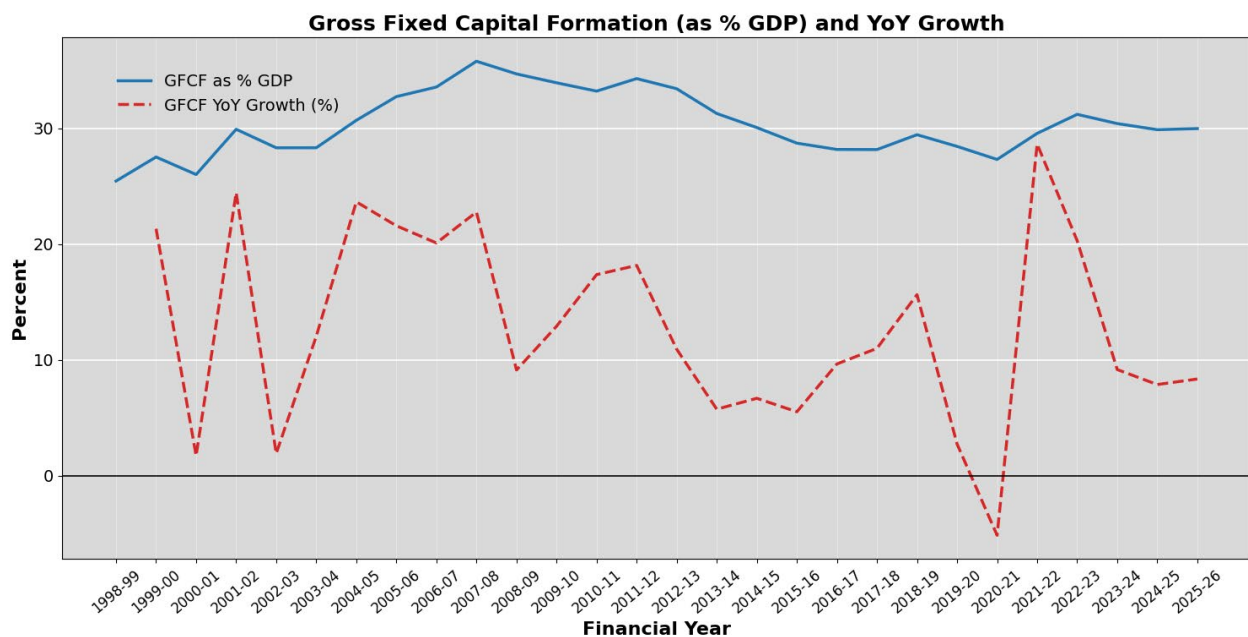
Figure 1.5: Index of Industrial Production, select sectors

The Index of Industrial Production (IIP) data further helps triangulate what the FoFs data suggests about slowing investments (Fig. 1.5). 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.

This also relates to the second question as 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 investment that can be expected to follow a prolonged period of deleveraging has happened only partially; residential and non-residential construction being the main drivers. Put differently, corporate India has healed itself by deleveraging and has restored its financial credibility and stability, which is a positive development. But one that has come at the cost of productive capacity not expanding. Importantly, there is no morality tale to be told here as restrained investments on part of firms is not necessarily irrational. 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 before. Not only are banks in a strong position, with low NPAs and adequate capital (Fig. 1.2), but interest rates are also trending down while the banking system remains awash with liquidity (see Figs. 2.3 and 3.3). Under such permissive financial conditions, firms can surely be expected to forego caution and accelerate investment. However, there appears to be little evidence of this in the aggregate as annual gross fixed capital formation (GFCF), having recovered from its pandemic trough, has held steady post-pandemic at an average of 30 percent of GDP (Fig. 1.6). Contrast this with the acceleration from FY2003-04 to FY2007-08, when it peaked at 35.8 percent, and India's dampened private investment cycle becomes clear. Year-over-year (YoY) growth

in GFCF has been positive but is not trending upward on an annual basis either. To be sure, the latest quarterly GDP release for Q1 FY2026-27 shows an encouraging uptick in private investment, though it is much too early to tell if a revived investment cycle is underway. The point, importantly, is that even under permissive financial conditions, India's capex cycle has not yet shown clear signs of re-acceleration.



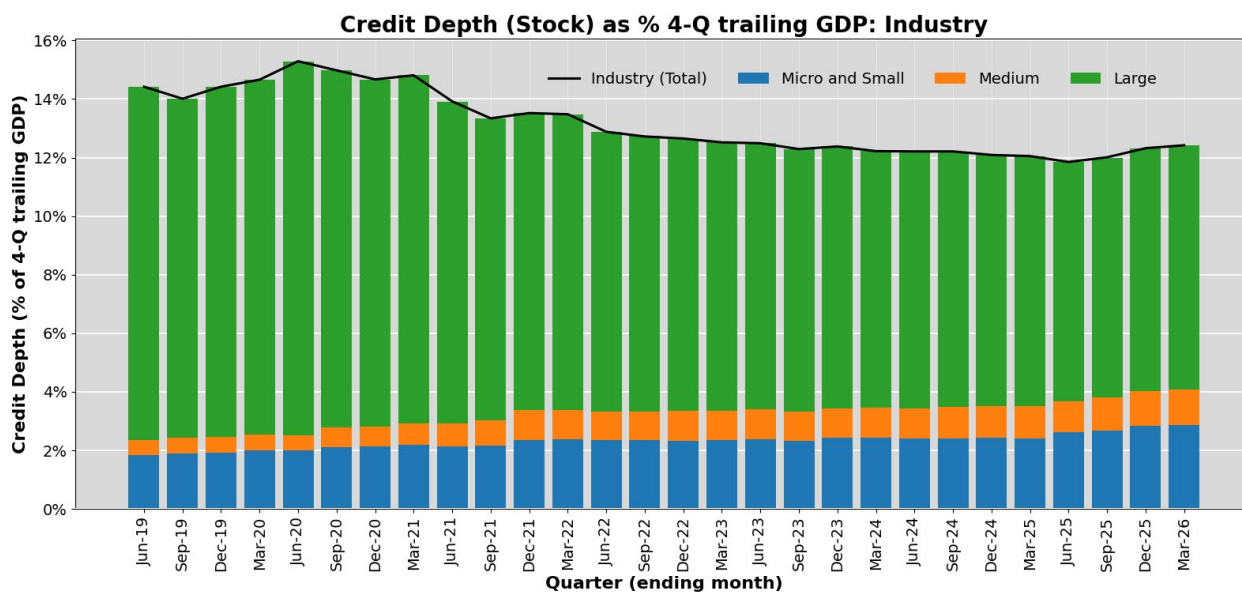
Data Source: Database on the Indian Economy (DBIE), RBI

Figure 1.6: Gross Fixed Capital Formation as % GDP and % year-over-year growth

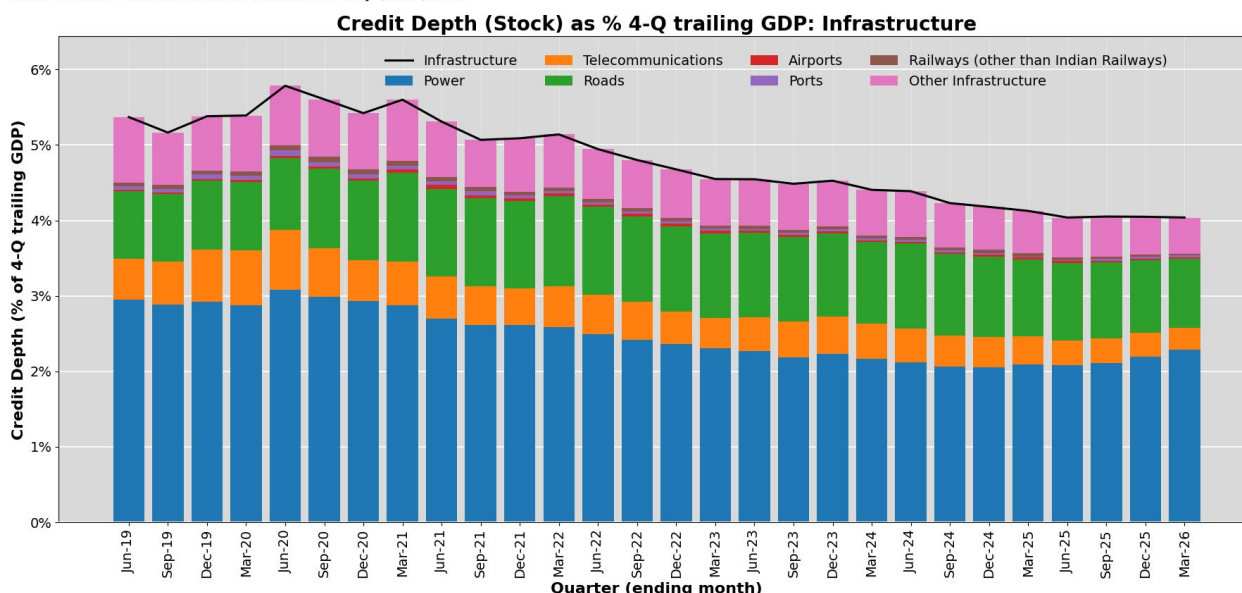
The likely explanation for a sluggish investment climate then lies on the demand, and not the financial side of investment decisions. Firm owners invest when they *expect* demand that justifies expanding capacity. However, at a time when household consumption, as discussed in section 6, is being ‘held 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 exports, as shown in Figure 8.2, have averaged 21.8 percent of GDP over the post-pandemic years of FY2021-26. This is lower than even the 24.4 percent 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 buyback their stock. 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 production linked incentive (PLI) schemes 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 conditions suggests. What would matter instead is for aggregate demand conditions to improve meaningfully and significantly. One way this can happen is if demand for India's exports accelerates, but the chances of such are not that high in a de-globalising world with 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 stronger than before.

2. 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 to NFCs versus households, with sectoral credit patterns only reinforcing the demand-constrained investment climate noted in the previous section.



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



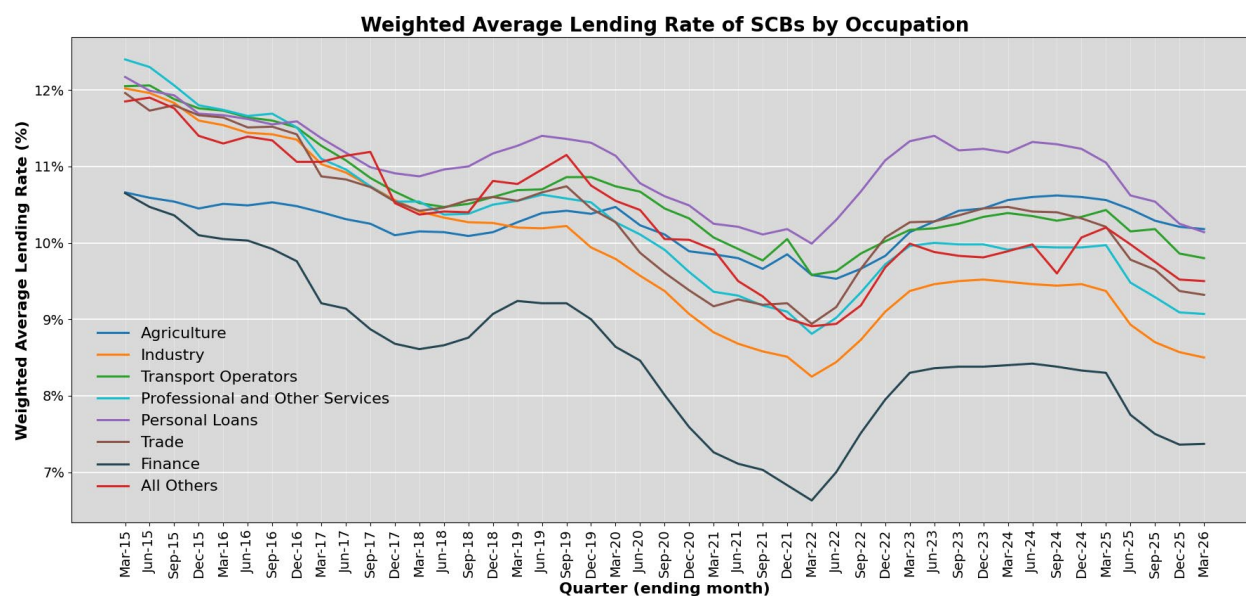
Data Source: Database on the Indian Economy (DBIE), RBI

Figure 2.1 and 2.2: Credit depth (total credit outstanding), industrial and infrastructure sectors respectively

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. 2.1). 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. 2.2). 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.

Lending rates of SCBs by occupation (Fig. 2.3) 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 awash with liquidity (see Fig. 3.3). Clearly, there seems to be no credit supply issue, but a demand issue resulting from spare capacity in the industrial sector.



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

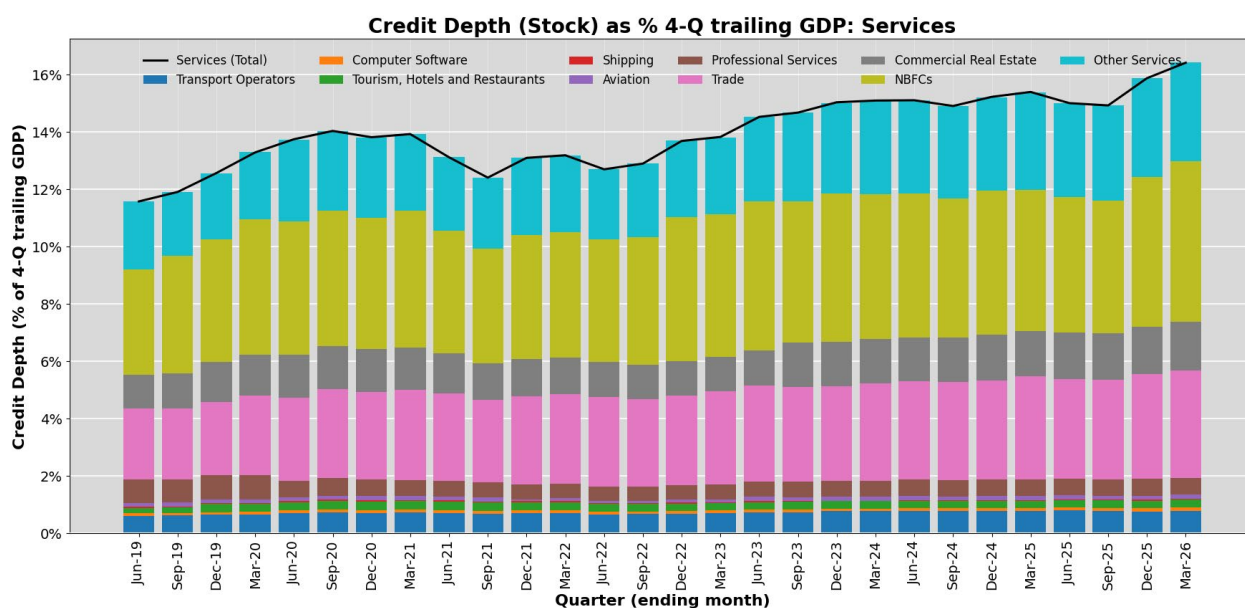
Figure 2.3: Lending rates of SCBs by occupation

The pattern of credit depth is more encouraging in the services sector (Fig. 2.4), 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 show how services exports have grown significantly since 2022, resulting in a growing services trade surplus. It 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 personal loans to households has seemingly grown dramatically and continues to trend upward (Fig. 2.5). Total quarterly personal credit depth has risen from an average of 13.5 percent

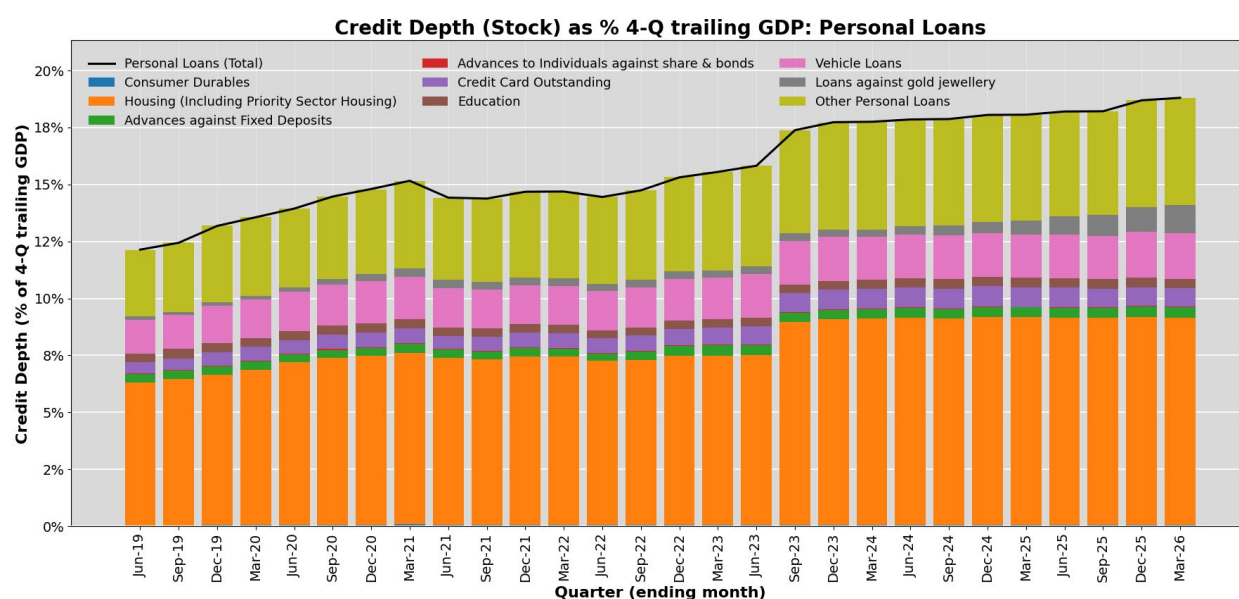
2 Being highly financialized, NBFCs also invest heavily in other NBFCs and in various financial securities. Their growing significance is further considered in the section concerning the transformation of India's financial system.

of GDP in FY2019-20 to 18.4 percent 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 periodic reclassification of credit between priority and non-priority sector housing buckets, or more likely, the acquisition of HDFC's mortgage business that was structured as an NBFC but is now subsumed in HDFC Bank, 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 weaker.



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

Figure 2.4: Credit depth (total credit outstanding), services sector



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

Figure 2.5: Credit depth (total credit outstanding), household sector

The categories of ‘other personal loans’, and of ‘loans against gold jewellery’ (grey bars) do show 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 particularly grown since FY2024-25. This is likely due to gold prices rising, which in turn enables households to take on fresh loans against the same physical stock of collateral.

Given the foregoing, households are indeed expressing demand for credit, but this when considered with the fact that household real incomes have not grown meaningfully, only suggests that increased household leverage is likely keeping up personal consumption. More importantly, what this analysis of credit conditions shows is that credit may lead only if the aggregate demand structure shifts, such that private ‘animal spirits’ move the needle on risk-taking and accelerate investments. In the absence of that, which is the case, credit patterns are only reflecting the structural weakness in demand.

3. The central government has consolidated. The RBI's current easing cycle makes increased deficit spending easier.

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; credit patterns further reflect the demand shortfall; and households are likely sustaining consumption by increased borrowing in the absence of meaningful real wage rise. What the preceding entries have not directly addressed, which this section does, 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.

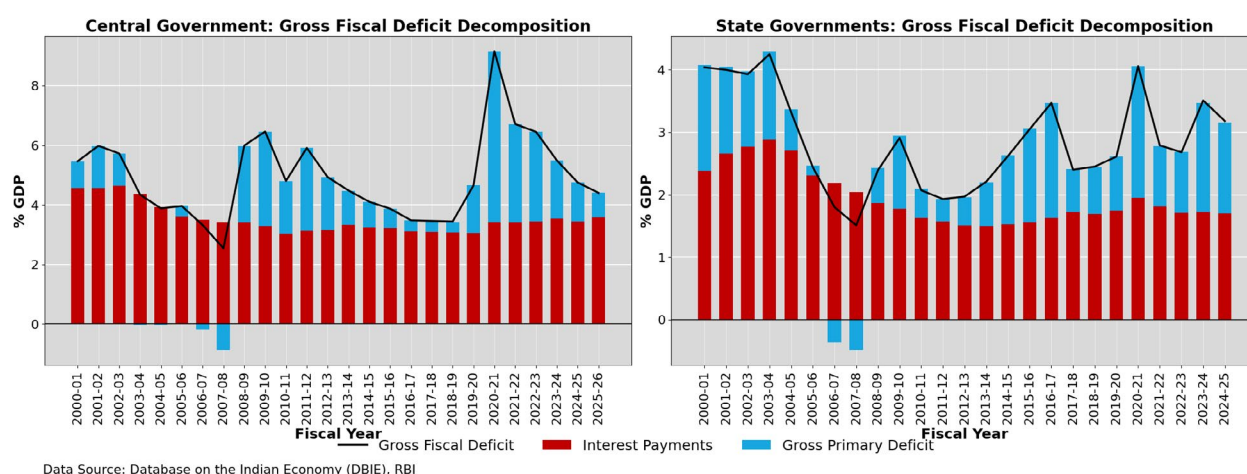


Figure 3.1: Central and State Governments Gross Fiscal Deficit Decomposition, Gross Primary Deficit and Interest Payments

The two fiscal deficit decomposition charts (Fig. 3.1) reveal an interesting asymmetry in the primary deficits (blue bars) of the central and state governments. The central government's primary deficit was

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

under 1 percent of GDP and nearing 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 sharply over FY2019-20 and FY2020-21. What is noteworthy, though, is the post-pandemic compression of the primary deficit, which too has been sharp: Declining from its peak of 5.7 percent of GDP in FY2020-21 to 0.8 percent in FY2025-26 – a period of just five years.

The central government's primary deficit pattern 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. Indeed, providing a counter-cyclical impulse to aggregate demand in moments of crisis till recovery takes hold with the private sector picking back up is the role of the government. In principle at least. However, as discussed in section 1, private investments continue to be tepid, which 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.

By contrast, the primary deficit pattern of state governments tells a different story. Their primary deficit at 1.75 percent of GDP in FY2024-25 (until when data is available for states) has followed a more consistently positive path, both post-pandemic as well as 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. As such, 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 percent (Fig. 3.1) and seemingly trending toward the Fiscal Responsibility and Budget Management (FRBM) act's target of 3 percent or lower, needed to cap the debt-to-GDP ratio at 60 percent of GDP. However, this will further draw from aggregate demand, which being sub-par already has likely forestalled adjustments in expectations of private actors for a new investment cycle to take-off.

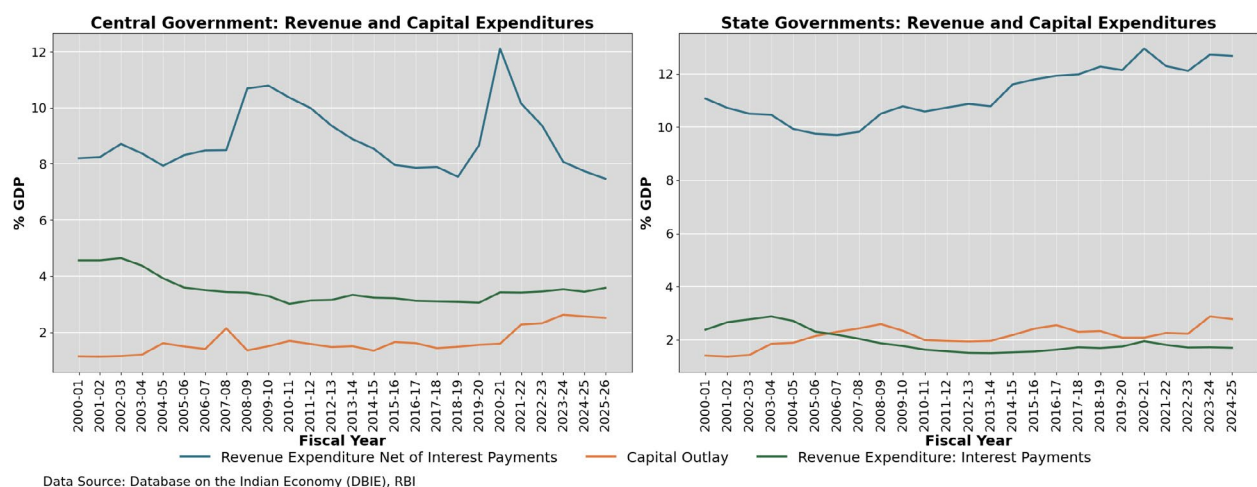


Figure 3.2: Revenue and capital expenditures, % GDP

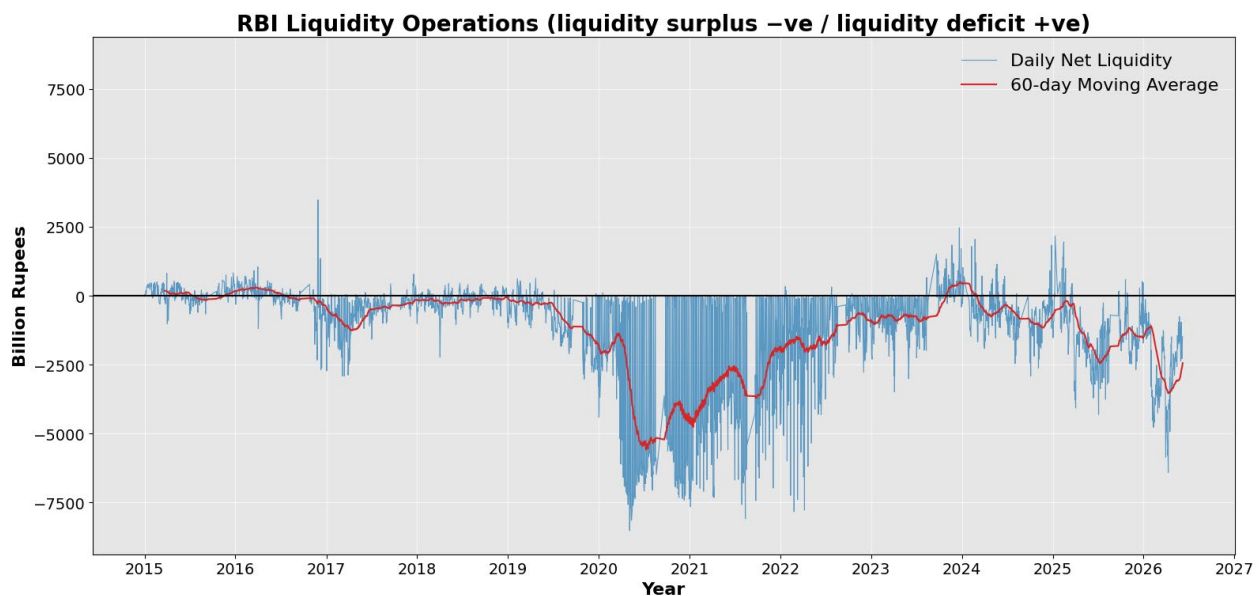
A counterpoint to this reading can be that a declining primary deficit to GDP ratio after all does not imply that government spending is contracting in absolute terms. Government spending is still growing, just more slowly than the economy is, thereby, lowering the ratio mechanically. Some may even argue 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. 3.2).

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 percent of GDP in the pandemic year FY2020-21 to being 7.5 percent 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 for holding up aggregate demand, has in fact risen over the same period from 1.6 percent to 2.5 percent of GDP. Though low for a growing economy like India, this is nevertheless a positive recent development as pre-pandemic rates hovered lower, between 1.5-2 percent. Also, interest rate payments (green) have remained stable throughout at roughly 3-3.5 percent of GDP.

In effect, the central government's fiscal consolidation is being achieved by cutting revenue account expenditures on wages, subsidies and grants and 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. Nor can it be the case that there is no need for such expenditures anymore as the economy is growing as youth unemployment for sure is high.

Interestingly, the picture for state governments is contrasting again with revenue expenditure net of interest payments rising consistently. In FY2024-25, it was 12.7 percent of GDP while capital outlay at 2.8 percent of GDP had only risen marginally. The four charts in Figures 3.1 and 3.2 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.

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 work to make the overall debt burden less onerous because 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 the current post-pandemic period of surplus liquidity, it helps to briefly analyse the RBI's liquidity operations over three sub-periods or phases.



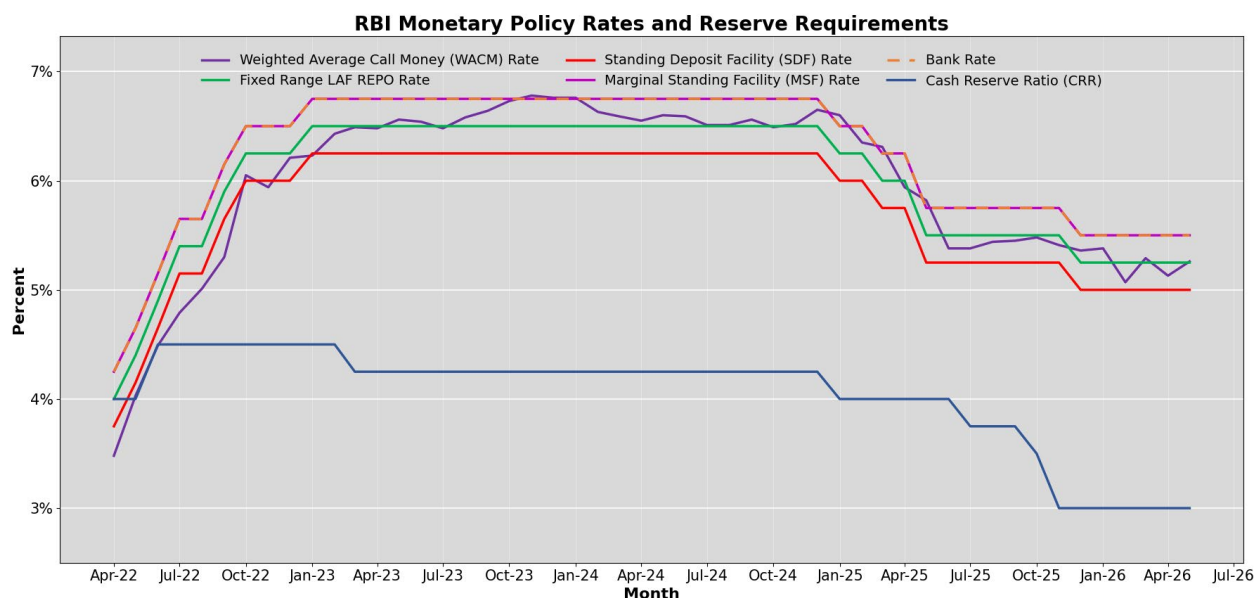
Data Source: Database on the Indian Economy (DBIE), RBI

Figure 3.3: Banking sector liquidity (negative values imply higher liquidity)

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 3.3 (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. 3.5, blue line), gives it away clearly: the long end was at 6.5 percent while the front-end that most closely follows the repo rate was at 3.25 percent. As such, new G-Secs issued during this period to fund the pandemic-related primary deficit increase in Figure 3.1 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 percent in a span of just seven months from April to October 2022 (Fig. 3.4, 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 exchanged for dollar reserves. The tightening of liquidity corresponding to this second phase is clearly visible in Figure 3.3. 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.

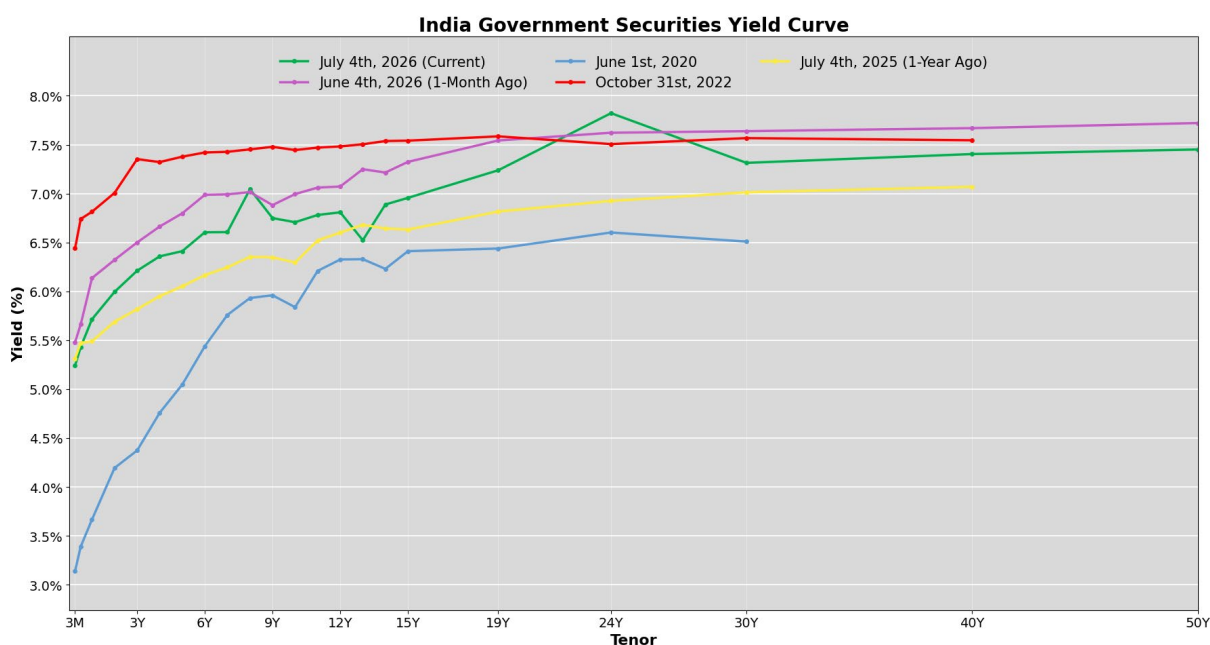
Finally, in the third and ongoing phase, starting the last quarter of FY2024–25 (January 2025), the RBI has reversed course again as inflationary pressures have significantly abated now. It began by lowering the repo rate by 25 basis points from 6.5 percent that it had been at for two years, and which currently stands at 5.25 percent (Fig. 3.4). The corresponding increase in liquidity starting 2025 is again visible as is the slight tightening recently due to the RBI's aggressive FX interventions to contain the INR's fall.



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

Figure 3.4: 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. 3.3, the yield curve, for example from 31st October 2022 (Fig. 3.5, 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 (yellow), but below the curve from a month ago (purple) in June 2026. This implies that government borrowing costs now are easing back into highly accommodative territory, which in turn matters for fiscal policy.



Data Source: TradingView

Figure 3.5: Indian G-Secs yield curve snapshots, various dates (with latest being July 4th, 2026)

Against the backdrop of a likely premature fiscal consolidation that has been carried out post-pandemic, the case for it continuing is now weaker considering 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 3.2, 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 by that, deficit spending.

Section B:

Financialisation Of The Indian Economy

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

The answer to 'who funds the Indian state' was clear prior to liberalisation: Nationalised banks, directed by a high 40 percent 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 percent, 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.

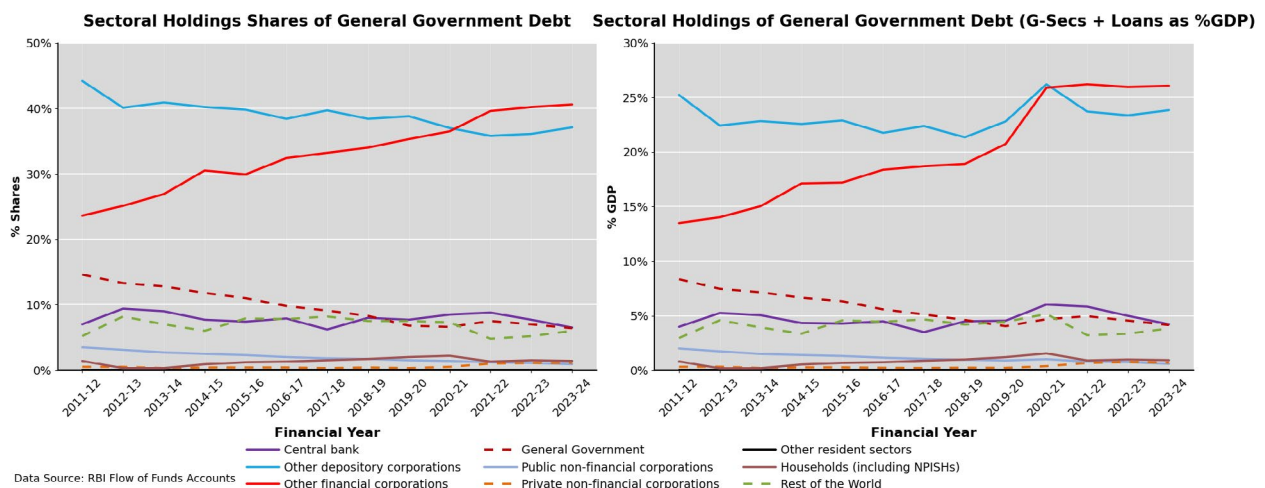


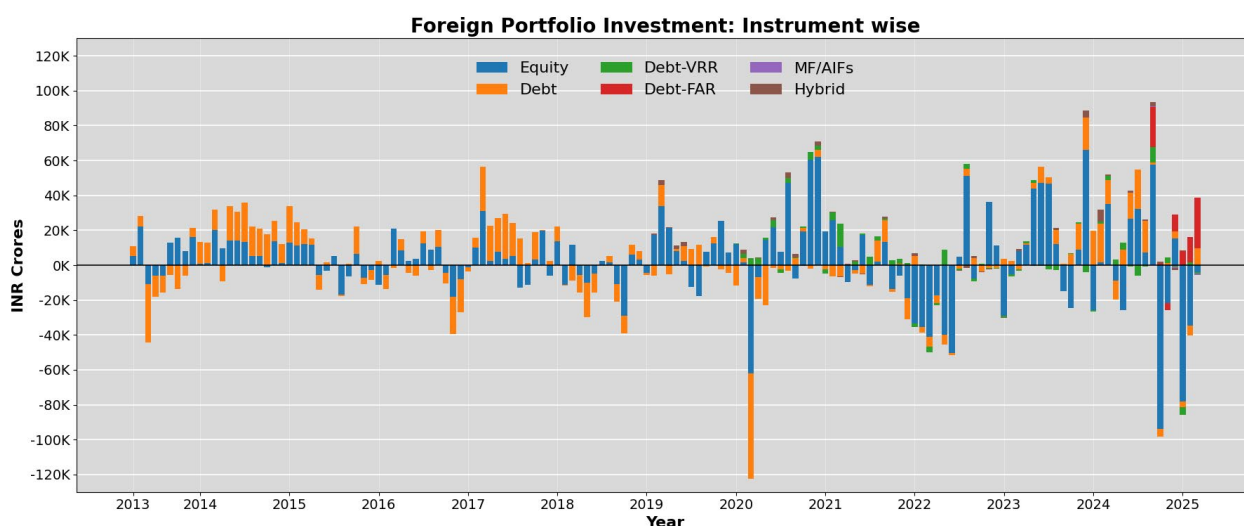
Figure 4.1: Sectoral holdings of government debt, distributional shares and relative value

Based on the latest flow of funds (FoFs) data, by FY2023-24 OFCs held 40.6 percent of general government debt (i.e., centre plus state government debt) amounting to 26.1 percent of GDP, up from 23.6 percent and 13.5 percent respectively in FY2011-12 (Fig. 4.1). Other Depository Corporations (mainly SCBs), by contrast, held 37.1 percent of government debt amounting to 23.8 percent of GDP in FY2023-24, down from 44.2 percent and 25.2 percent 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. However, mutual funds have likely contributed far more to this reversal, given the growing popularity of retail Systematic Investment Plans (SIPs).

The demand for SIPs has grown significantly as Indian households increasingly channel their savings via them into mutual funds. We elaborate upon this in a separate section below, which discusses 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 in the last decade. Mutual funds consequently have gone on to invest bigger amounts of their portfolios into G-Secs. The government bond market after all is the deepest and most liquid fixed income market in India as the corporate bond market is not. As such, SIP-channelled household savings now constitute an important albeit indirect intermediation link for financing the fiscal deficit.

Furthermore, contra common perception, the rest of the world (RoW) is not a major creditor of 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. 4.2, red bars). However, given that in FY2023-24 the RoW's share of Indian government debt stood at a mere 6 percent amounting to just 3.8 percent of GDP (Fig. 4.1), the impact of these recent changes remains low as yet.



Data Source: SEBI Handbook of Statistics

Figure 4.2: 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 financialisation 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. 4.3 and 4.4), 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

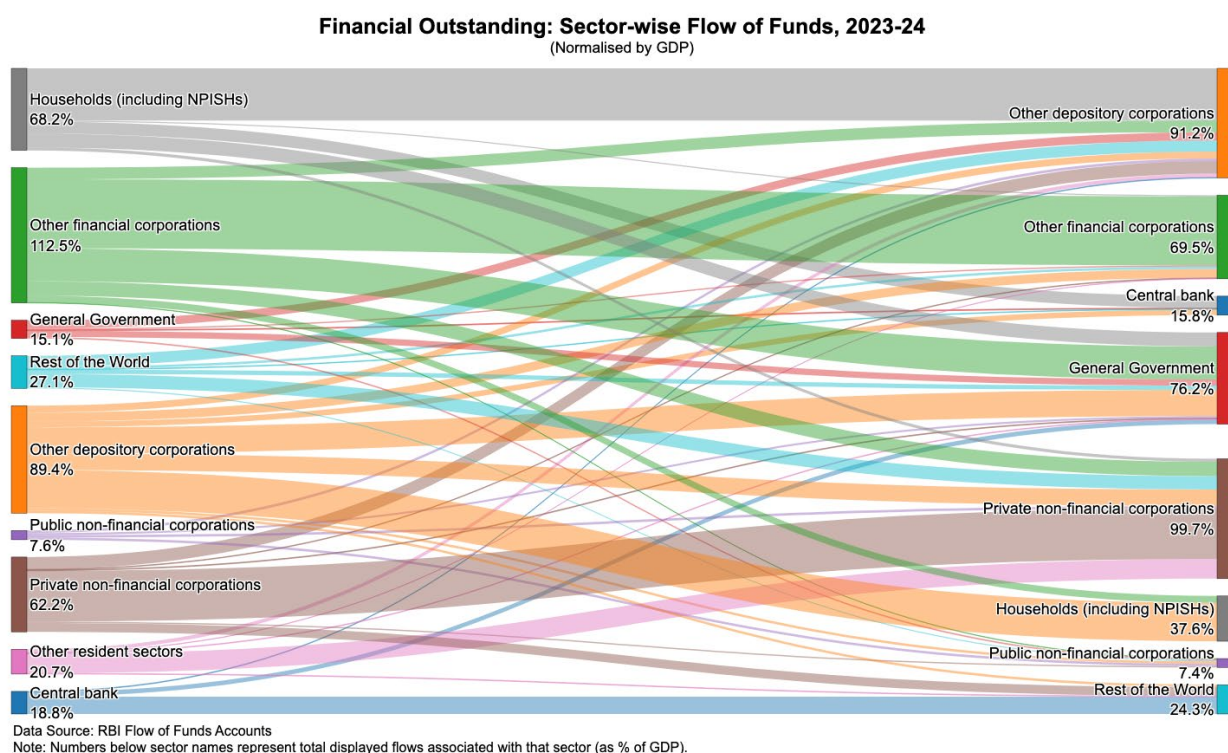
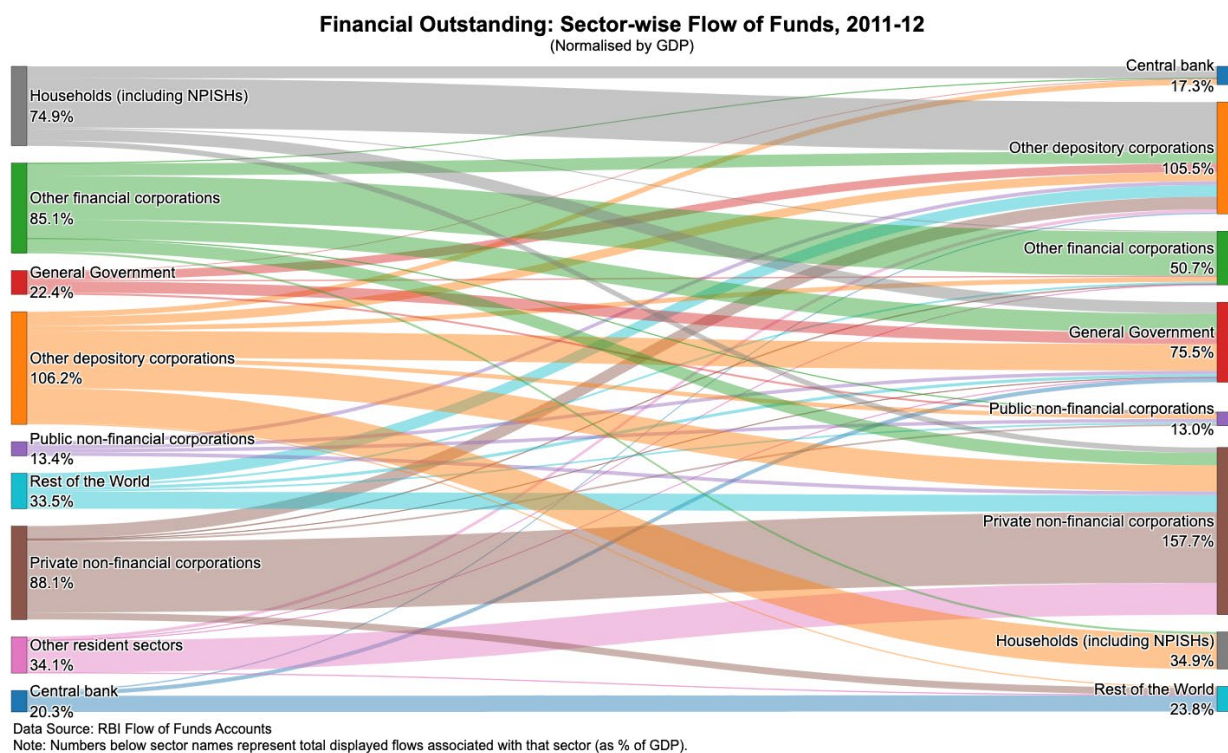


Figure 4.3 and 4.4: Cross-sectoral assets holdings (from who to whom), FY2011-12 and FY 2023-24

- 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.

In FY2011-12, India's financial system was undoubtedly bank-centred. ODCs held the largest amount of assets worth 106.2 percent of GDP while OFC assets were a distant second, 21.1 percentage points lower and amounting to 85.1 percent of GDP. Fast forward to FY2023-24 and the transformation is clear: ODC sector assets contracted by 16.8 percentage points to 89.4 percent of GDP while those of OFCs grew by 27.4 percentage points to be the largest, worth 112.5 percent of GDP. There are, as the saying goes, no free lunches though. 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, 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.

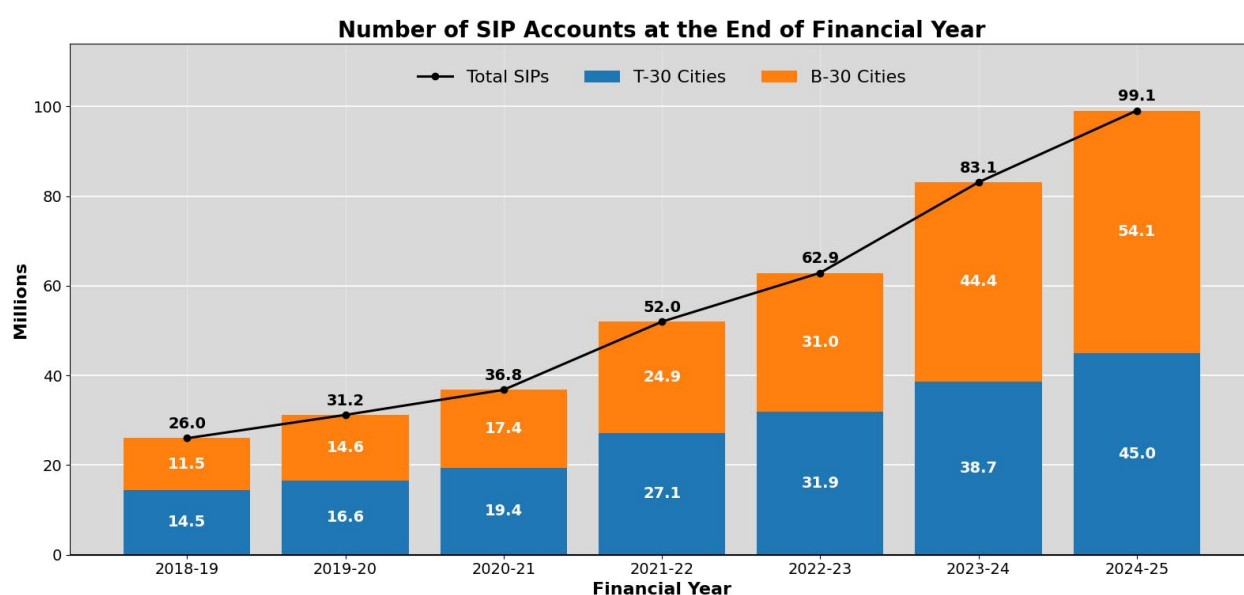
At the same time, the financial system's fragility is likely to increase as liquidity and solvency risks for the non-banking complex of OFCs (mutual funds, insurance companies, and pension funds) become increasingly tied to the performance of G-Secs in a way that has not been the case thus far. For instance, 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 then necessitated emergency intervention by the Bank of England. Not to mention 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. 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. However, once these notional losses were made public, a panic-induced run on the bank ensued, bringing it to an end. In both cases, therefore, the trigger was the same: A rise in sovereign bond yields effecting the balance sheets of institutions that held significant holdings of government securities.

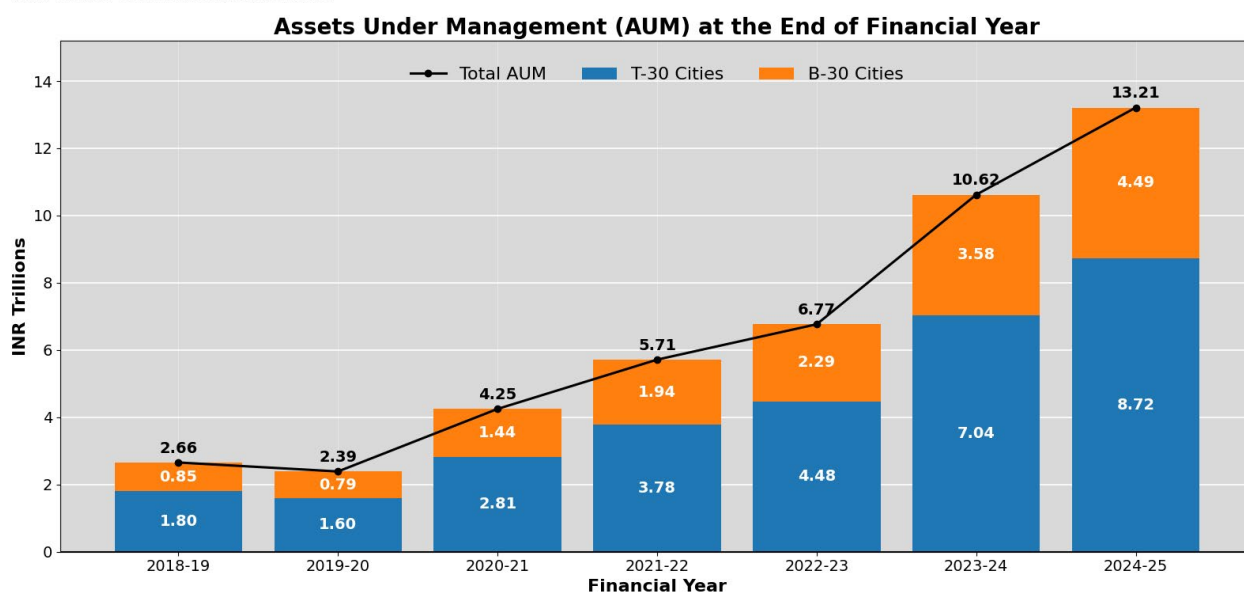
India's OFC complex, with its growing and regulation-mandated holdings of G-Secs, is not immune to this dynamic. To be sure, the Indian OFC sector is highly regulated, and its asset composition remains well balanced. But the overall transformation of OFCs becoming the dominant funders of the Indian state and having the entire financial system increasingly centred on them, implies that financial stability is also now more contingent on asset market conditions. Especially, Hence, prudent macro financial regulation is also a much-needed safeguard now.

5. 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), markets typically fell; when they bought (risk-on), they 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.



Data Source: SEBI Handbook of Statistics



Data Source: SEBI Handbook of Statistics

Figure 5.1 and 5.2: SIP registrations and AUM distributions across T-30 and B-30 cities

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. 5.1 and 5.2).

Over four years from FY2020-25, SIP registrations grew 3.1x in B-30 cities compared to 2.3x in T-30 ones (Fig. 5.1). By FY2022-23, the number of SIPs in B-30 cities had caught up with those in T-30 (31.9 million) for a near-equal distribution (31:31.9 million). But, by FY2024-25, B-30 registration numbers overshoot to be 20 percent 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, so 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.

Notably, 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. One consequence of this, as has been the case recently, is that the Indian equity markets are now less sensitive to global risk-off episodes. For instance, net FPI inflows as shown in Figure 7.2 (blue bars) ebbed sharply from Q3 FY2020-21 to Q1 FY2022-23. Yet, equity markets rallied over the same period, as the Nifty 50 and Sensex indices show (Fig. 5.3).

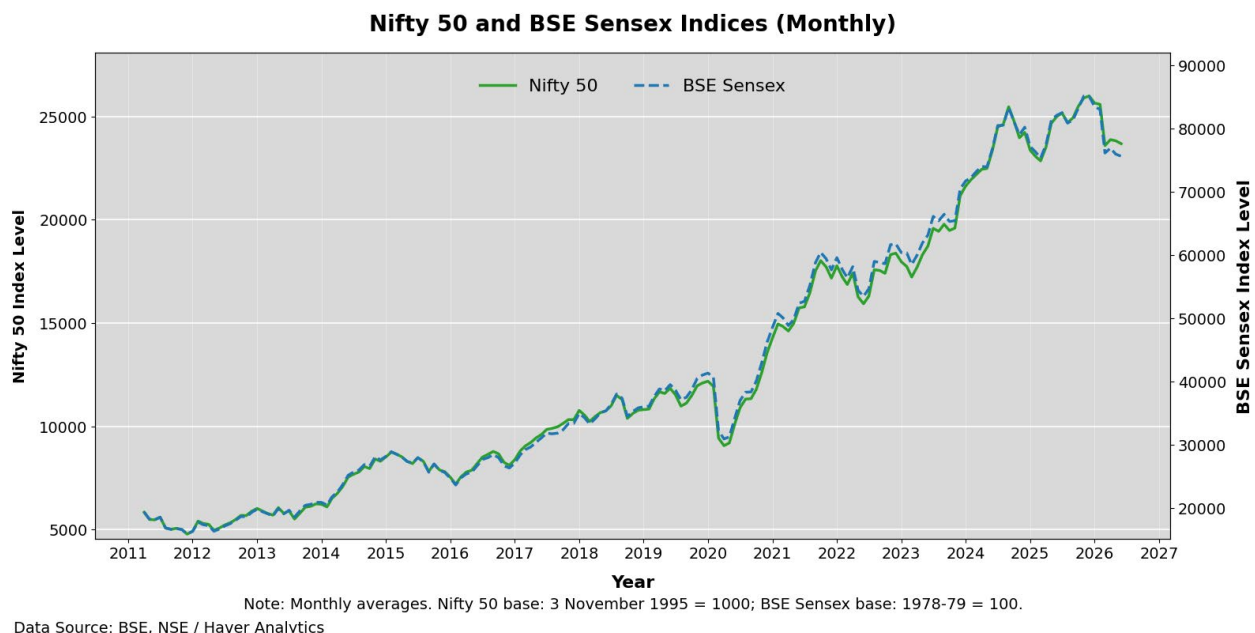


Figure 5.3: Nifty 50 and BSE Sensex Indices

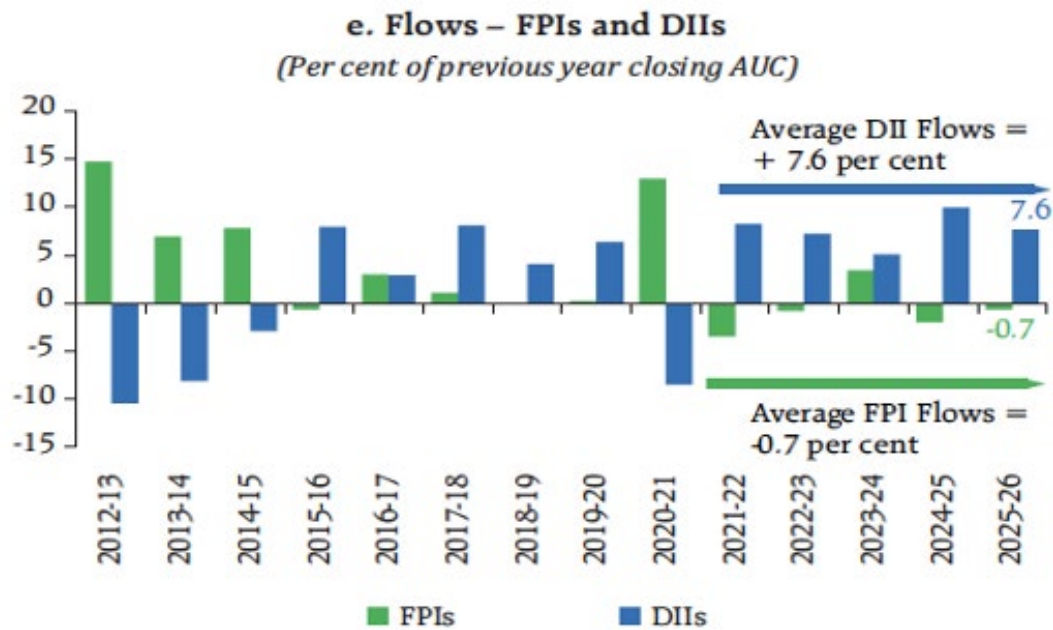


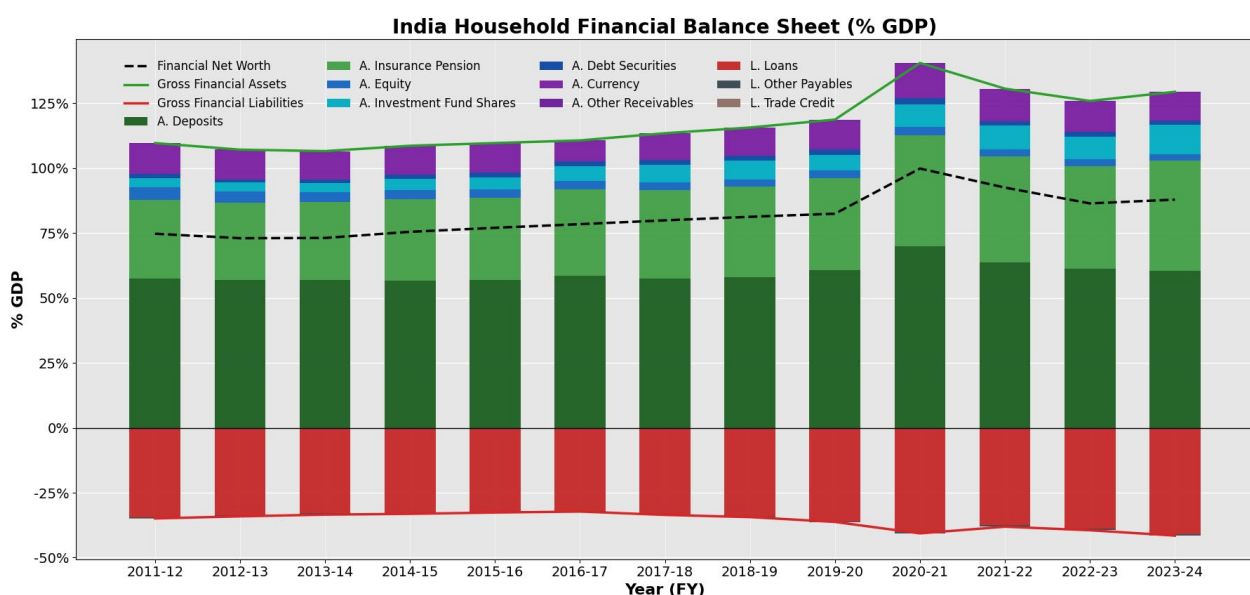
Figure 5.4: FPI versus DII flow changes (from RBI Financial Stability Report, December 2025)

A chart from the RBI's *Financial Stability Report* released in December 2025 is also worth revisiting here (Fig. 5.4). Considering it in conjunction with Fig. 5.3 helps buttress the point about the effect on India's equity markets as it shows how, as FPIs exited their positions from FY2021-22 to FY2025-26, at an average annual outflow rate of -0.7 percent of the previous year's assets under custody (AUC), DIIs stepped in with an average net inflow rate of 7.6 percent. As a result, equity markets, unlike previous risk-off episodes, held up during this period.

Interestingly, the post-pandemic resilience of the Indian markets is commonly attributed to strong 'fundamentals' of the Indian economy. However, a more plausible 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-globalisation, and geopolitical volatility in global capital flows, this domestic stabilisation mechanism 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 though, 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 Indian equity markets well for 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 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 concerning investments in riskier assets. Indian equity markets have notably moved to being sensitive to domestic household conditions of real income growth, consumer confidence, debt serviceability and leverage behaviour. However, much remains to be seen, and perhaps, the ongoing correction in them will test how precisely this new domestic stabilisation mechanism, undergirded by DIIs, fares (or not).

6. Indian households are financialising 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 percent of GDP in FY2011-12 to 87.8 percent by FY2023-24, with gross financial assets touching 129 percent of GDP (Fig. 6.1). The pandemic year, FY2020-21, produced the largest single-year jump in household net worth, spiking it to 100 percent of GDP as household savings surged briefly (see Fig. 1.4) and mainly for the upper decile of the income distribution. The subsequent normalisation 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 percent of GDP in FY2019-20. Against this backdrop, two constitutive changes currently underway stand out and are worth examining in detail – the first a bit more than the second. The first is a change in composition of households' asset portfolio and the second is about increasing leverage.



Data Source: RBI Flow of Funds Accounts

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 in the composition of its asset portfolio (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 percent, and FY2023-24 when it was 8.6 percent. A key driver behind this is the rise of SIPs as discussed in the previous section. Notably, though, bank deposits reduced their share over the same period by five percentage points to 46.8 percent. To be sure, bank deposits remain the largest asset class for households, but this shift, though seemingly small, is significant since the share of bank deposits in the household asset portfolio hovered between 52 to 54 percent. Importantly, it signals a change in the 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 tells us that households are now

increasingly willing to invest their savings in market-linked securities whose returns can be volatile and contingent upon market performance.

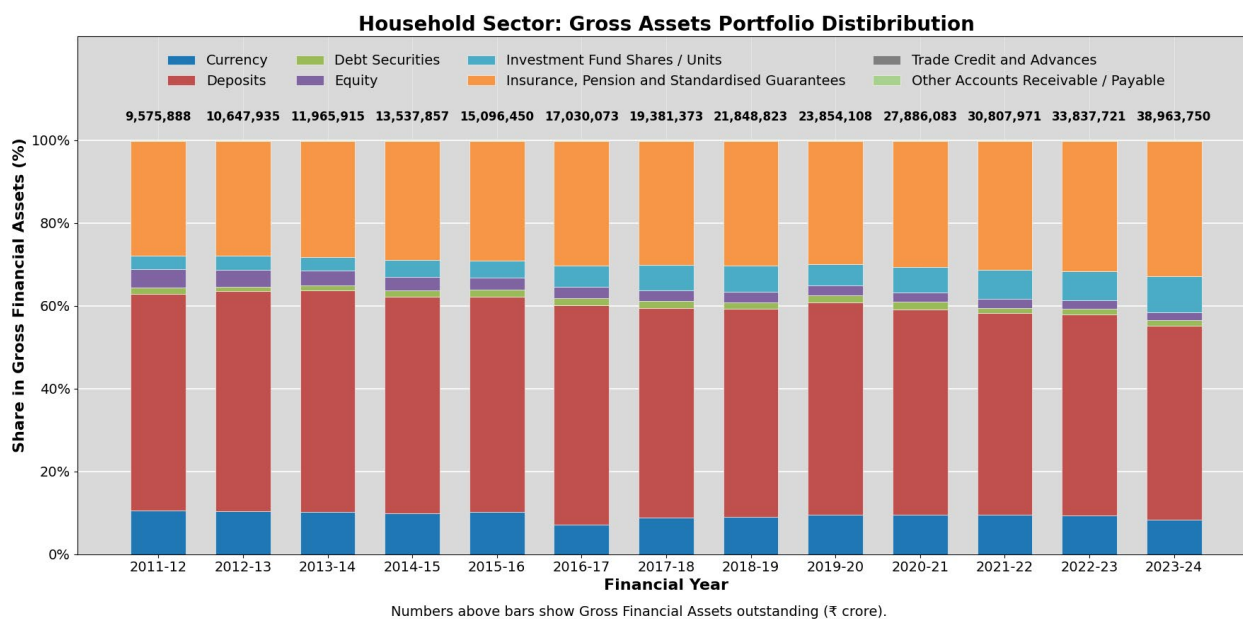
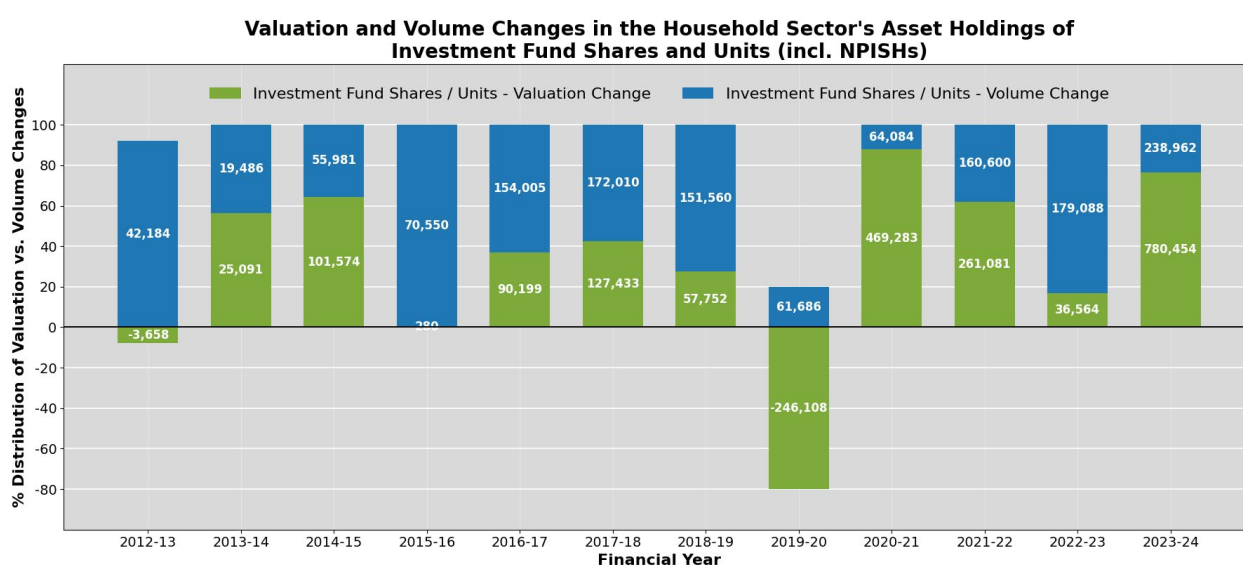


Figure 6.2: Household sector gross assets portfolio composition

Moreover, 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 percent of the change 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 percent 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 percent 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 4,69,283 crore 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 have continued 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 as they decouple the investment decision from market timing: households need to commit once, and periodic contributions execute regardless of market conditions. That said, with optionality built in, i.e., households can stop their periodic contributions at any time, 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's 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 percent of GDP in FY2018-19 (pre-pandemic) to 41 percent 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 percent of GDP. However, starting FY2022-23, it surged to 5.9 percent and then to 6.2 percent in FY2023-24.

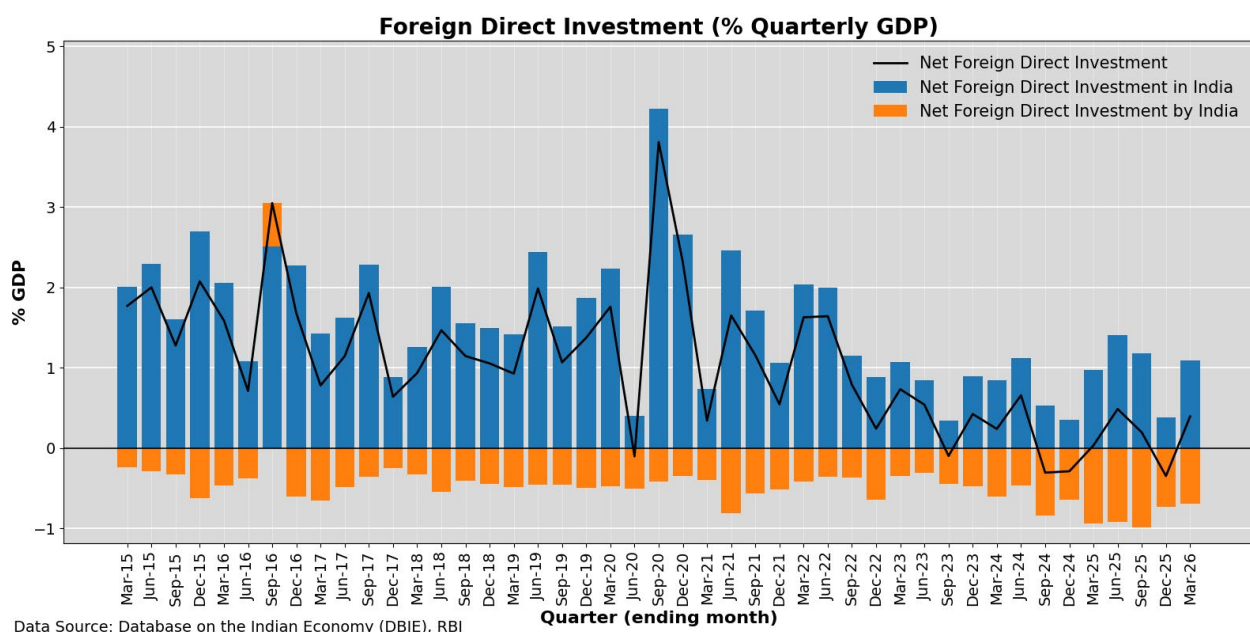
Rising household leverage though can be read in two ways. An optimistic reading can be that it reflects increased confidence in debt serviceability, and more so, access to formal channels of (un)secured credit that was not the case before. Especially, for the masses at the lower rungs of the income distribution 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.

Overall, we can 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, the household sector is financialising at a rapid pace. It is surely richer in the aggregate, but at the same time it is also more levered-up, which is always concerning because its macroeconomic fallout in the event of a significant economic downturn is rarely, if ever, linear.

External sector considerations

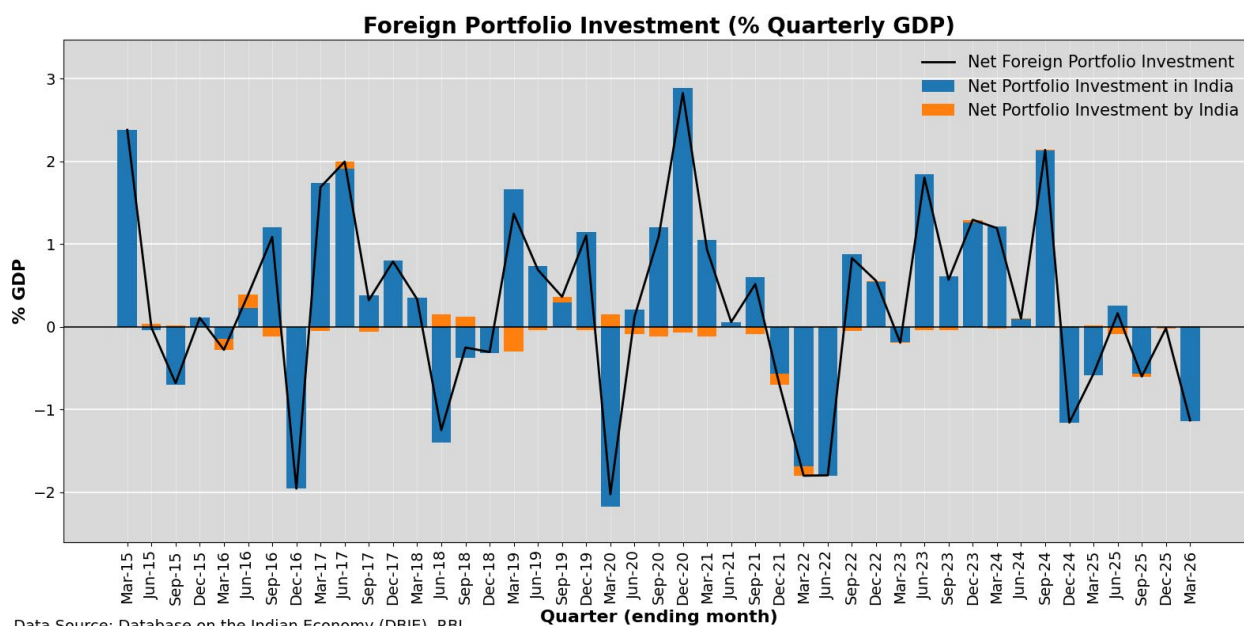
7. Remittances are the understated anchor of India's external balances and the rupee⁵

The Indian rupee (INR) lost nearly 12 percent 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. 7.1 and 7.2). 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 7.1: Net FDI as % GDP

5 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.”



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

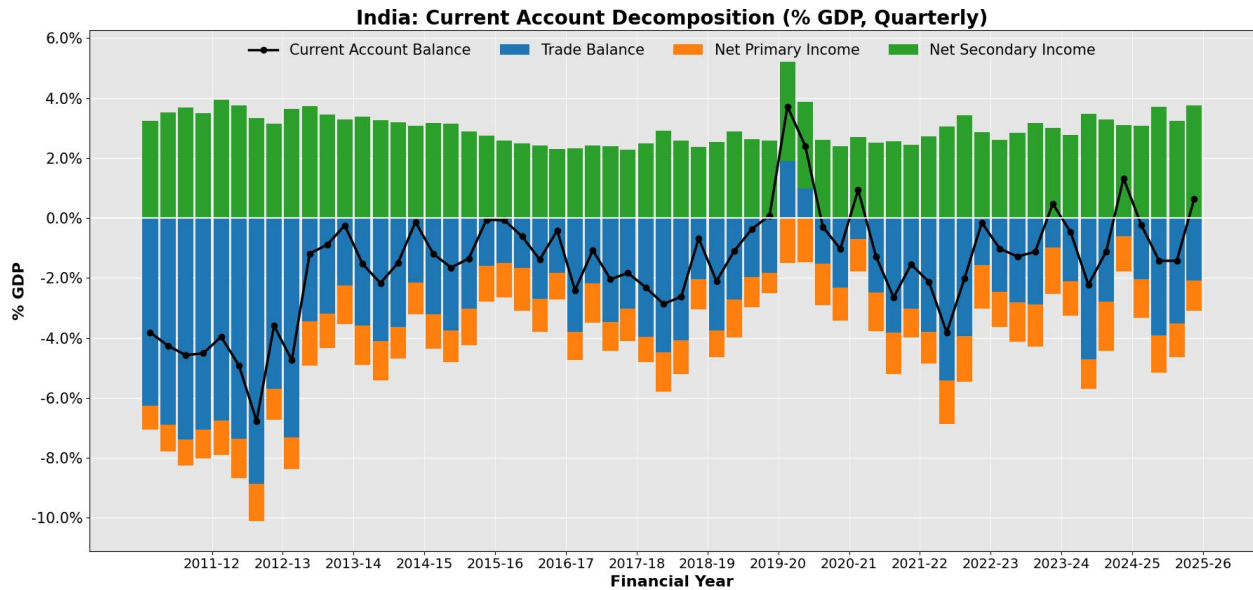
Figures 7.2: Net FPI as % GDP

FDI and FPI flows, recorded in the financial account (FA), are certainly 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 ignoring a major external vulnerability: The ebbing of India's huge remittance flows due to geopolitical or other reasons. Accounting for both remittances and FA flows, on the other hand, offers a fuller understanding of India's external dynamics and the pressure 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. 7.3, blue bars). The trade balance being a major component in the CA leads to India's persistent CAD (Fig. 7.3, 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. Put differently, 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 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.

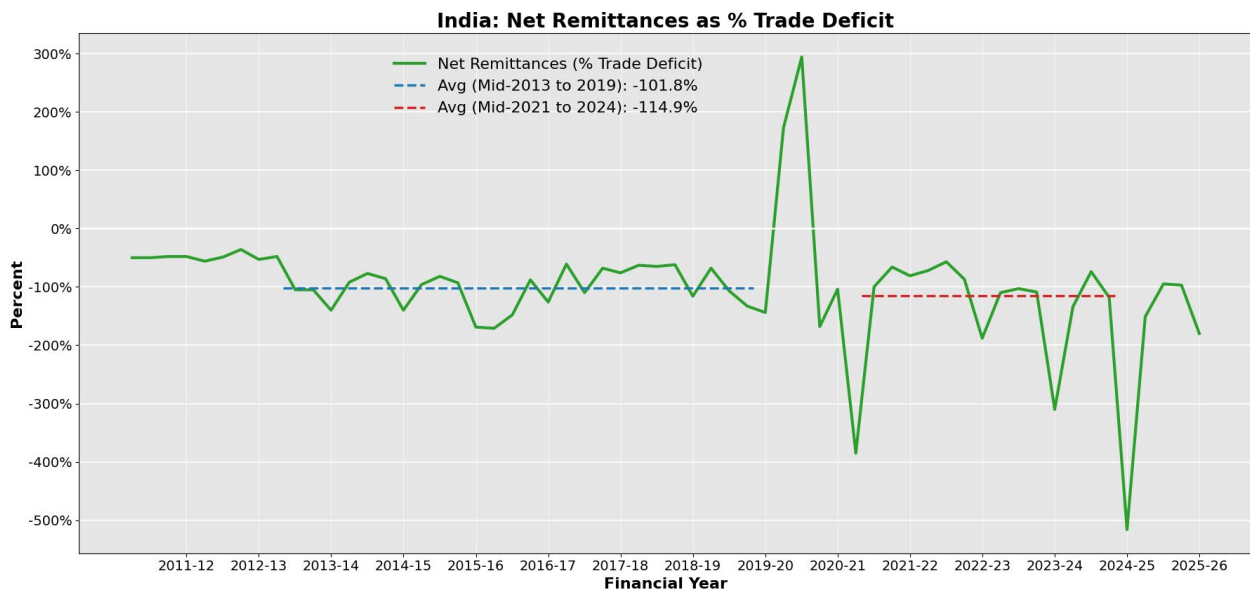
Such explanations, mainly emphasising the importance of FDI/FPI flows for financing the CAD and supporting the INR, are incomplete as they do not give due credence to how remittances, recorded in the CA, in fact serve to anchor both. Briefly, the CA consists of three component flows, with the first two being in persistent deficit in the case of India. First is the trade deficit as already noted. Second is the net primary income deficit (Fig. 7.3, orange bars), which reflects the net balance of investment income (e.g., interest, dividends, and capital gains) earned by Indian residents on foreign assets and those paid by Indian residents on liabilities held by foreign counterparts. The third flow, by contrast, is that of net secondary income (green bars), which in the case of India remains in surplus and comprises mainly of

its high net 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), and these matter for its CAD and the INR for the following reasons.



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

Figure 7.3: Current account decomposition as % GDP



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

Figure 7.4: Net remittances as % trade deficit

First, and importantly, since mid-2013, remittances have on average financed more than the entirety (>100 percent) of India's trade deficit (pandemic and Trump's 'liberation day' disruptions notwithstanding). Figure 7.4 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 percent 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.

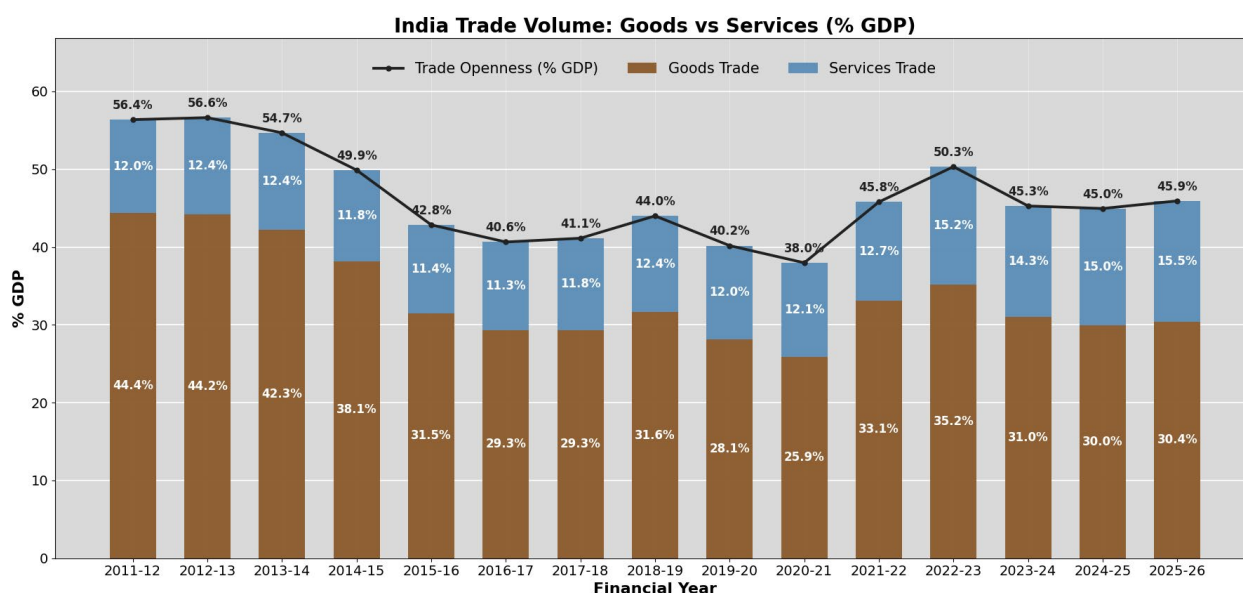
Yet, despite their importance, analyses of remittances commonly pale in comparison to those of FDI/FPI flows. This is perhaps because India's unparalleled remittances are largely the result of small financial decisions by thousands of working-class Indians abroad who do not animate globalised elites 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 net FDI/FPI flows 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 is likely to widen with imports becoming dearer. As a result of this, a gap in the remittances coverage of the trade deficit 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, and more importantly, by instituting such schemes as FCNR(B) deposits that have incentivised and increased remittance flows to India. Hence, the most recent read from Q4 FY2025-26 shows remittances being high (Fig. 7.3, last green bar). In fact, as Fig. 7.4 shows, remittances were so far in excess of the trade deficit that they even covered the net primary income deficit, thereby delivering a rare CA surplus quarter 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 last section below. What is important for now, however, is to recognise 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.

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

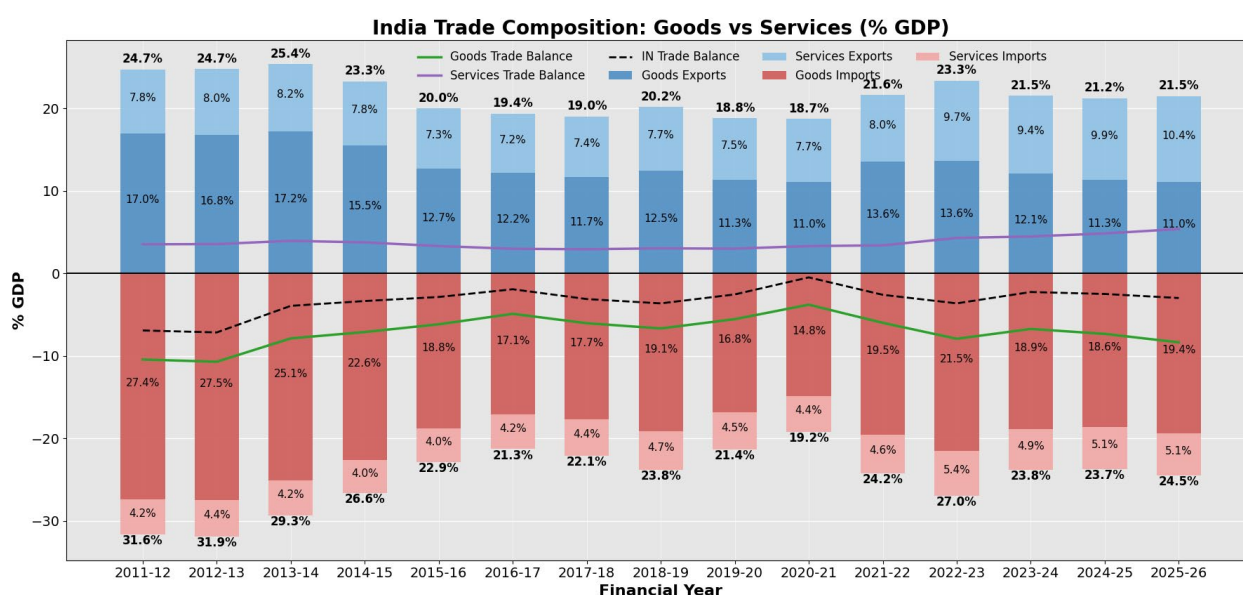
The Indian economy, relative to the early 2010s, is now less integrated with the global economy. Contrary to common perceptions, a measure for trade integration, namely, trade openness—calculated as imports plus exports as percentage of GDP—is now lower than it was from FY2012–15 (Fig. 8.1). Despite a post-pandemic recovery, this is not necessarily surprising because India is a domestic demand-led economy, not an export-led one. Total trading volume thus need not grow at the same pace as GDP. The decomposition of India's trade openness shows that the total volume or turnover of the goods trade (Fig. 8.1, brown bars) has tempered compared to the period FY2011-12 through FY2014-15 but remains above the immediate pre-pandemic levels starting FY2015-16. Furthermore, following the goods trade deficit line in Figure 8.2 (green line below zero) shows that it largely moves in-step with the total goods trade volume, but in the opposite direction. Implying therefore, that it is India's rising goods imports (Fig 8.2, dark rust bars below zero) that are driving its goods trade and deficit, not goods exports that have been stagnant and in fact declining recently (dark blue bars).

The aggregate trade openness and balance charts further reflect a contrasting dynamic – that of India's services trade. As opposed to running a persistent deficit in the goods trade, India runs a persistent surplus in its services trade (Fig. 8.2, violet line), which notably has also been growing post-pandemic. The same is true of services trade integration, with total volumes growing consistently post-pandemic from 12.1 percent of GDP in FY2020-21 to 15.5 percent in FY2025-26 (Fig. 8.1, blue bars). This is significantly due to a rise in services exports from 7.7 percent to 10.4 percent of GDP by FY2025-26 (Fig. 8.2, light blue bars), which outpacing the more modest rise in services imports (light rust bars), has positively widened the services trade surplus from 3.3 percent to 5.4 percent of GDP (after a rather stable pre-pandemic run). In absolute terms, India's services exports more than doubled from USD 206 billion in FY2020-21 to USD 421.3 billion in FY2025-26, while imports grew 74 percent 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.



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

Figure 8.1: Trade openness (goods and services) as % GDP



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

Figure 8.2: Trade balance (goods and services) as % GDP

The composition of India's services trade is straightforward, with the top 10 services export as well as import baskets (Figs. 8.3 and 8.4) 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 these together account for nearly 96-97 percent of the overall services trade turnover.

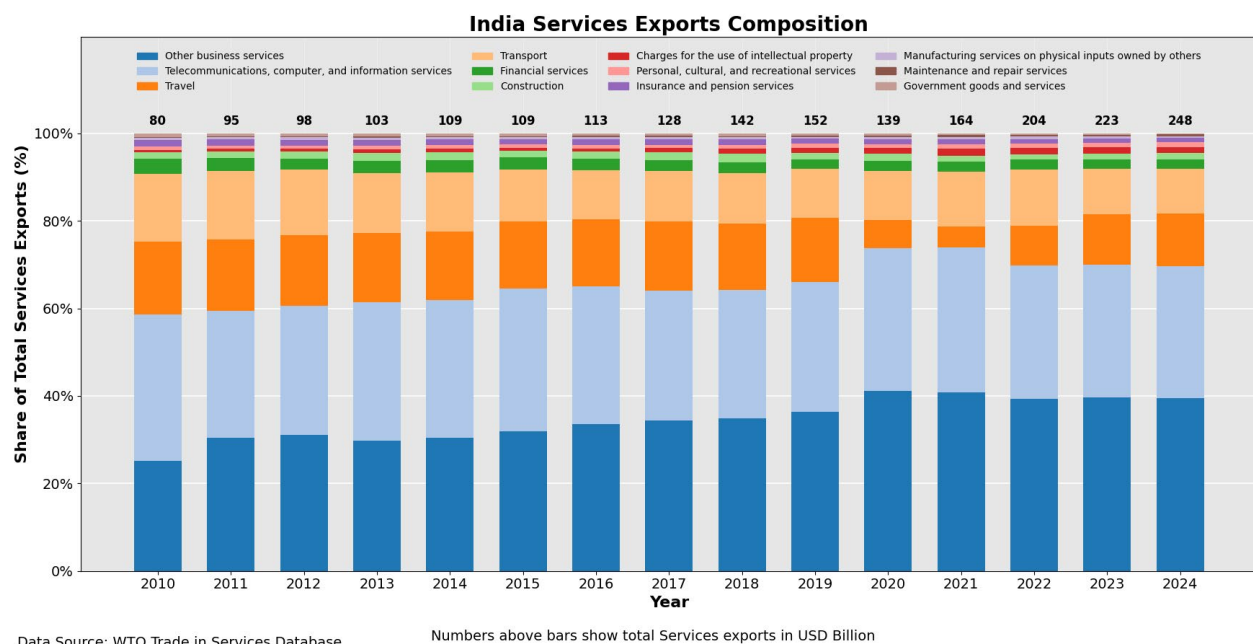


Figure 8.3: Top 10 services exports, compositional shares

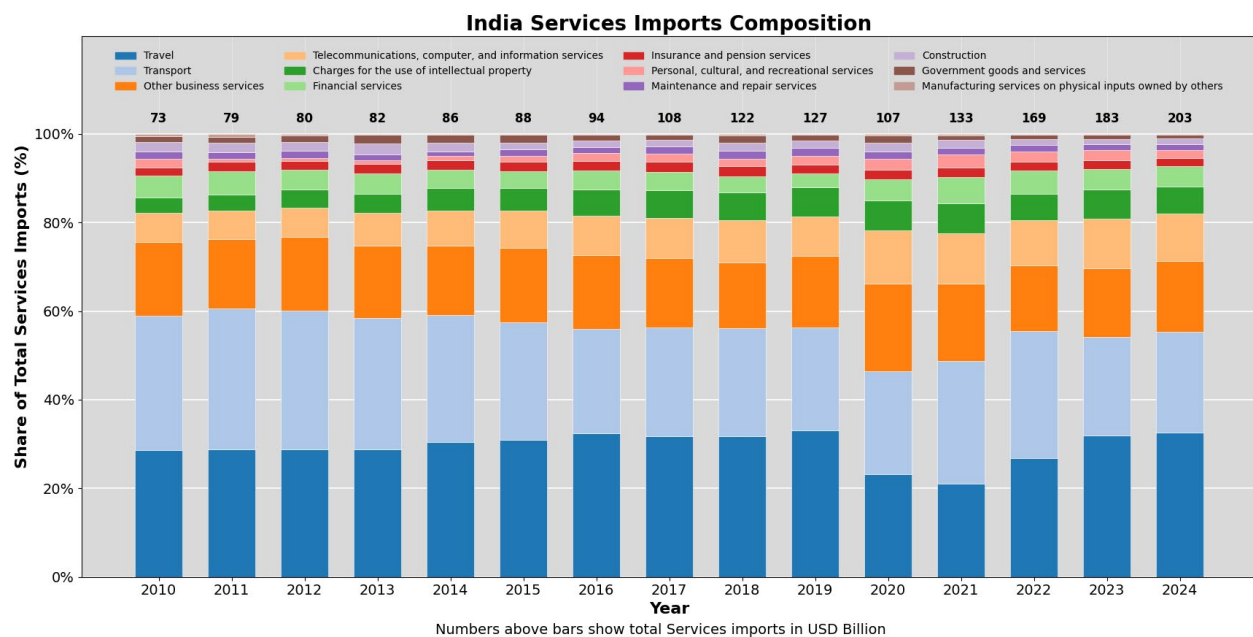
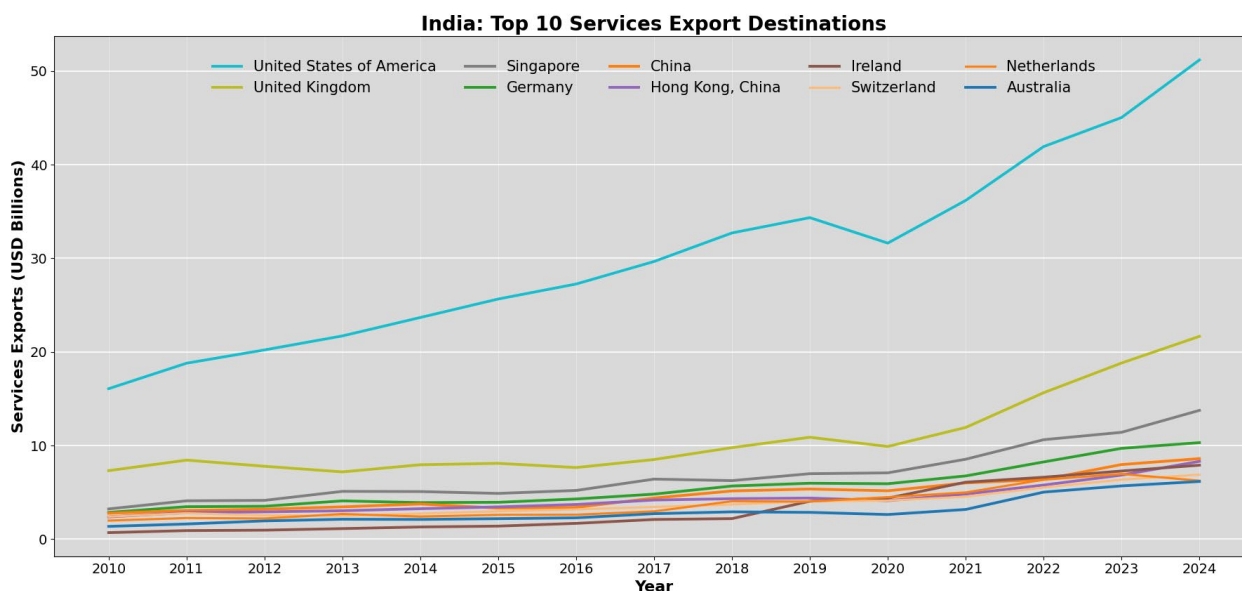
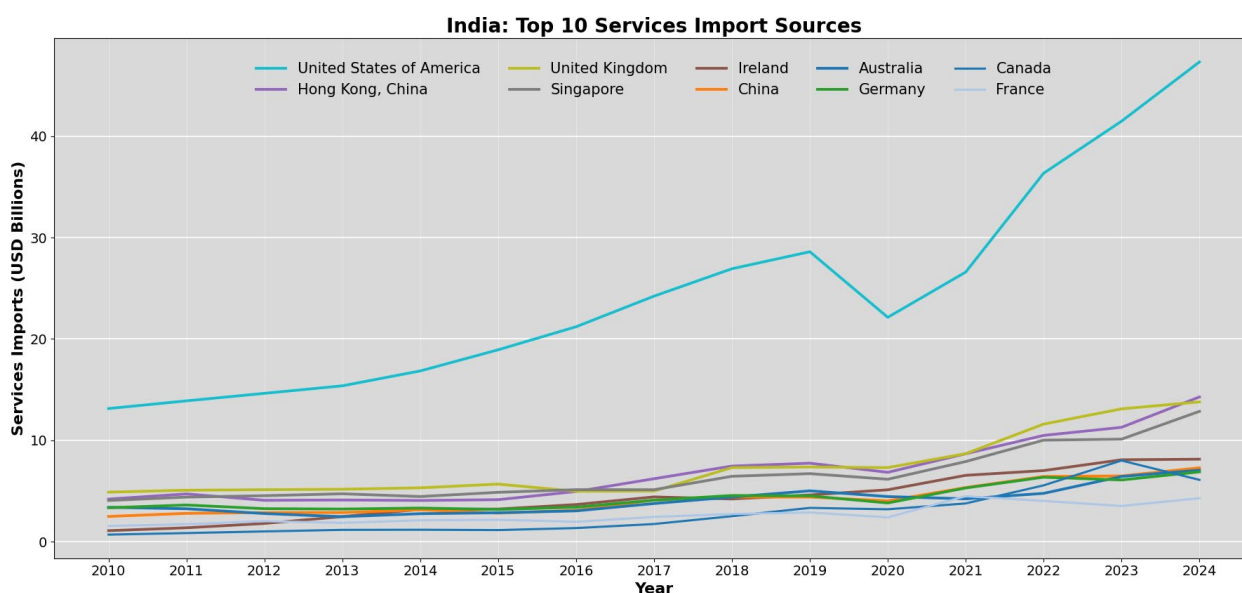


Figure 8.4: Top 10 services imports, compositional shares

It is the geographic distribution (Figs. 8.5 and 8.6) 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 now 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 is in fact symbiotic as it runs both ways. 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, the UK comes in 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

Figure 8.5: Top 10 services export destinations

Data Source: WTO Trade in Services Database

Figure 8.6: Top 10 services import sources

The centrality of the US further comes into sharp relief once we consider that the US is also the largest destination for India's goods exports (more on this in the next section). However, these being geopolitical times, the centrality of the US in India's trade flows also makes it a 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 add the risk of AI driven automation now. 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. 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. As such, diversifying India's trade portfolio is certainly in order, and in this regard, the recent signing of free trade agreements with the world's largest trading bloc, the European Union, as well as the United Kingdom are positive developments.

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

A common perception is that India's goods imports are largely a function of its oil imports. India does import nearly 85 percent of its oil but this perception is only 1/4th true as oil imports account for about 25 percent of the total goods import bill (Fig. 9.1, dark blue bars). This share of oil imports has also decreased slightly over time. To be sure, as Figure 9.2 shows, oil imports (petroleum, crude and products marked as dark blue bars) constitute the dominant share within India's top 10 imported goods basket but not the entire basket. Interestingly, electronic goods (Fig. 9.2, light blue) have now displaced gold (orange) for the second spot, thereby increasing their share within the top 10 imports basket from 10.4 percent in 2015 to 17.26 percent 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 percent in the top 10 goods imports. Gold's share, to be sure, fluctuates but its demand in India can be expected to remain strong due to cultural preferences and its mass use by households 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 constraints that are not a function of cyclical demand conditions per se.

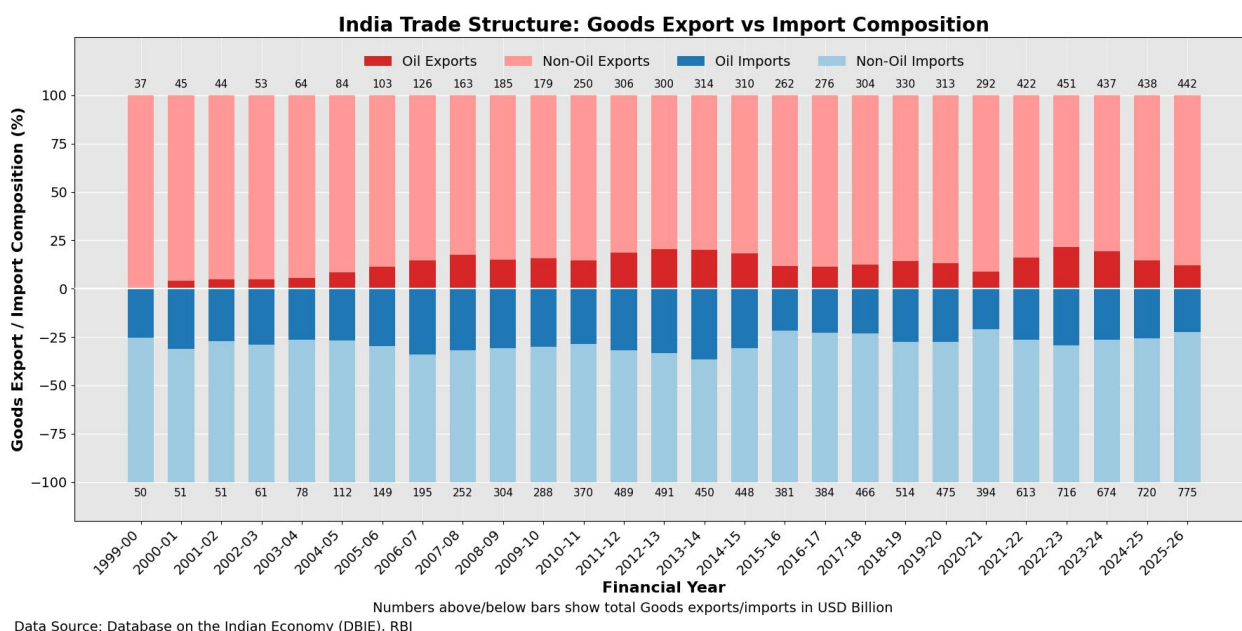


Figure 9.1: Goods trade compositional shares of oil versus non-oil goods

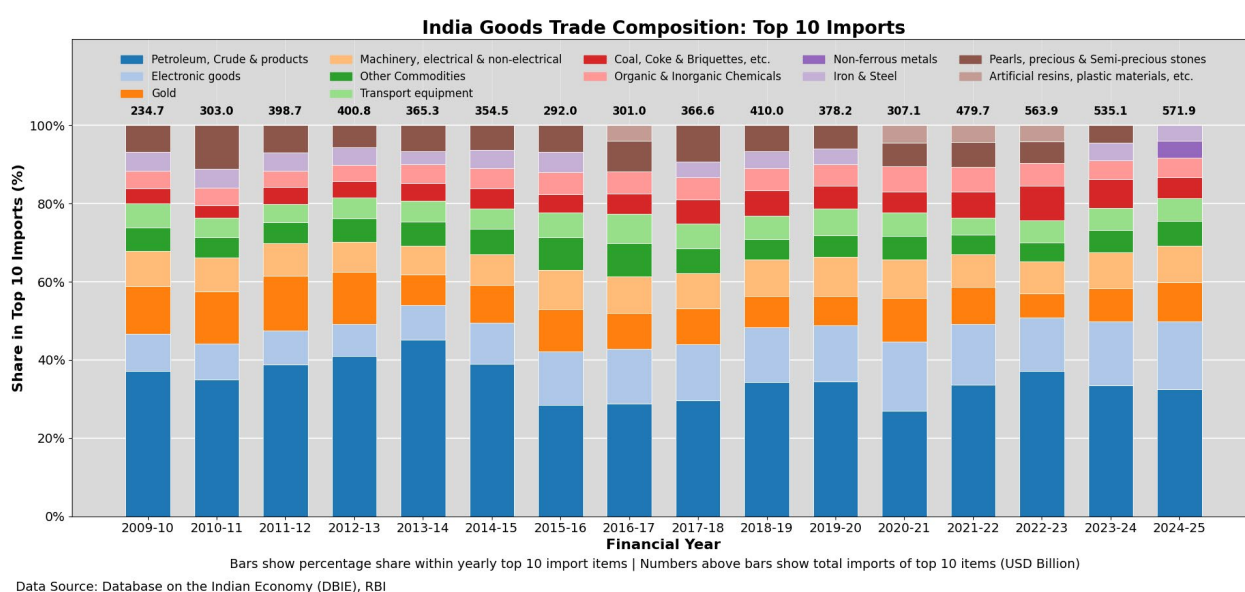


Figure 9.2: Top 10 goods imports, compositional shares

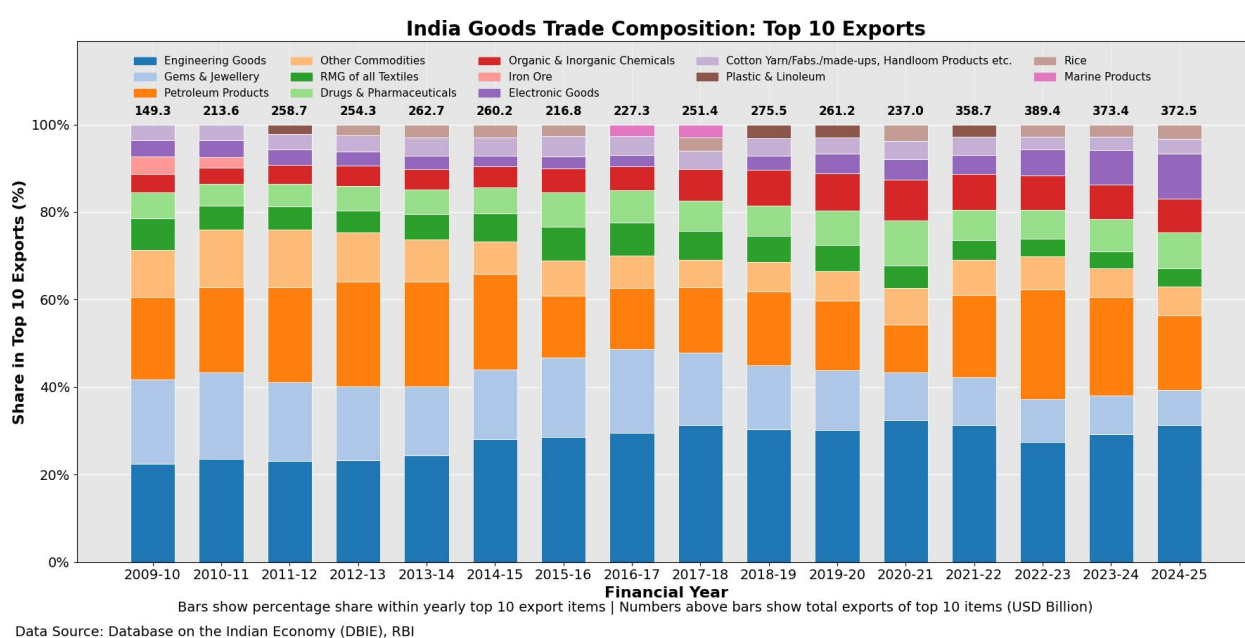
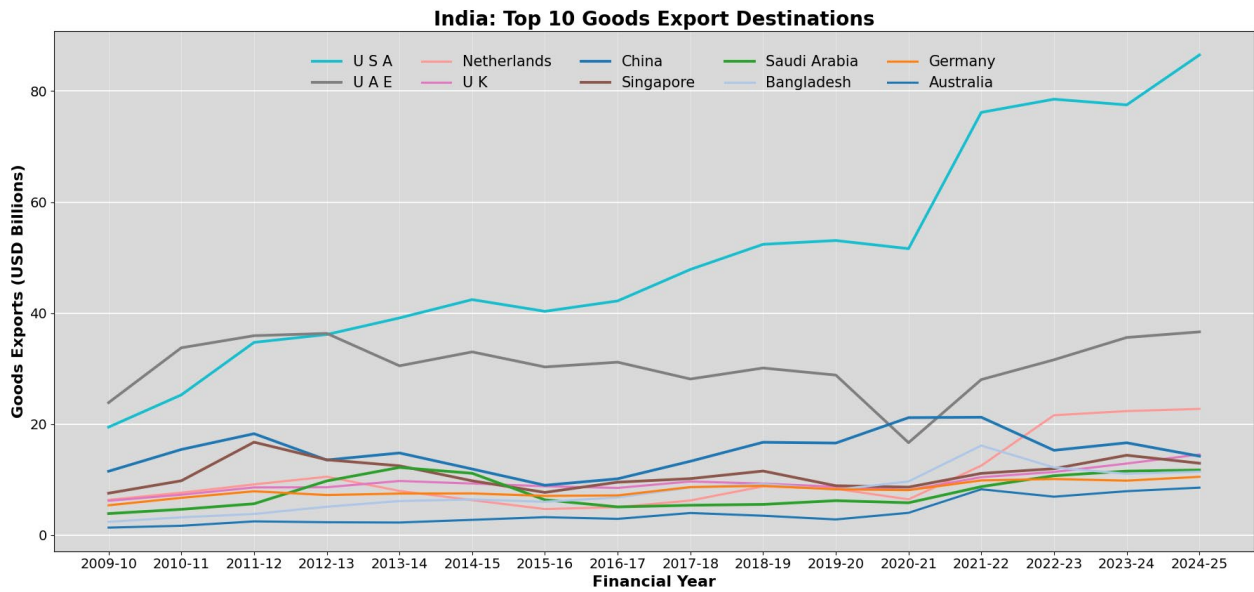


Figure 9.3: Top 10 goods exports, compositional shares

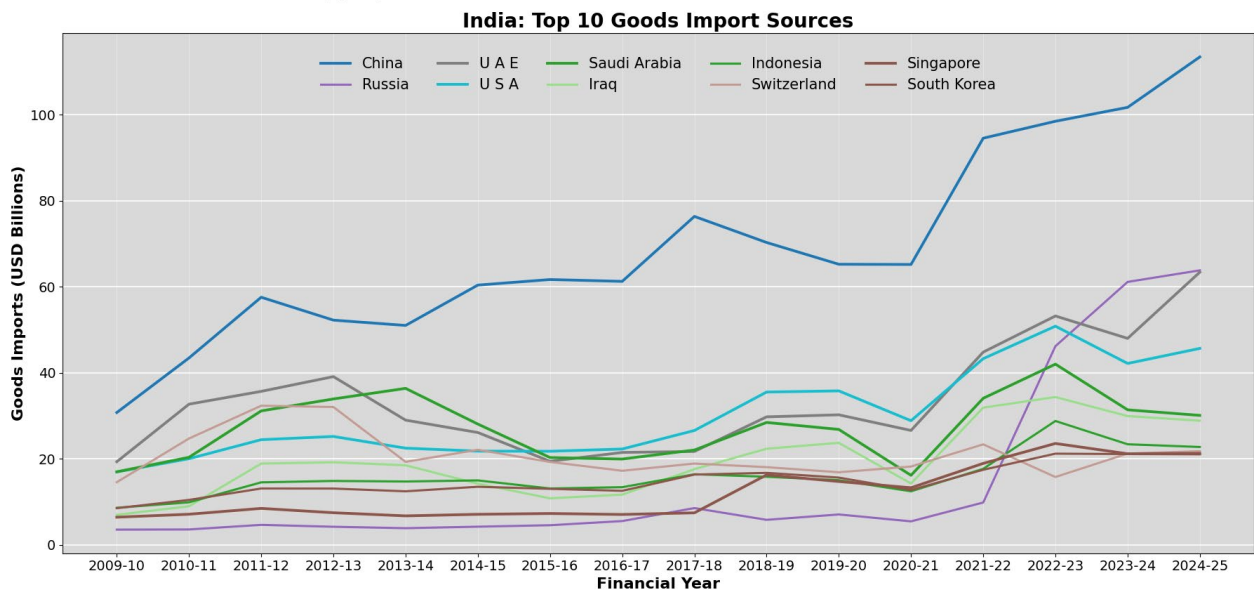
As Figure 9.3 shows, out of 13 categories, just three of engineering goods (dark blue bars), gems and jewellery (light blue) and petroleum products (orange; mainly imported crude refined and exported) have consistently composed nearly 60 percent of the top 10 exports basket. Barring four goods categories 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 percent in FY2019-20 to 10.36 percent in FY2024-25. This is likely due to an increase in exports of assembled electronic goods such as iPhones and is a positive development even as 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. 9.4). In FY2024-25, India exported USD 86.5 billion worth of goods to the US, amounting to 19.8 percent of its total goods exports. By contrast, China is now the dominant source for India's imports by a wide margin (Fig. 9.5). In

FY2024-25, Indian imported USD 113.5 billion worth of goods from China, amounting to 15.8 percent of its total goods imports.



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



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

Figure 9.4 and 9.5: Top 10 goods export destinations and import sources

In a seemingly de-globalising world wherein established rules of trade now stand disrupted, a high degree of single-country concentration on both the export and import sides of India's goods trade raises the risk of arbitrary changes and uncertainty that can worsen the goods trade deficit. Recall from the previous section that India's persistent trade deficit is the result of it running a persistent goods trade deficit, for it in fact runs a healthy surplus in its services trade. So, given that the goods trade deficit is in turn a function of rising non-oil imports, it further implies that India's domestic industrial base needs to expand substantially, especially in medium to high-value manufacturing sectors.

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 one of the thinnest but rapidly growing categories on the exports side. Effectively, it is the same domestic capabilities gap in high value electronics manufacturing in this case that is playing up on both side of the goods trade balance; though differentially, to be sure. In contrast to oil imports that are a structural constraint, an under-developed manufacturing base need not be so. What is needed, especially now in an emerging new world of multi-bilateralism, is a globally competitive manufacturing sector that is strategically directed by robust industrial policies working in-sync with astute trade policies. This is now both an economic and national security concern.

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