

# Global Uncertainty and Impact on Indian Financial Markets

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Tariffs are a key element of President Trump's economic agenda. Since taking office, President Trump has introduced several tariff actions, including a 20% additional tariff on all goods from China and a 25% tariff on goods from Mexico and Canada, with Canadian oil subject to a lower 10% rate. However, tariffs on auto imports from Mexico and Canada were later postponed by a month, while tariffs on goods meeting United States-Mexico-Canada Agreement (USMCA) requirements were delayed until 02 April. President Trump has also imposed sector-specific tariffs, such as a 25% tariff on all steel and aluminium imports and a 25% tariff on auto imports. He has warned of targeting other industries too, including semiconductors and pharmaceuticals. He has also threatened to impose reciprocal tariffs on other economies, details of which will be revealed on 02 April.

Uncertainty around trade policy has grown due to fluctuating tariff announcements and the potential for further tariff hikes. Retaliatory measures from countries like the EU, Canada and China have increased risks to global trade and growth. Amidst these uncertainties, the OECD recently downgraded its global growth forecast for 2025 to 3.1% (from 3.3% previously) and for 2026 to 3.0% (down from 3.3%).

Global financial markets have remained highly volatile amidst these trade uncertainties. In the sections below, we look at the potential implications of rising global uncertainty for the Indian economy and financial markets in detail.

India faces the risk of reciprocal tariffs from the US. Our analysis, based on certain assumptions, suggests that India's direct export loss due to such tariffs could be limited to around 0.1% of GDP. However, the broader impact of a global trade war could be more significant through various indirect channels, including weaker exports, investment and consumption sentiment, and potential pressures on capital flows and currency.

FPI flows are likely to remain volatile amidst global uncertainties, putting pressure on the rupee. We expect the USD/INR to trade with a depreciation bias, around 88-89 by the end of FY26. We expect the RBI MPC to cut the policy rate by 25-50bps in FY26 due to moderating inflation and the need to support growth. However, the RBI will also take cues from global developments.

## **Volatile Global Markets**

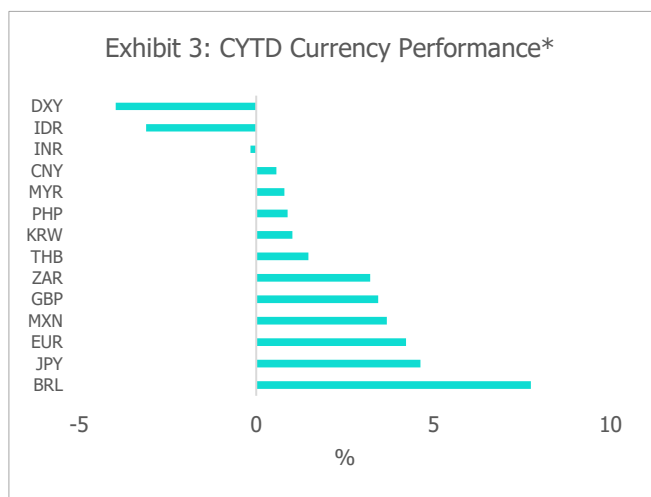
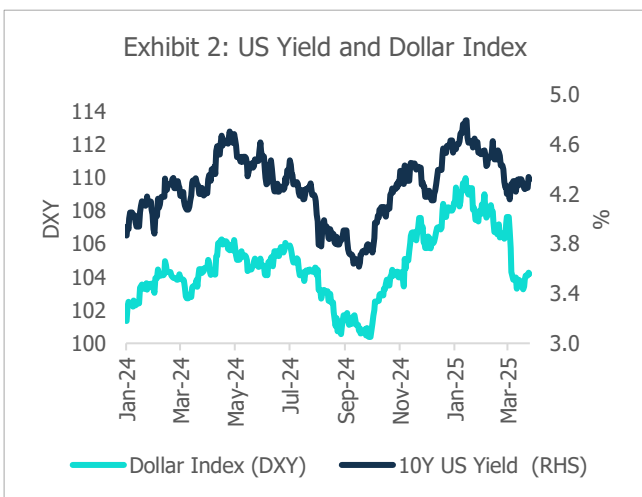
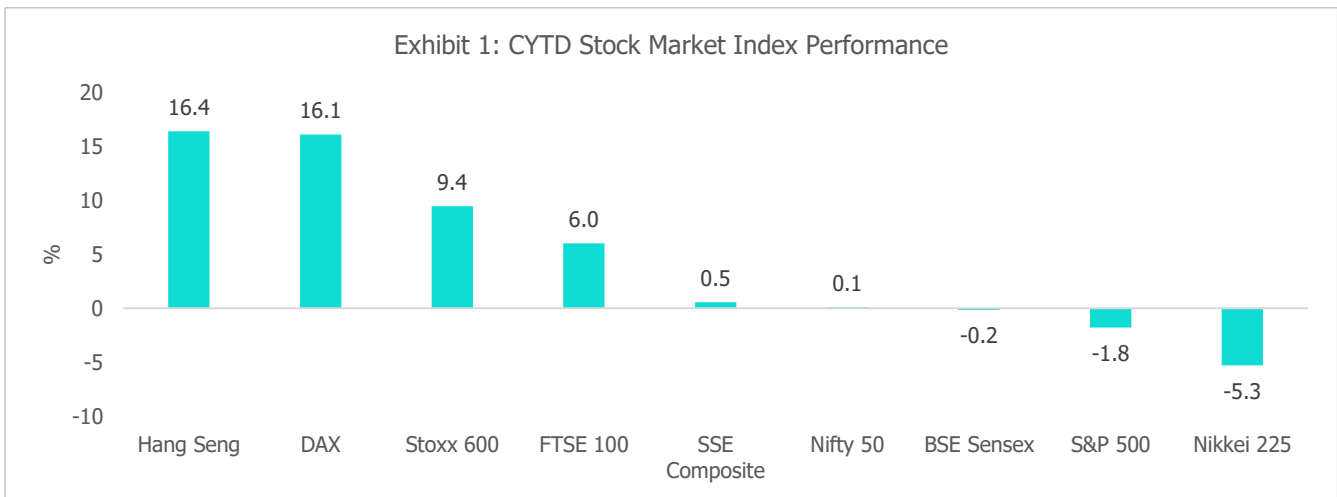
Concerns about growth amidst unpredictable trade policies have triggered a sell-off in US equities. The S&P 500 Index is down 6% from its February 2025 peak. The index has now returned to pre-election levels. Meanwhile, Chinese and European markets have performed well. Chinese stocks have benefitted from an AI-driven boost, while European equities have gained support from Germany's fiscal policy shift and increased infrastructure and defence spending. The Hang Seng index has risen 16% CYTD, while the DAX and Europe Stoxx 600 have gained 16% and 9%, respectively. In contrast, Indian equities have remained flat (Refer to Exhibit 1).

The 10Y US yield has fallen to 4.3%, down from its 4.8% peak in January 2025 (Refer to Exhibit 2). The US dollar index (DXY) initially strengthened by 9% between October 2024 and early January 2025, reaching a peak of 109.96 on 13 January. However, it has since declined sharply by 5% to around 104 level. Apart from concerns about growth, a stronger euro has also weighed on the dollar. The euro has strengthened by 4% CYTD, supported by market optimism over Europe's growth prospects. Most other major currencies have also appreciated against the

dollar in 2025 (Refer to Exhibit 3). The Japanese yen has strengthened by 4.6%, the British pound by 3.4%, and the Chinese yuan by 0.6%. In contrast, the Indian rupee and Indonesian rupiah have depreciated by 0.2% and 3.1% CYTD, respectively.

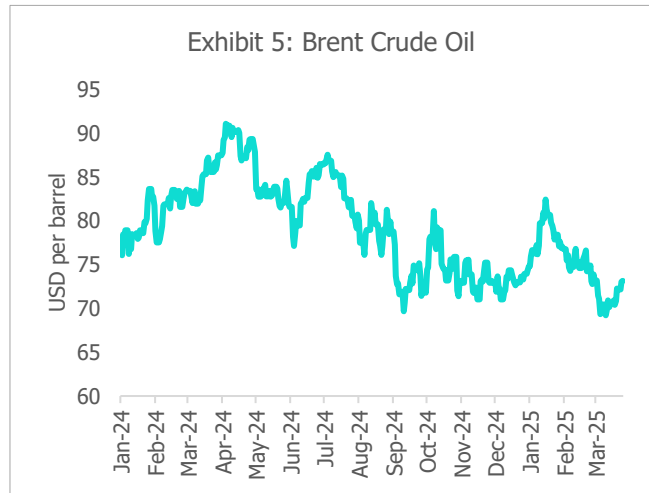
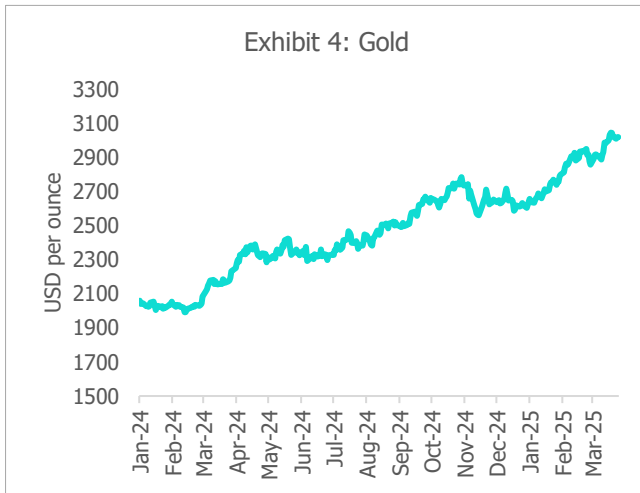
Gold prices have surged 15% in 2025, trading near a record high of USD 3,000 per ounce (Refer to Exhibit 4), driven by safe haven demand.

Meanwhile, trade tensions have weakened the global demand outlook, causing crude oil prices to fall by 11% from their January 2025 peak (Refer to Exhibit 5). Brent crude oil is currently trading near USD 73 per barrel. Other factors, such as OPEC+ output hikes and the US' push for increased oil production, have also contributed to lower oil prices.



Source: Refinitiv. Data as of 25 March 2025.

\*Note: Negative values imply currency has weakened. DXY measures the dollar's performance against a basket of currencies, while the performance of other currencies is measured against the USD.



Source: Refinitiv. Data as of 25 March 2025

### Lower Growth and Higher Inflation Expected in the US

Recent economic data for the US has been disappointing, raising concerns about growth. The ISM Manufacturing PMI fell to 50.3 in February 2025 from 50.9 in January, with the new orders PMI falling sharply to 48.6 (contractionary zone) from 55.1 in January. The US economy also added fewer jobs than expected in February (151k vs forecasts of 160k), while the number of jobs added in January was revised down (to 125k from 143k). The unemployment rate rose to 4.1% in February from 4.0% in January. Retail sales increased by only 0.2% month-on-month in February, below the 0.6% forecast. Additionally, the University of Michigan's consumer sentiment index fell for the third consecutive month to 57.9 in March, its lowest since November 2022.

In its March meeting, the Fed left its policy rate unchanged but lowered its GDP growth projections. The 2025 GDP growth projection was revised down to 1.7% from 2.1%, for 2026 to 1.8% from 2%, and for 2027 to 1.8% from 1.9%. The 2025 unemployment rate projection was slightly raised to 4.4% from 4.3%, while projections for 2026 and 2027 remained unchanged at 4.3%.

US CPI inflation eased to 2.8% in February from 3% in January, while core inflation stood at 3.1%. However, inflation remains well above the Fed's 2% target. With the ensuing trade war, there are concerns around inflationary impact of the same on the US economy. The one-year ahead inflation expectations jumped to 4.9% in March from 4.3% in February (University of Michigan Consumer Survey), marking the fourth consecutive month of increase. Additionally, the five-year ahead inflation expectations rose to 3.9% in March, the highest in nearly 30 years. The Fed also raised its inflation projections in its March Summary of Economic Projections. The PCE inflation forecast for 2025 was raised to 2.7% from 2.5% and the core PCE inflation was raised to 2.8% from 2.5%. For 2026 also the inflation projections have been marginally revised upwards by the Fed.

While rising inflation expectations are a concern, market pricing suggests the Fed may cut rates to support the economy. Markets now expect two to three rate cuts in 2025, up from one initially expected at the start of the year. These cuts are expected in H2 2025 and will be in addition to the 100bps of rate cuts in 2024. The March Fed dot plot indicates two rate cuts in 2025, unchanged from December's projection.

Globally, central banks are closely monitoring the rise in trade policy uncertainties. In March, the Bank of England kept its policy rate unchanged amidst persistent inflation and global economic uncertainties. The Bank of Japan also held its key interest rate steady and highlighted potential risks to economic activity and prices from the evolving trade situation.

### **India at Risk of Reciprocal Tariffs**

India's goods trade surplus with the US has doubled over the last decade, reaching USD 35 billion in FY24. Additionally, India imposes higher tariffs on US imports, with a simple average tariff rate of around 12%, compared to the US tariff rate of around 3% on Indian imports. This makes India vulnerable to reciprocal tariffs from the US.

If we make the simplistic assumption that the US imposes an additional 8% tariff on all imports from India, our analysis suggests that India's direct export loss from such tariffs could be limited to around USD 3.1 billion annually, which is approximately 0.1% of GDP. This estimate assumes the price elasticity of demand for India's exports to the US is 1. The analysis also assumes some rupee depreciation, which would offset part of the impact of higher tariffs. However, the exact nature of reciprocal tariffs is not clear. The impact could be more severe if they also include indirect taxes or any non-tariff barriers.

India's domestically driven economy may offer some resilience, with exports of goods and services accounting for 21% of GDP as of FY24. In fact, the share of goods exports alone is even lower, at 12% of GDP. In contrast, some other Asian economies, such as Thailand, have a much larger export dependency, with goods and services exports accounting for around 60% of GDP. Nevertheless, the tariff war would still affect India through various indirect channels. India's overall exports (goods and services) would feel the pinch as global trade and growth slow amidst rising trade tensions. India could also face weaker investment and consumption sentiments in midst of these uncertainties, as well as potential pressures on capital flows and currency. As a result, the overall impact of tariffs on India could be more significant than the direct impact alone.

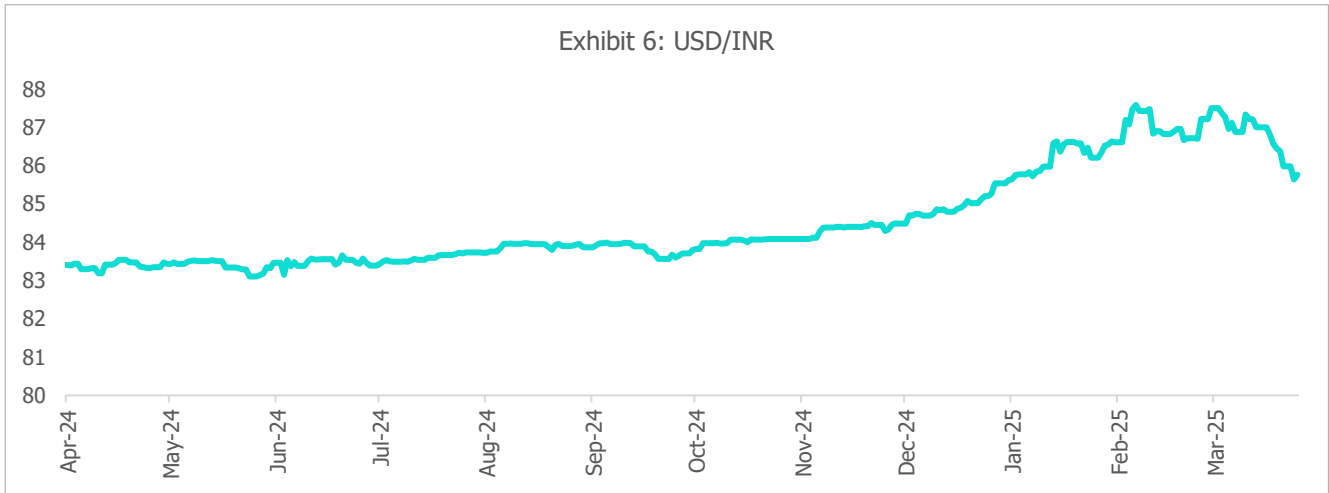
### **Indian Rupee Weakens but Shows Some Signs of Recovery**

The Indian rupee traded in a narrow range of 83-84 in H1 FY25 (Refer to Exhibit 6), supported by the RBI's interventions. However, it weakened by a sharp 4.4% against the dollar between October 2024 and February 2025, primarily due to high foreign portfolio investment (FPI) outflows. During this period, FPIs pulled out a net USD 23 billion from Indian markets, mainly from equities. Rising US yields and a stronger dollar around the US election drove the outflows. Domestic factors also weighed on investor sentiment, including concerns over slowing economic growth, modest corporate earnings and worries about equity market overvaluation.

The RBI also appears to have become more tolerant of rupee depreciation in H2 FY25 amidst concerns about its overvaluation. India's 40-currency trade-weighted real effective exchange rate (REER) touched a record high of 108.1 in November 2024, indicating the currency was significantly overvalued. However, following the rupee's decline, the REER corrected to 102.4 by February 2025, suggesting the currency was no longer overvalued compared to its 5Y average of around 104.

In recent days, the rupee has shown signs of recovery, appreciating by around 2% in March (as of 25 March), supported by a weaker DXY and India's better-than-expected trade data. India's goods trade deficit narrowed sharply to around USD 14 billion in February 2025 from USD 23 billion in January. Meanwhile, services net exports remained strong at USD 18.5 billion in February, resulting in a total trade balance (goods and services) surplus of around USD 4 billion. FPI flows have also improved. In March 2025 (up to 25 March), there have been net FPI

inflows of USD 2 billion, following two consecutive months of outflows. These inflows were driven by a pickup in debt inflows, while outflows from equities moderated.



Source: Refinitiv. Data as of 25 March 2025

### Rupee to Trade with a Depreciation Bias in FY26

India's current account deficit is expected to remain manageable in FY26 supported by healthy services exports; however, FPI flows are likely to stay volatile, putting pressure on India's balance of payments and the rupee. Moreover, external factors - such as a potential yuan depreciation to mitigate tariff impact – could further intensify depreciation pressures on the rupee.

We expect the USD/INR to be trading around 88-89 by the end of FY26, with RBI interventions helping to limit excessive volatility. However, the outlook faces risks from any stronger rebound in the DXY, a sharp rise in oil prices or significant yuan depreciation.

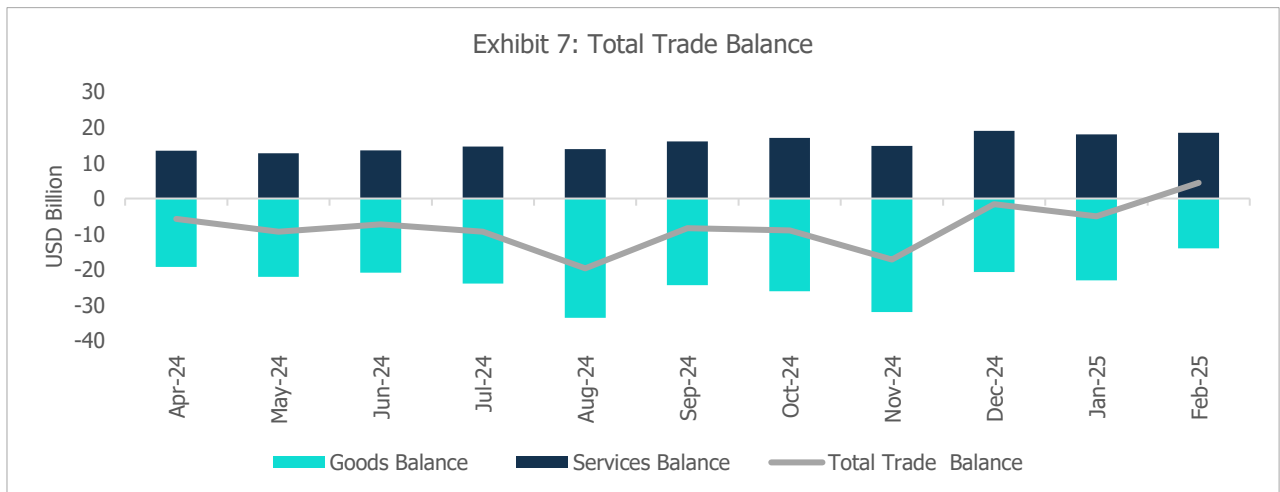
#### A. FY26 Current Account Deficit to be Manageable at 1.1% of GDP

India's current account deficit (CAD) is likely to widen in FY26 against the backdrop of a global trade war. A slowdown in goods exports is expected, reflecting a broader decline in global trade and growth. Simultaneously, imports may increase if US tariffs lead some countries to dump goods into India.

While services exports may face some pressure from a global slowdown, they are expected to remain resilient enough to cover a significant portion of the goods trade deficit. Services exports have grown at a CAGR of 12% over the last six years – twice the growth rate of goods exports. As of FY24, net services exports covered ~67% of the goods trade deficit, representing a significant increase from 23% in the early 2000s.

Additionally, crude oil prices are expected to remain favourable, ranging between USD 65-75 per barrel during FY26, driven by low demand, OPEC+ output hikes and the US' push for higher oil production.

We have revised our FY25 CAD estimate to 0.7% of GDP from 0.9% earlier, supported by recent data showing a narrower goods trade deficit and strong services exports (Refer to Exhibit 7). However, we expect the CAD to widen to 1.1% of GDP in FY26 due to a slowdown in global trade, although it is likely to remain manageable.

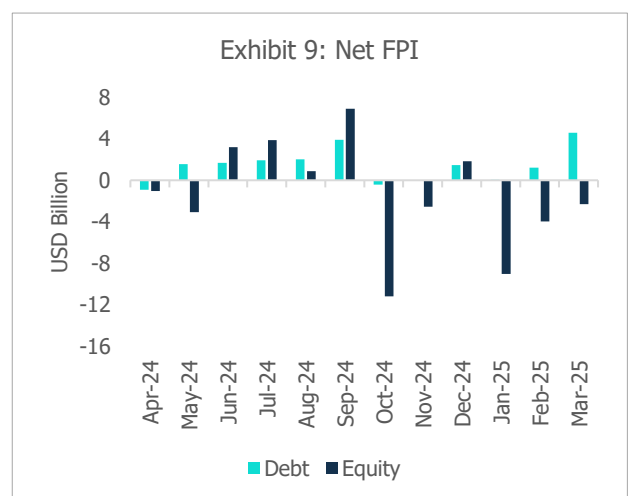
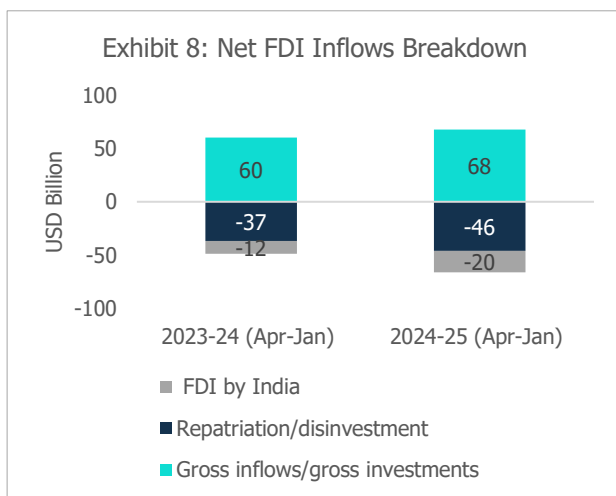


Source: CMIE

**B. Capital Flows to Remain Volatile in FY26**

Net foreign direct investment (FDI) inflows amounted to USD 1.4 billion in 10MFY25 (Refer to Exhibit 8), down 88% YoY. The sharp decline was primarily driven by higher repatriation/disinvestment, as well as increased FDI outflows from India. Going forward, India could attract higher FDI inflows as companies seek to diversify global supply chains. However, heightened trade policy uncertainty is likely to keep overall investment sentiment subdued, resulting in muted FDI inflows in FY26.

Net FPI inflows in FYTD25 (up to 25 March) fell sharply to USD 1 billion, down from USD 41 billion in FY24, due to heavy outflows from equities. In contrast, there were net FPI inflows in debt, of around USD 17 billion in FYTD25, supported by global bond index inclusion. As we enter FY26, FPI debt inflows are likely to continue, while equity flows will remain volatile amidst the global turmoil. Certain factors are now turning favourable for investor sentiment, such as some correction in domestic equity market valuations and fiscal and monetary policy support to demand. However, we expect FPI outflow pressures to persist at least through H1 FY26 in the midst of global uncertainties.

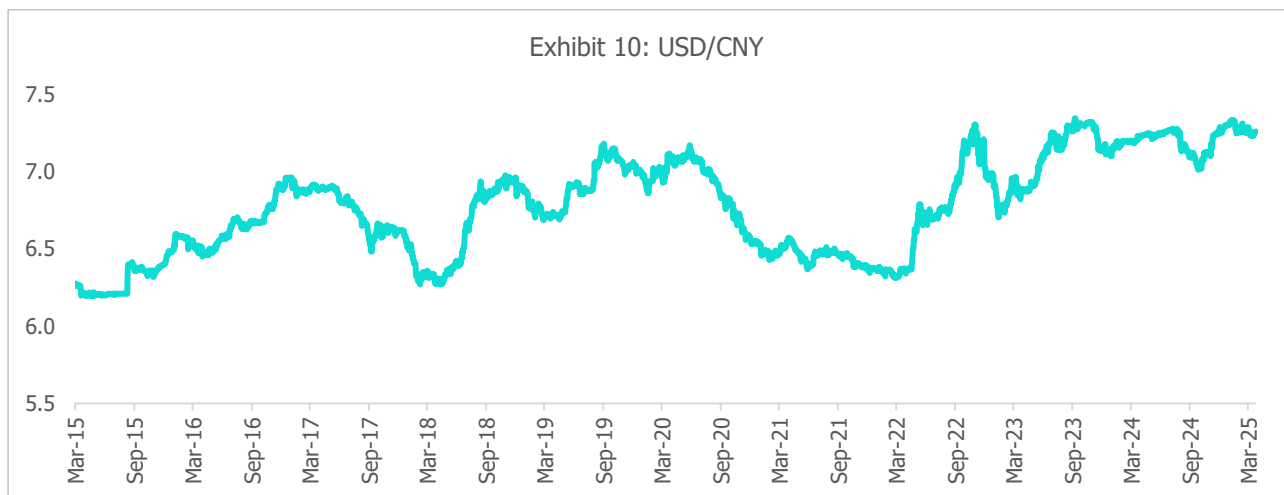


Source: CMIE, NSDL. FPI data as of 25 March 2025

### C. Any Significant Yuan Depreciation Could Put Pressure on the Rupee

After depreciating by around 4% against the dollar between October and December 2024 due to a widening interest rate differential with the US and trade war concerns, the yuan has strengthened by 0.6% in 2025. This recovery has been supported by a weaker dollar, stronger PBOC daily fixings, and a recent rally in Chinese equities. The ambitious 5% growth target set at the March National People's Congress (NPC) meeting has also helped.

Looking ahead, the yuan may weaken as a countermeasure against President Trump's tariff actions. During the previous trade war, the US trade-weighted tariff rate on Chinese goods surged to around 21% in 2019 from around 3% in 2018. The yuan depreciated by 10-12% during this period (Refer to Exhibit 10), putting pressure on the Indian rupee. A similar trend could emerge if aggressive tariffs are imposed on China again. However, this time, the yuan's depreciation may be more gradual, given China's focus on currency stability, as highlighted at the March NPC meeting. Additionally, sharp yuan depreciation may be unlikely, as it could provoke tariff threats from other countries amidst rising global trade protectionism.

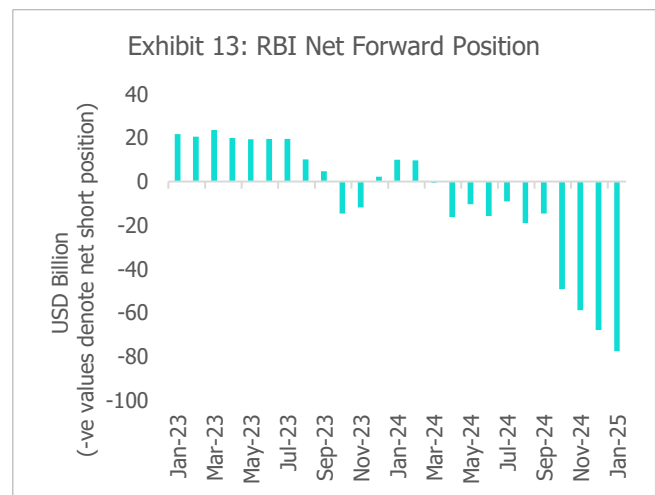
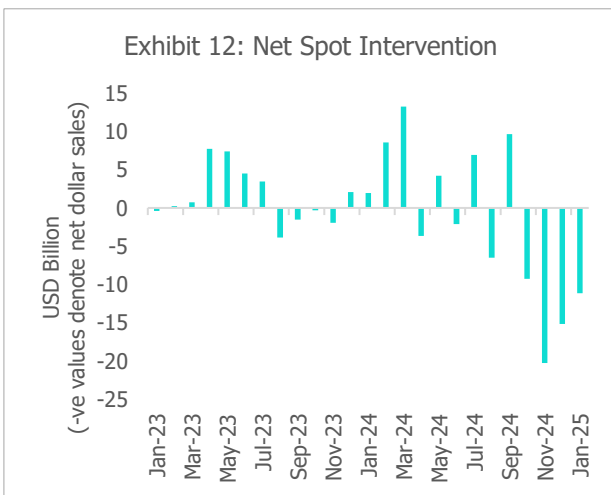
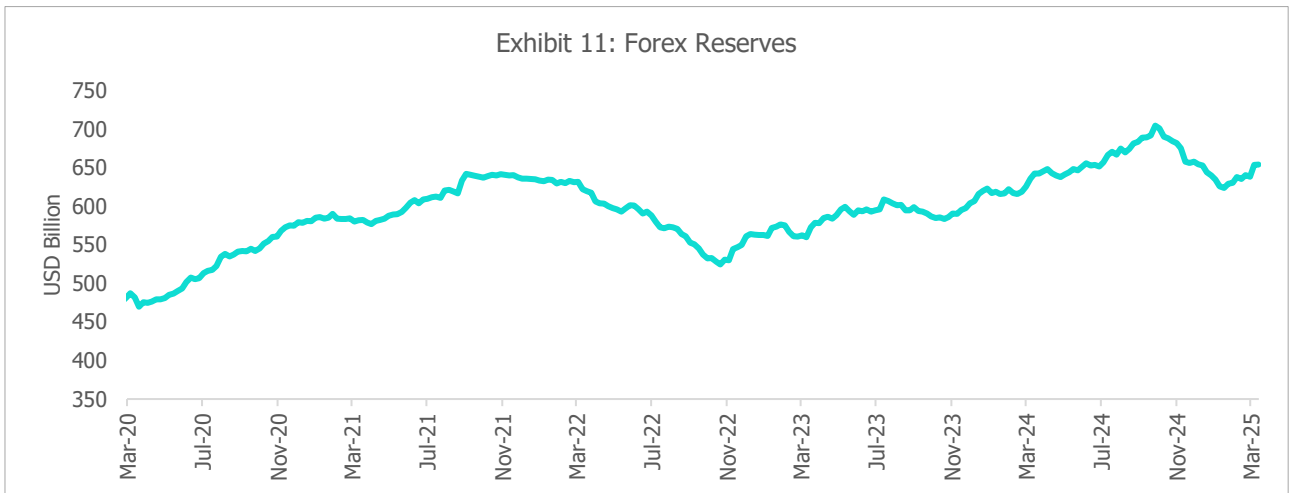


Source: Refinitiv. Data as of 25 March 2025

### D. Foreign Exchange Reserves Decline but Remain Healthy

India's forex reserves stood at around USD 654 billion as of 14 March 2025, down from the USD 705 billion peak in September 2024, largely due to RBI interventions (Refer to Exhibit 11). However, CYTD forex reserves have increased by USD 14 billion, offering a comfortable import cover of around 11 months (based on the goods trade deficit). After factoring in the RBI's sizeable net forward sales position of around USD 78 billion (as of January 2025) and USD/INR buy/sell swaps, forex reserves are estimated to be around USD 552 billion, equivalent to a 9-month import cover.

Looking ahead, we expect the RBI to focus on rebuilding its forex reserves, which could limit the recent rupee appreciation.



Source: CEIC. Latest data available as of 25 March 2025

**RBI to Cut Policy Rate by Another 25bps in April While Monitoring Rising Global Uncertainties**

In its February 2025 meeting, the RBI MPC reduced the policy repo rate by 25bps to 6.25%, marking the first rate cut since 2020, while maintaining a neutral stance. This decision was driven by moderating growth momentum and easing inflationary pressures.

The RBI has also been injecting liquidity into the banking system to facilitate better transmission of its rate cuts. The banking system liquidity deficit had widened considerably at the beginning of the current quarter, largely due to RBI’s interventions in the foreign exchange market. However, the RBI has ramped up measures to inject liquidity into the system. So far this quarter, it has injected around Rs 6.8 lakh crore of durable liquidity through OMO purchases, longer-term VRR auctions and forex swaps. As a result, the banking system liquidity deficit has narrowed from its January peak. The average deficit for March 2025 (as of 25 Mar) was Rs 1.6 lakh crore compared to Rs 2 lakh crore in January. Core liquidity has also returned to a surplus, at Rs 0.5 lakh crore as of 07 March, and is expected to remain in surplus. The RBI dividend, expected in Q1 FY26, is likely to support liquidity conditions further.

Looking ahead, we expect the RBI MPC to cut the policy rate by 25bps in its April meeting amidst moderating inflation and the need to support growth. With food inflation moderating and core inflation under control, the RBI could overlook concerns around imported inflation in midst of the global trade war. Another 25bps rate cut in FY26 is also possible depending on the monsoon situation and domestic inflation. The RBI will also take cues from global developments. For instance, if the Fed cuts rates to support its economy, the pressure on the Indian rupee may ease, giving the RBI more room for further rate cuts.

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