Global Macro Research

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New US tariffs will test the RBI's neutral stance

India faces higher-than-expected US tariffs, but we expect the economic fallout to be contained. Indeed, an eventual compromise, which should allow activity to recover and reduce the need for further monetary easing, is still likely. However, the risks of further rate cuts by the Reserve Bank of India are significantly higher.

Key Takeaways

- India now faces a cumulative 50% tariff on exports to the US, a 25% baseline plus an additional 25% penalty for Russian oil purchases.
- Despite sectoral exemptions, India's trade-weighted tariff rate rises to 35%, undermining its appeal as a supply-chain relocation hub compared to regional peers.
- Prime Minister Modi is unlikely to concede to US pressure in the near term given India's low economic exposure (2.3% of GDP) to US goods demand.
- Still, we expect a trade détente, with 'face saving' compromises, before year-end, leaving India with an effective tariff rate close to around 20%.
- Assuming a trade compromise and factoring in fiscal support measures, we forecast real GDP growth of 6.8% in the fiscal year (FY) 2025/2026, but risks are to the downside.
- In our view, this is unlikely to be enough to convince the RBI to resume its rate cutting cycle this year, but risks of further rate cuts are elevated.
- If trade negotiations fail to reduce the tariff rate and the growth drag becomes more pronounced, then we would expect the RBI to deliver a further 50bps of rate cuts in December to support the economy.

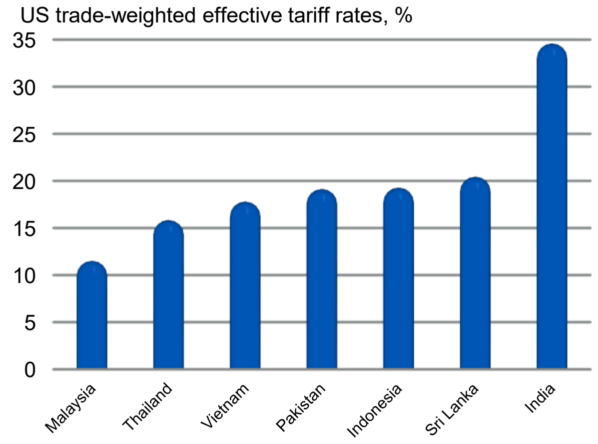
Trump turns on India

India has become an unexpected target of US President Donald Trump's tariff policy in recent weeks, as relations between the two countries sour.

Since 7 August, a baseline tariff rate of 25% has been applied to Indian goods, excluding those subject to sectoral carve-outs. However, an additional 25% tariff has also been added from 27 August due to India's purchases of Russian oil. This takes the total US import tariff on India to 50%.

In our estimation, this could bring the trade-weighted tariff rate for India to around 35%, given sectoral exemptions for pharmaceuticals, crude oil, mobile phones and semiconductors, among other goods. Nevertheless, this would put India in an unfavourable position compared to other major EMs and regional peers (see Figure 1).

Figure 1: India's tariff rate unfavourable next to peers



Source: TradeMap, Aberdeen, September, 2025

Unlike China, which has control over critical minerals, India has limited leverage over the US. However, Narendra Modi is likely to stand firm in the near term, given the economic impact from the tariffs should be manageable for India's economy: the country's goods exports exposure to the US is low (2.3% of GDP).

As such, we expect both sides will be unwilling to concede in the near term, and tensions will at least remain elevated until Trump and Modi potentially meet at the East Asia Summit in October. However, unless the differences are resolved, the 50% tariff could remain in place for longer.

India's geopolitical non-alignment is a point of tension

Trump's targeting of India's relationship with Russia has further strained relations with New Delhi, which views the additional tariff as an attempt to apply further pressure on India to concede on trade negotiations.

Since gaining independence, India has sought to be geopolitically non-aligned. And, while it supports the US in counterweighting China's influence in Asia Pacific, it is also a member of the BRICS, which Trump perceives as a challenge to US hegemony.

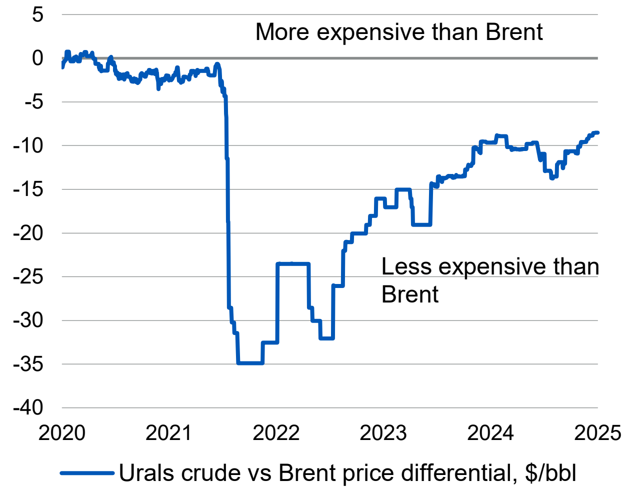
Trump has threatened tariffs on BRICS members and has engaged in public spats with all five key members in his second term. The higher tariff on India for purchases of Russian oil may in part reflect his attempts to draw divisions within the organisation.

India has been purchasing Russian oil at a price discount, in part encouraged by former US President Joe Biden. This has lowered Russia's oil revenues, allowed India to maintain geopolitical independence and avoided a major supply shock to global oil markets.

As such, India has increased its share of oil supply from Russia in recent years, from around 2% in 2020 to 35% in 2025.

This has benefited India's trade balance. Russian oil trades at a discount (see Figure 2), but the benefit has shrunk. At current prices, if India were to completely switch from Russian oil, this would only add around $3-4bn (0.1% of GDP) to India's goods trade deficit, but the cost would increase if global oil prices rose sharply.

Figure 2: The Russian oil arbitrage



Source: Refinitiv, Aberdeen, September 2025. Note: using an Urals price proxy.

India's refiners have also been able to generate better margins from imports of discounted Russian oil, with the refined products sold to global markets. The loss of this arbitrage could result in a still potentially small cost of around 0.2% of GDP to India's trade balance.

Modi has stood firm, calling on refiners – around 60% of which are state owned – to continue buying Russian oil, and Russia has offered to maintain a $5 discount to entice Indian buyers.

Other geopolitical factors have also contributed to relations worsening. Trump's intervention in the India-Pakistan conflict in May, in which he claimed credit for the eventual ceasefire, annoyed New Delhi. Trump followed this with a cordial meeting with Pakistani Army Chief Asim Munir, further irritating Indian officials.

Economic fallout to be manageable

With India now facing a significantly higher tariff rate than previously and relative to its peers, the Reserve Bank of India (RBI)'s growth forecast of 6.5% for fiscal year (FY) 2025/26, which covers the period from March 2025 to April 2026, is at risk of being missed.

We think the drag on growth could become visible over a multi-year horizon if the tariffs remain in place. The near-term impact of the tariffs should still be manageable given India's low exposure to US goods demand and the tailwinds for the domestic growth outlook.

We continue to expect a strengthening of domestic demand as several factors drive household consumption. Soft inflation, easing monetary policy, higher rural incomes and an improved labour market, should all support a pickup in consumption.

And the Indian government is reportedly preparing to provide INR 40bn of credit guarantees for small businesses and exporters, as support amid the trade uncertainty.

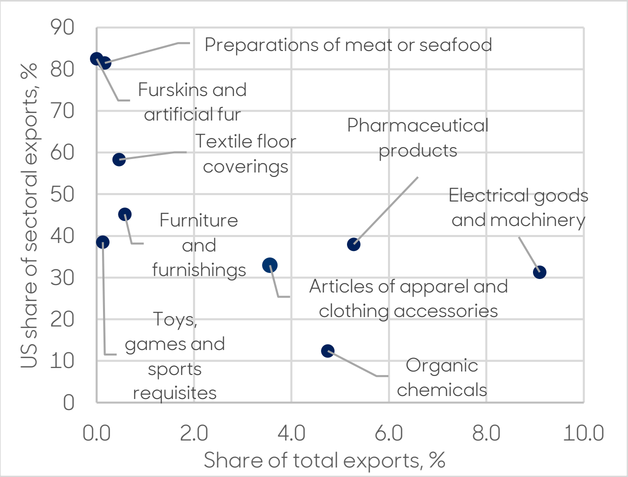
Moreover, reforms of the Goods and Services Tax – a simplification of the tax groupings, which is expected on balance to reduce tax rates – should prove a fiscal boost to consumption and investment in 2026.

Our view is that a trade deal will ultimately be agreed by year-end, with India and the US finding a 'face saving' compromise that would see India's baseline tariff rate fall to around 20% and some sectoral carve-outs.

Modi is aware that access to India's growing consumer market is a bargaining chip and could offer more longer-term purchase commitments around military, aircraft, semiconductor and energy goods. India could also offer to comply with any further tightening of US sanctions on Russian oil trade.

Risks clearly stem from a worsening of relations with the US and further sectoral tariffs. Were Trump to move ahead with his threat of higher sectoral tariffs on electrical and pharmaceutical goods, India could suffer from a broader reduction in US imports of such goods (see Figure 3).

Figure 3: India's most US demand-dependent exports, not significant to its overall export basket



Source: TradeMap, Aberdeen, September 2025

More generally, the longer India faces unfavourable US tariff rates, the more damaging it is likely be to the sectors highly exposed to US demand. In particular, labour-intensive exports such as jewellery, apparel and textiles goods, could shed jobs or at least curtail hiring ambitions.

India's ability to benefit from shifting global supply chains and become a 'reshoring winner' could be dented. This would dampen some of investors' optimism around India's longer-term potential growth path.

Made In India looks to new markets

The trade difficulties with the US underscore the need for diversification in India's export push, particularly if the US becomes more protectionist moving forward.

Manufacturing still only accounts for 12% of India's economy, whereas the middle-income average is around 22% according to the World Bank. India is unlikely to be able to raise its potential growth and create the employment for its growing workforce without a larger manufacturing sector.

However, there are signs of some renewed appetite to embrace trade by the Modi administration. Having signed a free trade agreement with the UK in July, Modi has also been pushing to secure trade deals with the EU and regional agreements such as with the GCC or European Free Trade Association to gain access to new markets.

And as a sign of Modi's awareness of the need to embrace global trade, he travelled to China for the Shanghai Cooperation Organisation summit at the end of August. This marked Modi's first visit to the country since relations deteriorated over border tensions in 2020.

India's resistance to Chinese investment has hampered its ability to integrate into Asia's supply chains. Indeed, we do not expect geopolitical alignment between the two countries, given long-standing issues over borders and China's relations with Pakistan.

Still, the seeming détente with President Xi could set a path to increased investment and a pivot towards the growing consumer market on its doorstep.

The RBI is sensitive to downward growth revisions

Uncertainty around trade complicates the RBI's decision-making process. At its August meeting, the central bank took a more neutral stance than some market participants were anticipating. The monetary policy committee voted unanimously for a hold, despite the RBI revising down its inflation forecasts (see Figure 4).

Figure 4: Inflation likely to undershoot RBI's forecasts

FY2025/26	RBI forecast (April)	RBI forecast (June)	Actual	Global Macro Research forecast
Q1	2.9		2.7	
Q2	3.4	2.1	1.5*	2.0
Q3	3.9	3.1		2.4
Q4	4.4	4.4		4.3

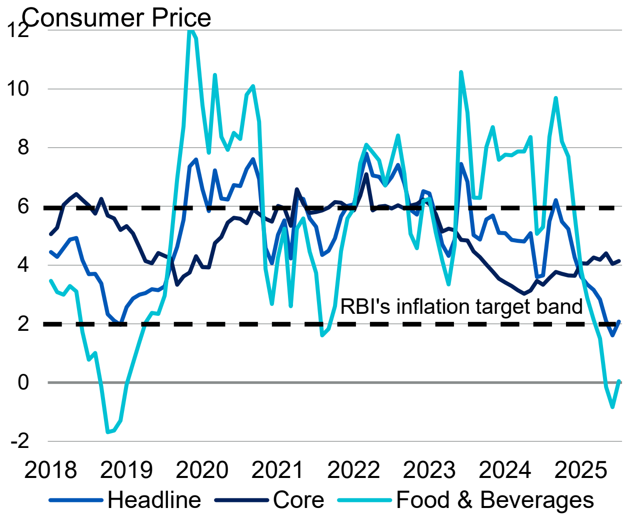
Source: Haver, RBI, Aberdeen, September 2025. Note: * reflects we only have the July inflation print for Q2 FY2025/26.

Year-over-year headline inflation came in at 2.1% in August. Importantly, food prices have been in deflation since the turn of the year, and energy prices have been well behaved.

However, the RBI's decision was more forward-looking, noting the likely pickup in inflation in future quarters.

It also pointed to core inflation, which came in at 4.1% year over year in August, just above the central bank's 4% target midpoint (see Figure 5).

Figure 5: Falling food prices drag Indian inflation lower



Source: Haver, Aberdeen, September 2025

With household demand likely to strengthen, we expect inflation to average 4.9% in FY 2026/27. But we see risks as more to the downside given the positive outlook for food prices. The monsoon season has progressed well, albeit with regional variances. Reservoir levels are at a decade-high, boding well for future agricultural output.

Even if India was to switch away from Russian oil, the inflationary impact would likely be muted by increased supply by other oil producers and government offsets.

That said, the RBI's confidence in the economy also factored into the August decision. Growth forecasts were left unchanged despite the trade headwinds.

This confidence has likely dimmed following the additional 25% tariff. But, given the unanimity of the August hold decision, a cut would require a significant sentiment shift at the central bank.

We think the RBI will take a more dovish stance at its October meeting but keep its policy rate on hold through year-end, in part because the RBI already committed to cutting its cash reserve ratio 100bps from September to November. And this liquidity injection should help the transmission of the RBI's prior cuts into the domestic economy.

That said, if no progress is made on reducing the tariff rates faced by Indian exporters before year-end and tensions remain elevated, the RBI would need to do more to mitigate the growth impact. In this instance, we would not rule out the possibility of the RBI delivering another 50bps policy rate cut at its December meeting.

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