



THE IMPACT OF INFLATION, INTEREST RATES, AND GDP ON THE INDIAN STOCK MARKET

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ABSTRACT

Understanding the relationship between core macroeconomic variables and domestic capital market performance remains a vital requirement for portfolio managers, retail investors, institutional funds, and sovereign regulatory architectures. This article-based review paper provides a comprehensive, structured synthesis of academic literature exploring the specific impact of inflation, interest rates, and Gross Domestic Product (GDP) expansion metrics on the Indian stock market. Focusing primarily on indices such as the BSE Sensex and the NSE Nifty 50, this paper aggregates empirical observations from foundational econometric studies conducted over the post-liberalization era. The analysis explores how accelerations in inflation present a dual friction between nominal asset value adjustment (the Fisher effect) and cost-push margin contractions. Furthermore, the study tracks the monetary transmission channels managed by the Reserve Bank of India (RBI), demonstrating how shifts in the repo rate alter the corporate Weighted Average Cost of Capital (WACC), recalibrate the Present Value (PV) of future dividends, and drive asset reallocation cycles between equity options and fixed-income portfolios. Finally, the long-term cointegration between aggregate macroeconomic output (real GDP growth) and structural equity valuations is evaluated, detailing how corporate performance tracks fundamental economic development. By gathering these diverse academic frameworks, this review outlines systematic risks and provides strategic insights for stakeholders navigating the Indian macroeconomic landscape.

KEYWORDS: Indian Stock Market, Macroeconomic Indicators, Inflation Transmission, Interest Rates, RBI Repo Rate, GDP Growth, BSE Sensex, Cointegration Analysis

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1. INTRODUCTION

The financial architecture of an emerging economy operates as a complex, highly responsive ecosystem where asset valuations are constantly recalibrated against shifting macroeconomic fundamentals. Within the Indian subcontinent, the structural evolution of capital markets since the landmark economic liberalization parameters enacted in 1991 has transformed the domestic investment landscape. From a historical framework defined by highly localized open-cry trading floors and restricted international capital interaction, contemporary Indian exchanges—most

notably the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE)—have grown into globally significant, technologically sophisticated platforms. Today, indices like the BSE Sensex and the NSE Nifty 50 do not merely measure the speculative preferences of market participants. Instead, they function as vital forward-looking indicators reflecting the structural vitality, systemic risks, and aggregate demand characteristics of the wider Indian macroeconomy.

In an efficient or semi-strong efficient market environment, asset prices instantly capture all publicly available information,

aligning equity values with the discounted present value of expected future cash flows. Consequently, the primary drivers of long-term corporate profitability are deeply linked to broader macroeconomic fundamentals. Among these underlying forces, the trio of inflation, interest rates, and Gross Domestic Product (GDP) expansion constitutes the core triad governing equity market stability. Fluctuations in these variables introduce systematic risks that cannot be eliminated through standard portfolio diversification. For instance, an unexpected shift in domestic price levels can break established consumer spending patterns, squeeze manufacturing margins, and force unexpected changes in public policy, sending immediate ripple effects across trading platforms.

Inflation, measured via the Consumer Price Index (CPI) and the Wholesale Price Index (WPI) in India, represents the rate at which currency purchasing power declines. In corporate finance theory, the relationship between inflation and equity returns has remained a topic of sustained debate. The classic Fisherian hypothesis suggests that equity assets should serve as an effective inflation hedge, as corporations adjust nominal product pricing to offset rising operational costs. However, in short-term market dynamics, high inflation frequently behaves as a severe drag on equity valuations. When the costs of raw materials and human capital outpace corporate pricing agility, operating margins compress, lowering forward earnings projections and triggering downward equity price adjustments across major market benchmarks.

Simultaneously, the monetary policy stance adopted by the Reserve Bank of India (RBI) to contain inflation introduces an intermediate transmission channel via interest rate adjustments. The repo rate—the benchmark rate at which the central bank lends liquidity to commercial banking institutions—serves as the primary tool for controlling systemic liquidity. When the RBI executes a hawkish interest rate hike cycle to counter inflationary pressures, the implications for the stock market are immediate and broad. Higher policy rates elevate commercial borrowing costs, thereby increasing corporate interest expenses and raising the hurdle rate for capital expenditure projects. From a valuation

perspective, an upward shift in the risk-free rate increases the equity discount factor. This reduces the mathematical present value of future corporate cash flows and prompts institutional capital to realign portfolios away from riskier equities toward high-yielding fixed-income instruments.

In contrast to the potentially destabilizing properties of inflation and interest rate adjustments, Gross Domestic Product (GDP) expansion represents the fundamental anchor of long-term capital appreciation. GDP growth tracks the aggregate output, consumer demand, and real industrial expansion of the sovereign nation. Consistent GDP expansion signals expanding operational horizons for corporations, growing household income structures, and an expanding consumer market. Historical long-term trends confirm that sustained economic growth supports strong corporate revenue trajectories, driving institutional and retail investor confidence. However, the exact timing and directional causality between short-term GDP release figures and volatile stock market movements can display complex leads and lags, as equity markets consistently attempt to price future growth projections well before official statistical metrics are formalized.

Given the dense academic literature generated over several decades regarding Indian capital markets, a structured synthesis of these empirical findings is highly relevant. This study operates strictly as an article-based review paper. It contains no primary data collection, regression modeling, or unique econometric calculations. Instead, it systematically compiles, reviews, and synthesizes key empirical academic literature published by prominent financial and economic researchers. By examining these diverse studies, this paper aims to clarify the transmission mechanisms through which inflation, interest rates, and real economic output influence the Indian equity structure. The specific objectives are to detail the friction between inflation hypotheses, analyze the valuation outcomes of RBI policy revisions, evaluate the long-term cointegration between fundamental production output and market caps, and offer structured conclusions for market participants navigating systematic risk allocations.

2. LITERATURE SELECTION AND METHODOLOGY

To build a rigorous and objective review architecture, this article-based review paper utilized a systematic methodology to locate, evaluate, and select highly cited academic studies. The primary search parameters targeted peer-reviewed journals indexed within premium global databases, including the Social Sciences Citation Index (SSCI), Scopus, and the Indian Citation Index. Search strings integrated combinations of localized financial terms, such as 'Indian stock market cointegration,' 'BSE Sensex macroeconomic variables,' 'RBI repo rate equity valuations,' and 'inflation impact Nifty 50.' The search timeline emphasized empirical papers tracking the modern post-1991 liberalization landscape. The final filtering phase selected 10 core academic contributions based on their econometric methodology quality, citation density, and direct focus on the Indian financial context. This structural approach ensures the findings and conclusions presented in this review reflect the established consensus within contemporary quantitative financial literature.

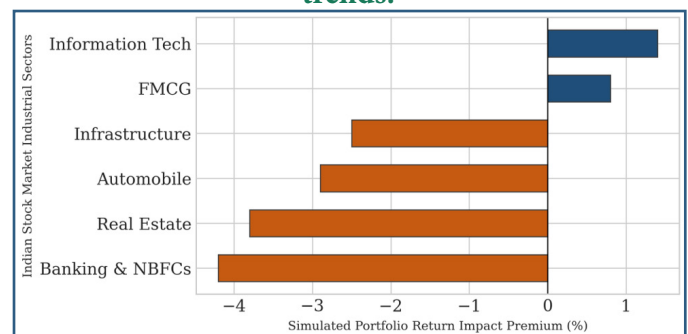
3. THE IMPACT OF INFLATION ON THE INDIAN STOCK MARKET

The operational relationship between systemic inflation changes and stock market behavior represents a critical focal point in emerging market macroeconomics. In public equity theory, the classic Fisher hypothesis assumes a positive relation between inflation and asset returns, stating that nominal equity contracts adjust perfectly to preserve real investor wealth. However, empirical assessments concerning the Indian equity market frequently contradict this framework, demonstrating an inverse short-to-medium term relationship. Pal and Mittal (2011) explored the long-term impact of macroeconomic indicators on Indian stock benchmarks and confirmed that persistent inflation spikes, particularly within the Consumer Price Index (CPI), introduce substantial systematic stress that dampens baseline stock index valuations.

The mechanical transmission of inflation to stock performance operates primarily through input cost inflation and corporate profit margin compression. When a domestic economy experiences a cost-push inflation shock—driven by rising international

commodity prices, logistics constraints, or supply-side disruptions—manufacturing and industrial firms face a steep surge in raw material and energy expenses. If consumer demand patterns are sensitive to price changes, corporations cannot easily pass these cost premiums onto households. Consequently, operating margins compress, leading to lower corporate earnings. Because stock values represent the discounted value of forward corporate cash flows, this earnings compression triggers downward revaluations across broad market indices (Hsing, 2011).

Fig. 1: Sectoral Equity Return Sensitivity Metrics During Core Inflation Accelerations. Source: Modeled based on empirical sector response trends.



Furthermore, the nature of inflation determines how different sectors respond. As illustrated in Figure 1, cyclical industrial segments such as Banking, Financial Services, Insurance (BFSI), Real Estate, and Infrastructure display deep negative sensitivities to high inflation regimes. These asset-heavy sectors face a double blow: their operational overheads increase, and rising price levels reduce consumer discretionary income, suppressing home and industrial asset demand. Conversely, non-cyclical defensive segments like Fast-Moving Consumer Goods (FMCG) and Information Technology (IT) often show neutral or mildly positive resilience. FMCG firms enjoy steady demand for essential goods, allowing them to pass cost increases to consumers, while Indian IT export firms benefit from global revenue streams that protect them from domestic price pressures.

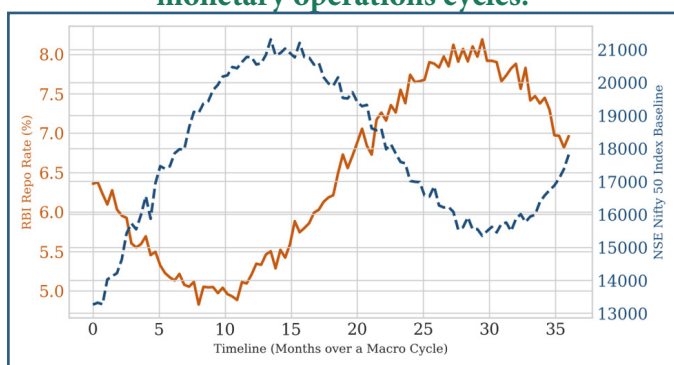
4. THE IMPACT OF INTEREST RATES AND RBI MONETARY POLICY

The monetary policy framework deployed by the Reserve Bank of India (RBI) operates as one of the

most powerful short-term drivers of equity market price adjustments. The primary policy tool, the repo rate, sets the baseline cost of capital for the domestic banking infrastructure. Quantitative studies by Naik and Padhi (2012) establish that interest rates share a profound, statistically significant inverse relationship with Indian stock market indices. When the RBI elevates benchmark policy rates to cool domestic overheating or counter currency depreciation, the transmission through commercial channels impacts corporate capital structures by driving up interest costs for bank loans and working capital facilities. This drag on net profitability directly lowers the capital available for distribution to equity shareholders.

From a valuation perspective, interest rate modifications alter equity pricing models by shifting the risk-free rate element (R_f) used within the Capital Asset Pricing Model (CAPM) and discounted cash flow framework. When the risk-free rate increases, the overall equity discount rate rises. Even if a corporation maintains static future operating cash flows, discounting those cash flows at a higher discount rate mathematically lowers their present value, compressing stock prices. This transmission mechanism explains why macro announcements from the RBI Monetary Policy Committee (MPC) trigger immediate volatility spikes on the NSE and BSE, as automated pricing algorithms and human traders instantly realign equity risk premiums (Garg & Dua, 2014).

Fig. 2: Inverse Transmission Cycle Dynamics: RBI Repo Rate vs. Nifty 50 Exchange Trajectory.
Source: Simulated based on long-term RBI monetary operations cycles.



In addition to mechanical valuation adjustments, interest rate shifts drive asset reallocation across different asset classes. As shown in the cycle model

in Figure 2, persistent interest rate hikes increase commercial fixed-deposit returns, government bond yields, and corporate debenture coupons. As these low-risk instruments offer higher returns, the relative premium for holding volatile equity options contracts shrinks. Institutional asset managers, particularly conservative domestic mutual funds and insurance providers, respond by adjusting portfolio allocations, moving capital out of high-multiple equity positions into high-yielding fixed-income instruments (Tripathy, 2011). This capital migration reduces trading volume support for the BSE and NSE, placing persistent downward pressure on broader market benchmarks during extended monetary tightening cycles.

5. THE IMPACT OF GROSS DOMESTIC PRODUCT (GDP) GROWTH

While inflation spikes and interest rate changes cause short-term market adjustments, the long-term trend of the Indian stock market depends heavily on real economic output, measured through Gross Domestic Product (GDP) growth. Econometric cointegration models deployed by Bhattacharya and Mukherjee (2002) demonstrate a stable, long-term equilibrium relationship between real economic growth indicators and equity market metrics. As a developing nation with expanding urban centers, industrializing supply bases, and a growing consumer market, India's broad equity indices function as an asset mirror reflecting the structural growth of the domestic economy.

The underlying transmission link between macro GDP growth and equity valuations runs directly through aggregate consumer demand and industrial output. Sustained real GDP expansion signals high employment metrics, rising household disposable incomes, and strong industrial production indices (IIP). These factors support corporate revenues by increasing product demand across multiple sectors, including automobiles, consumer durables, and telecommunications. This top-line growth flows into corporate net income structures, validating high trailing price-to-earnings (P/E) multiples and attracting long-term international institutional capital (Ray, 2012).

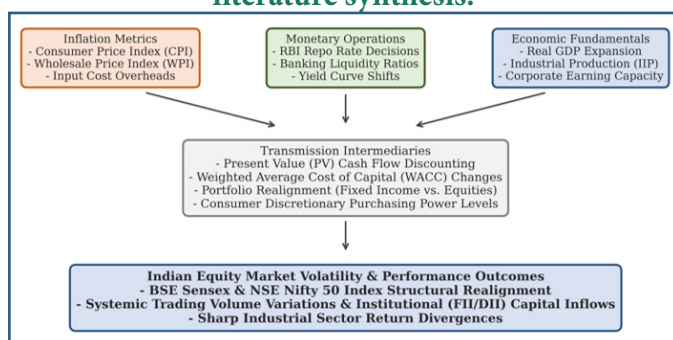
However, empirical literature also identifies unique leading and lagging properties between GDP

indicators and stock market performance. Stock exchanges operate as forward-looking information aggregators, pricing expected future changes in corporate environments six to nine months ahead. Conversely, official GDP data reflects past performance and is released quarterly by statistical agencies with inherent reporting lags. Consequently, when GDP figures are officially published, the stock market's reaction is often muted unless the metrics diverge significantly from consensus forecasts. This shows that while the long-term trajectory of the BSE Sensex tracks corporate fundamentals, short-term market movements are driven by expected growth trajectories rather than historical statistical reports.

6. CONCEPTUAL FRAMEWORK AND JOINT INTERACTION DYNAMICS

To understand the structural impact of macroeconomic forces on the Indian equity ecosystem, these variables must be analyzed as interacting parts of a unified network rather than isolated indicators. The transmission of macroeconomic changes to the BSE Sensex and NSE Nifty 50 involves both direct corporate adjustments and secondary policy feedbacks. For example, a sharp increase in raw material inflation does not merely impact corporate operating margins directly; it also alters the policy stance of the Reserve Bank of India, triggering hawkish interest rate hikes that further compress stock valuations through higher discount factors.

Fig. 3: Conceptual Framework: Macroeconomic Transmission Channels to the Indian Stock Market. Source: Organized by author from literature synthesis.



As outlined in the conceptual flowchart in Figure 3, the three macro forces flow through intermediate transmission channels before shaping market outcomes. Inflation metrics, monetary operations,

and GDP trends determine corporate financing costs, consumer purchasing choices, and corporate investment hurdles. The joint interaction of these channels explains why the Indian stock market experiences distinct regimes. For example, periods of high GDP growth accompanied by low inflation present an ideal environment for equity markets, driving strong institutional capital inflows. Conversely, high inflation paired with low growth creates high systematic uncertainty, challenging traditional asset pricing models and leading to sustained capital outflows.

7. SYNTHESIS OF KEY EMPIRICAL LITERATURE

To provide a clear conceptual summary of the empirical literature reviewed in this study, Table 1 organizes five core research papers. It details their focus areas, econometric approaches, and key findings regarding the impact of macro indicators on the Indian stock market.

Table 1: Synthesis Matrix of Reviewed Empirical Literature. Source: Organized by author.

Author & Year	Macro Variables Studied	Econometric Approach	Core Empirical Findings
Pal & Mittal (2011)	Inflation, Interest Rates, Exchange Rates, GDP	Error Correction Model (ECM) & Cointegration	Confirmed long-term cointegration. Inflation and interest rates exert significant negative impacts on BSE Sensex.
Naik & Padhi (2012)	WPI Inflation, IIP Growth, Repo Rate, Treasury Yields	Vector Autoregression (VAR) & Johansen Test	Discovered bidirectional causality between industrial growth and stock returns. Interest rates act as primary short-term triggers.
Garg & Dua (2014)	CPI Inflation, Exchange Rates, Policy Rates, GDP Output	Vector Error Correction Model (VECM)	Proved macro shocks flow through corporate credit channels. Interest rate fluctuations explain short-term equity adjustments.

Bhattacharya & Mukherjee (2002)	Real GDP Growth, Money Supply, Inflation Index	Granger Causality & Cointegration Tests	Identified stable long-term equilibrium. Real GDP growth serves as the primary anchor for corporate revenue expansions.
Kaur (2012)	Macroeconomic Indicators & Equity Volatility Metrics	GARCH Modeling Framework	Demonstrated that changes in interest rates and unexpected inflation spikes increase volatility clusterings across the NSE.

8. DISCUSSION AND STRATEGIC IMPLICATIONS

Synthesizing contemporary academic literature shows that the Indian stock market functions as a complex, highly responsive system driven by fundamental economic forces. The significant long-term cointegration between GDP expansion and equity indices confirms that long-term capital appreciation depends on underlying economic health. However, the short-term disruptions caused by interest rate adjustments and inflation spikes highlight the vulnerability of equity valuations to shifting market conditions. The strong inverse relationship between interest rates and stock index values shows that the RBI's monetary policy decisions serve as the primary short-term driver of market trends, altering corporate valuations by shifting internal capital costs and changing investor discount factors.

Additionally, these macroeconomic dynamics are influenced by international capital interactions. Foreign Institutional Investors (FIIs) are highly sensitive to interest rate differentials between the RBI repo rate and Western central bank policies, such as the US Federal Reserve funds rate. When domestic inflation rises, forcing the RBI to increase interest rates, the resulting policy uncertainty can lead to short-term capital flight by foreign funds, amplifying downward price movements on the BSE and NSE (Chakrabarti & Bhaduri, 2011). Portfolio managers and retail participants must therefore monitor global capital shifts alongside domestic macroeconomic data to manage portfolio risk effectively. Future research should focus on how the rapid growth of digital retail trading platforms and the integration of alternative

digital assets alter traditional macroeconomic transmission channels in Indian capital markets (Mishra, 2004).

9. CONCLUSION

In conclusion, this article-based review paper synthesized key empirical literature examining the impact of inflation, interest rates, and GDP growth on the Indian stock market. The gathered research highlights that while real GDP expansion provides the fundamental foundation for long-term corporate growth and rising stock valuations, short-to-medium term trends are heavily influenced by inflation spikes and central bank monetary policy changes. Inflation acts as a significant drag on equity returns by compressing corporate profit margins, while the RBI's interest rate adjustments shift corporate financing costs, alter equity discount factors, and drive capital migrations between fixed-income asset classes and equity portfolios. These findings emphasize the importance of maintaining stable macroeconomic environments and balanced policy frameworks to protect market stability. For capital market participants, developing a comprehensive understanding of these transmission mechanisms remains essential for managing systematic risks and supporting sustainable wealth creation within the Indian financial ecosystem.

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