

US tariffs on the horizon: How will India's economy be affected?

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Introduction

US trade policy is expected to change significantly under the new administration, with an anticipated average tariff increase of 10 to 20 percentage points on all imports.¹ Tariffs as high as 100 percent may be imposed on imports from select countries to address trade imbalances and to boost domestic manufacturing in the United States. India is one of the countries that may be significantly impacted by this policy change. Total merchandise trade between India and the United States increased rapidly in the past decade, rising from US\$53 billion in 2014 to US\$78 billion in 2022 (World Bank, 2024). The United States became India's top trading partner in 2022, accounting for 11 percent of India's total trade. India, in turn, accounts for around 2.5 percent of the total US trade.

Although India has a trade deficit overall, it is a net exporter to the United States. This partly reflects differences in current tariff schedules. In 2022, for instance, India imposed tariffs of around 32 percent on agricultural products, 10 percent on mining products, and 30 percent on manufacturing products from the United States. In contrast, US tariffs on imports from India on these products were only 3.2 percent, 0.5 percent and 5.0 percent, respectively (World Bank, 2024). This provides some justification for the new US administration to raise tariffs on Indian imports, and would follow a recent trade dispute between these countries in 2018 and 2019 (Athukorala, 2020).

¹ <https://www.brookings.edu/articles/tariffs-on-all-imports-would-create-chaos-for-business/>

It is likely that the Indian economy will be affected more by a shift in US trade policy than the United States. This note summarizes results from a rapid assessment—using an economywide model of the Indian economy—of the potential impacts of a US trade policy shift on India’s trade, gross domestic product (GDP), employment, and household income. We consider three scenarios. The first considers the initial impact of US tariff increases, which will likely dampen US demand for Indian imports, while the second considers a situation where India reciprocates by imposing even higher tariffs on US imports. The third considers a scenario where India offers tariff concessions as a preemptive measure to avoid higher US tariffs.

Methodology

We employ an economywide model for India to assess the impact of higher US tariffs and policy response options for India. The model itself is IFPRI’s dynamic computable general equilibrium (CGE) model (Thurlow, (2008)), calibrated to a recent economywide database for India (IFPRI, (2024)). The model runs over five years, and economic impacts—we focus on GDP (including by economy sector), employment, and household income—are reported as average percentage changes relative to a “business-as-usual” baseline that assumes no change in policy.

Although global trade models are best suited for assessing impacts of trade policy shifts on global trade flows and commodity prices in a multicountry setting, the use of a single-country model is appropriate given our interest in understanding the more detailed distributional and welfare impacts within the Indian economy. For instance, our model captures production and employment in 87 economic sectors and measures income and consumption changes for rural (including farm and nonfarm) and urban households, all disaggregated by per capita expenditure quintile. It also permits a rapid assessment of potential implications for India, especially at a time of great uncertainty about how US policy changes may eventually play out.

Table 1 describes the different scenarios. Scenario 1 examines the impact of US tariff increases on the Indian economy. Since we use a single-country model with exogenous global commodity prices, we assume that for every given tariff increase in the United States (that is, ranging from 5 to 50 percentage points over baseline US tariffs), US demand will fall, resulting in a decline in revenues of Indian exporters. As a proxy for this impact, we reduce the world price of exports earned by Indian exporters. The simulated revenue shock accounts for the commodity-specific shares of US exports in India’s export basket.²

² Adjusted world price of export in India = Baseline world price of export + (percentage point increase in US tariff rate * share of import from India).

Table 1: Description of tariff scenarios

Scenario	Definition	Assumptions/anticipated impacts
Scenario 1: United States imposes tariffs	United States imposes higher tariffs on imports from India	Higher US tariffs—ranging from 5 to 50 percentage points over their baseline—make Indian products dearer in the US market, resulting in lower demand and revenue losses for Indian exporters.
Scenario 2: India reciprocates	Same as scenario 1, plus India reciprocates by imposing higher tariffs on imports from the United States	In addition to higher US tariffs, higher Indian tariffs—ranging from 5 to 50 percentage points over their baseline—are imposed on US imports. This offers some protection to Indian producers but raises the cost of imports for Indian consumers.
Scenario 3: Preemptive action	India preemptively offers tariff concessions on imports from the United States to avoid a trade dispute	India lowers import tariffs on US imports—ranging from 5 percent to 50 percent points (or zero-rating) below baseline Indian tariffs. This removes the protection enjoyed by Indian producers but reduces the cost of imports for Indian consumers.

Source: Authors' compilation.

Scenario 2 replicates the US tariff shock from scenario 1 and, additionally, simulates the effect of reciprocal Indian tariff increases on US imports (that is, ranging from 5 to 50 percentage points over baseline Indian tariffs). Modeled tariff increases are weighted by the commodity-specific shares of US imports in total imports.³ Scenario 3 is distinct from the others because it assumes no change in US trade policy; instead, we model a hypothetical scenario where India preemptively offers to reduce tariffs on US imports (that is, ranging from 5 to 50 percentage points below baseline Indian tariffs). Note, tariffs are zero-rated if the assumed percentage point tariff reduction exceeds the baseline tariff rate for a commodity. Tariff reductions are weighted by the commodity-specific shares of US imports in total imports.⁴

³ In case of reciprocal tariff, the adjusted tariff collection rate in India = baseline tariff collection rate + percentage point tariff hike, where the percentage point tariff hike = (proposed tariff hike rate – baseline tariff collection rate) * share of the United States in India's import, if the proposed tariff hike rate – baseline tariff collection rate >0.

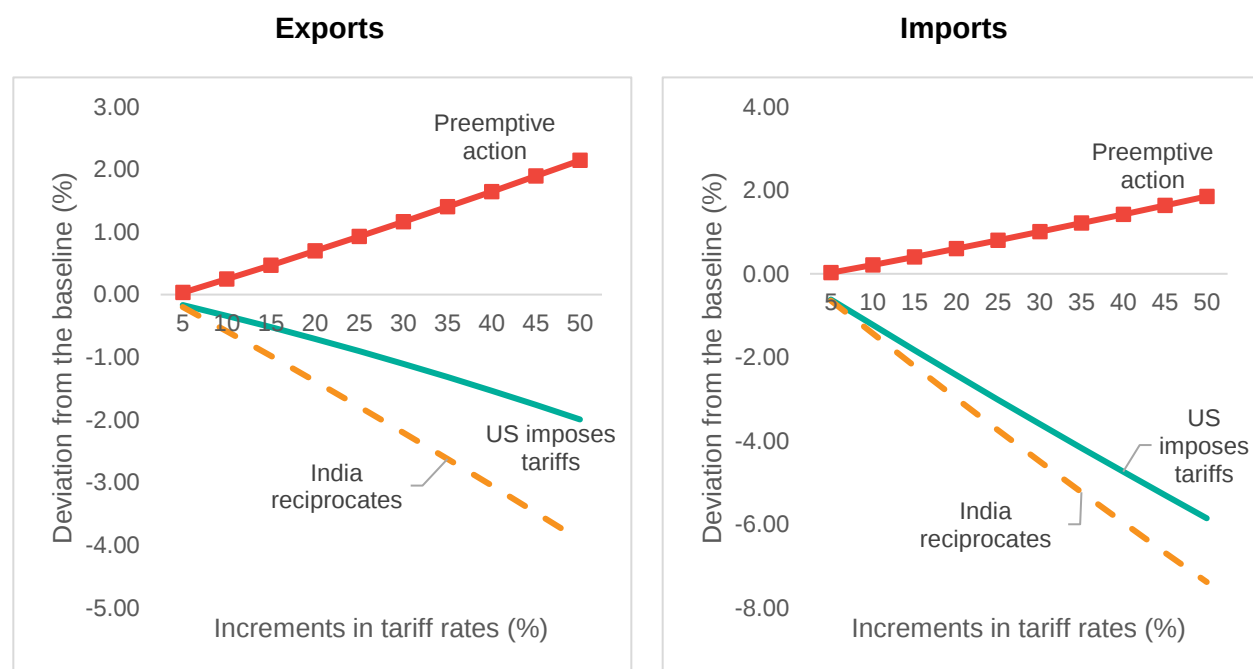
⁴ In case of tariff concession, the adjusted tariff collection rate in India = baseline tariff collection rate - percentage point tariff concession, where the percentage point tariff concession = (proposed tariff concession rate – baseline tariff collection rate) * share of the United States in India's import. If the proposed tariff concession rate – baseline tariff collection rate <0, we assume zero tariff.

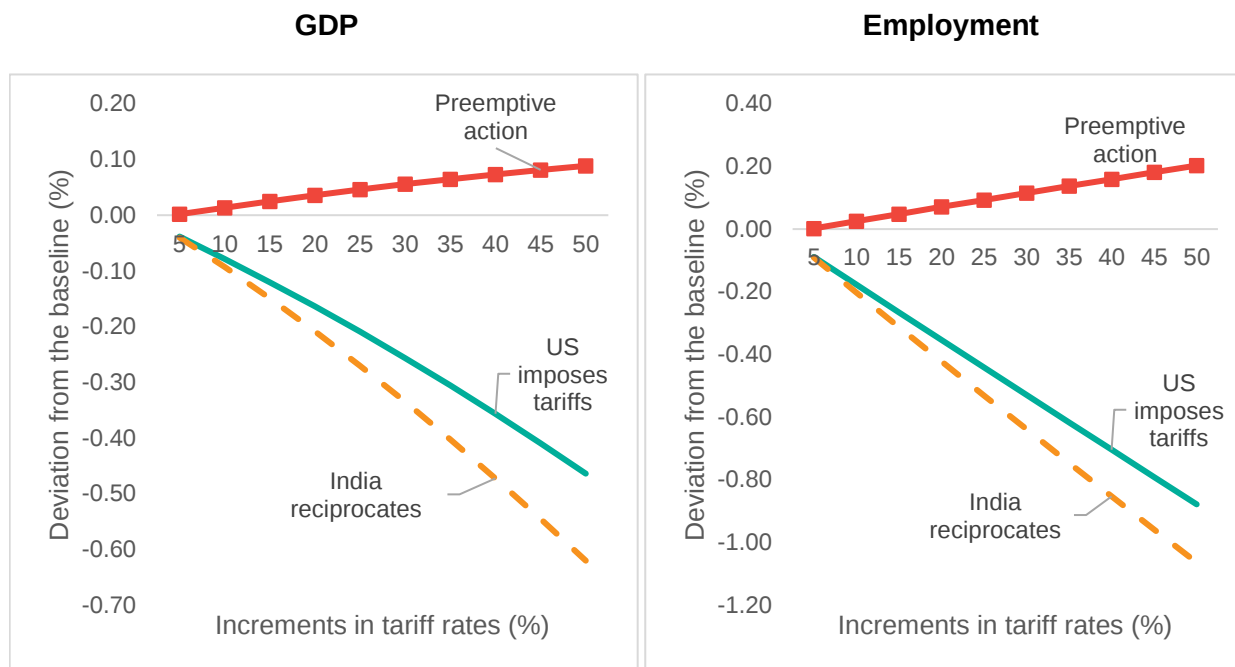
Results and discussion

Impact on international trade

In scenario 1, India's export revenues are, on average, 0.2 to 2.0 percent lower than the baseline over the simulation period. This reduction depends on US tariff rates (Figure 1). Since India is a trade-deficit country, the fall in total export increases the size of the trade deficit, which leads to a fall in foreign currency reserve and a depreciation of local currency (Indian rupees). This makes Indian imports costlier. Compared to the baseline, the import demand in India is 0.6 and 5.9 percent lower on average. In this situation, if India reciprocates (scenario 2), the domestic price of imports in India rises more, resulting in a further decrease in import demand. Figure 1 shows that import demand under scenario 2 falls between 0.6 and 7.4 percent, significantly higher than the fall observed in scenario 1. Although the depreciation of local currency has a favorable impact on exports, the costly imports increase the cost of production in the domestic market and make Indian products less competitive in the world market. As a result, exports fall more sharply under scenario 2 compared to scenario 1 (Figure 1).

Figure 1: Impact on macroeconomic indicators





Source: Model simulation results.

Impact on GDP

In both scenarios 1 and 2, India's imports fall more than the export corresponding to any rate of additional tariff imposed by both countries. This pushes the trade deficit down and should have a positive effect on the Indian GDP. In contrast, GDP declines in both scenarios, with a greater decrease observed in scenario 2 than in scenario 1 (Figure 1). For example, if the United States hikes import tariffs by 50 percentage points, India's GDP falls by 0.5 percent on average over the baseline (scenario 1) versus a 0.6 percent fall if India reciprocates with similar tariffs (scenario 2) (Figure 1). The decline in exports leads to reduced domestic production and lower demand for primary factors, resulting in higher unemployment and a fall in household income, all contributing to the GDP decline.

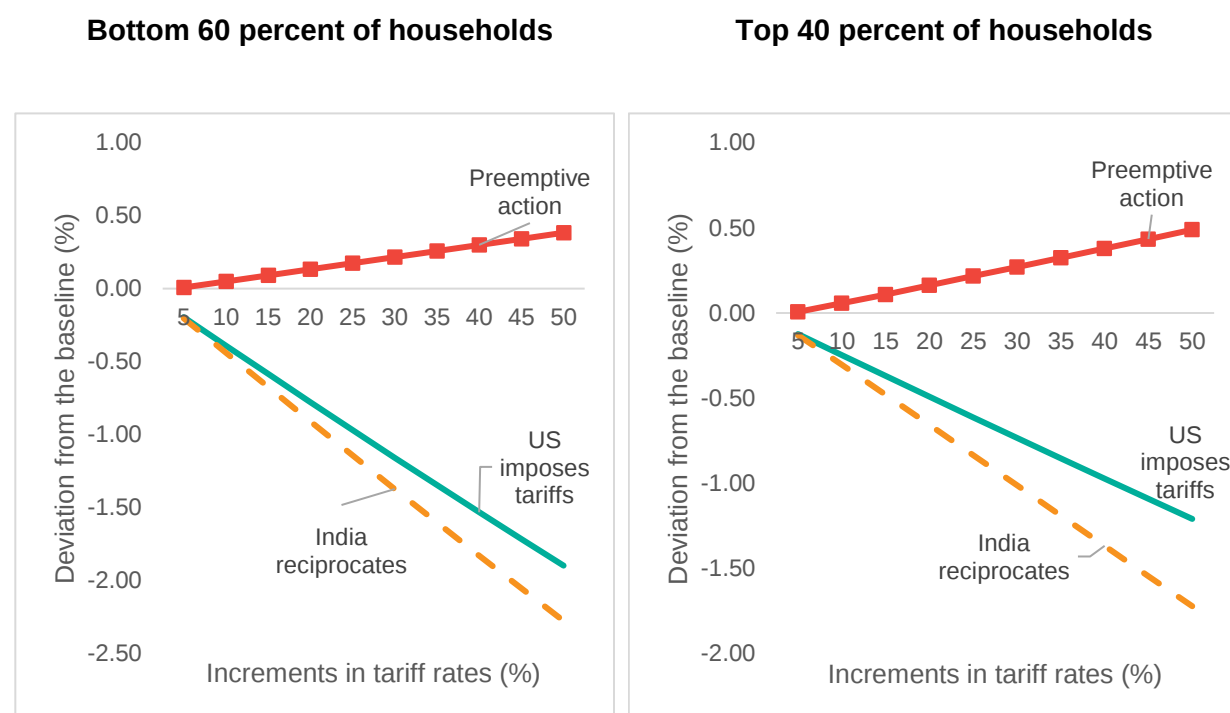
Imposing tariffs generates inefficiencies in resource allocation due to changes in production and trade. These changes affect different sectors in varying ways, depending on their linkages with other sectors of the economy. Simulated results show that textiles and clothing, wholesale and retail trade, and construction are the most adversely affected sectors. For example, in scenario 1, the United States increases tariffs by 50 percentage points. This increase results in a decline

of 1.9 percent in textiles, 1.1 percent in wholesale trade, and 1.0 percent in construction on average, compared to the baseline, over the simulated period. If India reciprocates with similar tariff hikes in scenario 2, these declines worsen to 2.4 percent, 1.3 percent, and 1.2 percent, respectively. On the other hand, the service sector sees the most growth in both scenarios, benefiting from a weaker rupee. However, despite gains in services, India's overall GDP declines in both scenarios due to greater losses in the vulnerable sectors.

Impact on employment and household income

Figure 1 reveals that in scenario 2, employment and household income are more adversely affected than in scenario 1. For example, if India does not reciprocate, employment in India falls between 0.1 and 0.9 percent on average, depending on the tariff rates imposed by the United States. On the other hand, if India reciprocates with similar tariff hikes, the fall is between 0.1 and 1.1 percent. This fall in employment results in a decrease in Indian household income. Like other macro indicators, the fall in household income is also higher under scenario 2 than in scenario 1 (Figure 2). Households are classified into two groups based on the expenditure quintile: the bottom 60 percent and the top 40 percent. The bottom 60 percent of households are the approximately 800 million beneficiaries out of India's total 1.4 billion population who receive free food grain under the Government of India's National Food Security Act. In scenario 1, the bottom 60 percent of households experience, on average, a 1.9 percent income reduction over the baseline, corresponding to a 50 percentage point increase in tariffs. This reduction increases to 2.3 percent in scenario 2. Therefore, if India retaliates with higher tariffs, the bottom 60 percent of households suffer with an additional 0.4 percentage point decrease in income. On the other hand, the top 40 percent of households experience a loss of income of 1.2 percent in scenario 1 and 1.7 percent in scenario 2. This means that India's reciprocity policy causes an additional 0.5 percentage point decline in income for the top 40 percent of households. As high-income households consume more imported products than low-income households, the adverse consequences of reciprocity are greater for the top 40 percent of households than for the bottom 60 percent. In short, both scenarios negatively impact household income, and more importantly, the trade protection measures implemented by the Indian government do not reverse this trend.

Figure 2: Impact on Indian household income



Source: Model simulation results.

Preemptive action

It is evident from the analysis above that India should explore alternative policy options instead of relying on tariff reciprocity to mitigate the potential negative impact on its economy caused by the United States imposing higher tariffs on Indian exports. In this regard, we consider India giving tariff concessions. A perusal of Figures 1 and 2 shows that such tariff concessions would have a positive effect on key macroeconomic indicators of the Indian economy. In scenario 3, for instance, implementing a tariff concession of 50 percentage points results in a slight 0.1 percent improvement in GDP compared to the baseline. Conversely, in scenario 1, imposing tariffs of the same magnitude leads to a 0.5 percent decline in GDP. However, India may want to negotiate with the United States before offering tariff concessions.

Conclusion and policy recommendations

India and the United States share a strong bilateral trade relationship. The United States is one of few countries with which India has a positive trade balance. Therefore, any shift in US tariff policy will significantly impact the Indian economy. In this note, we presented results from a single-country economywide model that was used to assess the impact of bilateral tariff policy on the Indian economy. The following policy insights emerged.

First, an increase in US tariffs on Indian imports has an adverse impact on India's exports, GDP, employment, and household income. Since India is a net exporter to the United States and since trade with the United States accounts for 11 percent of India's overall trade, the country is relatively exposed and significantly more vulnerable to trade policy shocks than the United States (for example, trade with India accounts for only 2.5 percent of overall US trade).

Second, should India choose to reciprocate by raising its own tariffs on US imports, the adverse impacts on the Indian economy will worsen. Higher import tariffs will make imports costlier and further weaken the Indian currency. Domestic production costs will increase, which in the longer run can harm investments, lower productive capacity, and slow down the pace of job creation and income growth in the Indian economy. These results, while preliminary, suggest there are no good economic reasons for India to engage in a trade dispute with the United States.

Third, if India preemptively offered tariff concessions to the United States to avoid higher US tariffs, adverse consequences on the Indian economy could be avoided altogether. In fact, our analysis shows that tariff concessions will result in a slight increase in exports, GDP, employment, and income. Of course, Indian tariffs do have the effect of shielding some domestic producers from foreign competitors, and while the overall impact of trade liberalization is positive for India, some sectors may be adversely affected.

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