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FROM TARIFFS TO TURBULENCE: TRADE POLICY AND FINANCIAL STABILITY IN INDIA'S BANKING SECTOR

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Abstract

When governments raise tariffs or impose sudden export restrictions, the immediate concern typically centres on trade competitiveness; however, the deeper consequence may lie elsewhere, in the stability of domestic banks. Trade regulation in India has historically operated through the Customs Act, 1962 and executive control over foreign commerce, shaped by commitments under the World Trade Organization and broader principles of international economic law. Banking stability, in contrast, is governed by the Reserve Bank of India Act, 1934, the Banking Regulation Act, 1949, and the Insolvency and Bankruptcy Code, 2016; frameworks designed to safeguard credit discipline, ensure capital adequacy, and preserve systemic resilience. These domains have evolved in parallel, institutionally and conceptually distinct, and are rarely examined as structurally interconnected within legal scholarship or regulatory design. Yet contemporary tariff escalations, retaliatory trade measures, export bans, carbon-border adjustments, and supply-chain realignments demonstrate that external trade shocks can significantly compress corporate revenues, disrupt export-dependent industries, intensify leverage stress, inflate non-performing assets, and accelerate insolvency proceedings. What begins as an instrument of economic diplomacy may therefore transmit volatility into bank balance sheets, credit markets, and broader financial stability indicators, affecting lending behaviour, capital provisioning, and risk-weight assessments. Despite this cascading effect, India's macroprudential regulatory architecture does not explicitly categorise trade-policy volatility or geopolitical economic conflict as a systemic banking risk, nor does it formally integrate such disruptions into supervisory stress-testing frameworks or prudential oversight mechanisms. By tracing the doctrinal separation between trade governance and financial regulation, and analysing how tariff-induced corporate distress interacts with prudential norms, insolvency processes, and supervisory discretion, this article reconceptualizes trade policy as an internal generator of financial risk rather than merely an external economic tool. It argues for a more integrated regulatory approach in which financial supervisors anticipate and incorporate trade-policy shocks into systemic risk assessment, thereby rethinking the boundaries between international economic law and domestic banking stability in India.

Keywords: *Banking Regulation, Financial Stability, Macroprudential, Systemic Risk, Tariffs, Trade Policy.*

I. Introduction: The Invisible Transmission

Tariffs are imposed at the border, but their economic consequences rarely remain confined to it. A sudden export restriction or retaliatory duty may initially appear as an instrument of economic diplomacy. Yet within weeks, exporters renegotiate contracts, revenues contract, working capital tightens, and loan repayments are deferred. What begins as

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a trade measure migrates inward, onto corporate balance sheets and, eventually, into bank ledgers. By the time its effects surface in non-performing asset ratios or provisioning requirements, the connection between trade policy and financial stress is seldom acknowledged in legal analysis. It is within this "invisible transmission" that the contemporary relationship between trade governance and banking stability must be located.

In India, trade measures derive statutory authority primarily from the Customs Act, 1962 and the Foreign Trade (Development and Regulation) Act, 1992, operating within the broader framework of international trade commitments, including obligations under the World Trade Organization. Banking stability, by contrast, is governed by the Reserve Bank of India Act, 1934, the Banking Regulation Act, 1949, and reinforced by the Insolvency and Bankruptcy Code, 2016, legal structures designed to preserve credit discipline, ensure capital adequacy, and safeguard systemic resilience. These spheres: trade governance and financial regulation, have traditionally evolved as distinct institutional and doctrinal domains.

Contemporary economic conditions, however, unsettle this separation. Tariff escalations, carbon-border adjustments, sanctions regimes, and supply-chain realignments generate revenue volatility in export-dependent sectors such as steel, pharmaceuticals, textiles, and information technology services. When market access contracts or input costs rise, corporate earnings decline, leverage stress intensifies, and debt-servicing capacity weakens. The consequences extend beyond individual firms. They transmit into the banking system through restructuring requests, asset downgrades, provisioning pressures, and insolvency proceedings.

India's macroprudential framework emphasises liquidity risk, credit growth, capital adequacy, and market volatility. Yet it does not expressly classify trade-policy volatility or geopolitical economic disruption as a distinct source of systemic banking risk. The prevailing legal architecture reflects an implicit assumption that trade shocks are external economic events rather than structural determinants of domestic financial stability.

This article challenges that assumption. It argues that in an era of intensified geopolitical contestation and economic interdependence, tariff volatility and export restrictions function as internal generators of financial risk. By tracing the doctrinal separation between trade law and banking regulation and analysing the pathway from tariff shocks to corporate distress and systemic banking exposure, this article reconceptualizes trade policy as a material component of financial stability analysis within India's banking system. Recognising this interdependence is essential to rethinking the boundaries of economic governance in India.

II. Trade Power at the Border: Law, Discretion, and Design

Trade power in India is legally anchored at the border, yet its consequences travel far beyond it. The authority to impose tariffs, grant exemptions, restrict exports, and regulate imports is principally derived from the Customs Act, 1962[2740] and the Foreign Trade (Development and Regulation) Act, 1992[2741] (FTDR Act). Together, these statutes vest substantial discretionary authority in the executive to alter trade conditions in response to economic, strategic, or public interest considerations.

Under Section 12 of the Customs Act, customs duties are levied on goods imported into or exported from India. More significantly, Section 25 empowers the Central Government to grant exemptions from customs duties "if it is satisfied that it is necessary in the public interest."[2742] This "public interest" standard is intentionally broad, enabling rapid tariff adjustments through

[2740] Customs Act, 1962, No. 52, Acts of Parliament, 1962 (India).
[2741] Foreign Trade (Development and Regulation) Act, 1992, No. 22, Acts of Parliament, 1992 (India).
[2742] Customs Act, 1962, §§ 12, 25, No. 52, Acts of Parliament, 1962 (India).

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executive notifications. Similarly, under Section 3 of the FTDR Act[2743], the Central Government may make provisions for the development and regulation of foreign trade, including prohibiting, restricting, or otherwise regulating the import or export of goods. These powers are frequently exercised through notifications and amendments to the Foreign Trade Policy.

The statutory design reflects a conscious choice: trade policy must remain flexible. In periods of inflationary pressure, export bans may be imposed to stabilise domestic supply. In strategic sectors, tariff adjustments may protect the domestic industry. During geopolitical conflict, sanctions or retaliatory measures may be deployed. The law thus prioritises responsiveness and executive agility. Judicial review of such measures has traditionally been deferential, with courts recognising trade regulation as a matter of economic policy falling within executive competence. The Supreme Court has consistently maintained that fiscal and trade decisions warrant limited interference unless they are manifestly arbitrary or unconstitutional.

This structure produces two important features. First, tariff and export decisions can be implemented swiftly, often without extended legislative deliberation. Second, there is no statutory requirement that a formal assessment of downstream financial-sector consequences precede trade measures. The legal inquest focuses on trade objectives: price stability, protection of domestic industry, and balance of payments management, not on intrinsic credit exposure.

India's trade governance framework also operates within international constraints. As a member of the World Trade Organization (WTO), India is bound by tariff commitments, the General Agreement on Tariffs and Trade (GATT),[2744] and related disciplines governing quantitative restrictions. Nevertheless, WTO law permits exceptions based on public interest, national security, and balance-of-payments concerns, leaving significant room for domestic policy scheming.[2745] Thus, even within multilateral commitments, the design of trade authority preserves sovereign discretion[2746].

What is striking, however, is the absence of institutional coordination between trade authorities and financial regulators. While the Ministry of Commerce and Industry formulates trade policy and issues notifications, and the Ministry of Finance exercises fiscal powers, there is no explicit statutory mechanism requiring consultation with the Reserve Bank of India regarding systemic credit exposure arising from major trade shifts. The design presumes that trade measures are sectoral economic tools rather than potential triggers of financial instability.

This institutional compartmentalization is not accidental; it reflects historical evolution. Trade law developed as part of fiscal and commercial governance, while banking regulation evolved in response to monetary stability concerns and financial crises. The Customs Act is rooted in revenue collection and border control. The RBI Act[2747] and Banking Regulation Act[2748], by contrast, respond to currency stability, depositor protection, and systemic risk. The Insolvency and Bankruptcy Code, 2016[2749] was enacted to resolve distressed assets efficiently and improve credit discipline, not to anticipate exogenous trade volatility. Each regime addresses distinct policy goals.

Yet in an economy characterised by export-oriented growth, cross-border supply chains, and leveraged corporate finance, the effects of tariff volatility cannot be confined to customs checkpoints. When trade measures compress sectoral revenues, banks exposed to those

[2743] Foreign Trade (Development and Regulation) Act, 1992, § 3, No. 22, Acts of Parliament, 1992 (India).
[2744] General Agreement on Tariffs and Trade art. II, Oct. 30, 1947, 61 Stat. A-11, 55 U.N.T.S. 194.
[2745] General Agreement on Tariffs and Trade art. XX, Oct. 30, 1947, 61 Stat. A-11, 55 U.N.T.S. 194.
[2746] JOHN H. JACKSON, THE WORLD TRADING SYSTEM: LAW AND POLICY OF INTERNATIONAL ECONOMIC RELATIONS 89-95 (MIT Press 1997).
[2747] Reserve Bank of India Act, 1934, No. 2, Acts of Parliament, 1934 (India).
[2748] Banking Regulation Act, 1949, No. 10, Acts of Parliament, 1949 (India).
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sectors absorb the stress through restructuring, asset classification downgrades, and provisioning obligations. The statutory framework of trade power does not deny this possibility; it simply does not account for it.

The legal design of trade authority in India, therefore, reveals a structural blind spot. Executive discretion is broad, judicial oversight is limited, and financial-stability implications remain institutionally peripheral. This separation sets the stage for the transmission mechanism as to how trade-policy shocks migrate from the border into corporate distress and, ultimately, into systemic banking risk.

III. Stability Behind the Balance Sheet: The Architecture of Banking Regulation

If trade power operates at the border, financial stability operates behind the balance sheet. India's banking framework is structured through a statutory architecture designed to preserve monetary stability, depositor confidence, and systemic resilience. The regulatory authority of the Reserve Bank of India (RBI) flows from the Reserve Bank of India Act, 1934[2750], while supervisory control over banking companies is established under the Banking Regulation Act, 1949[2751]. These enactments collectively empower the RBI to regulate credit expansion, prescribe prudential norms, and intervene in circumstances of financial stress.

Under Section 21 of the Banking Regulation Act, 1949, the RBI may determine policy in relation to advances made by banking companies, including the sectors and purposes to which credit may be directed.[2752] This statutory authority underpins prudential regulation, including capital adequacy standards, exposure norms, asset classification requirements, and provisioning obligations. The objective is integral: to prevent instability that may arise from excessive leverage, concentrated sectoral exposure, or deteriorating asset quality.

The concept of "systemic risk" has become central to modern banking supervision. Systemic risk refers to the possibility that distress in one institution or sector may propagate instability across the financial system as a whole.[2753] Macroprudential regulation seeks to mitigate such contagion by monitoring interconnectedness, capital buffers, and stress scenarios.[2754] In India, the RBI's *Financial Stability Report* periodically assesses vulnerabilities in credit growth, sectoral concentration, liquidity risk, and macroeconomic stress indicators.[2755] These assessments demonstrate that financial supervision is calibrated to monitor internal financial variables such as leverage ratios, capital adequacy, and non-performing asset trends.

Judicial recognition of the importance of financial stability further reinforces this architecture. In matters involving economic and fiscal policy, the Supreme Court of India has consistently adopted a deferential approach, emphasizing institutional competence and the complexity of regulatory design. In *R.K. Garg v. Union of India*, the Court observed that economic legislation must be accorded greater latitude, given its experimental character.[2756] Similarly, in *BALCO Employees' Union v. Union of India*, the Court reaffirmed that economic policy decisions are best left to executive and legislative judgment unless clearly unconstitutional.[2757] This jurisprudential posture indirectly strengthens the RBI's regulatory autonomy in maintaining financial stability.

The Insolvency and Bankruptcy Code, 2016 (IBC), further complements this framework by providing a structured mechanism for resolving

[2750] RESERVE BANK OF INDIA, *supra* note 9
[2751] BANKING REGULATION ACT, *supra* note 10
[2752] Banking Regulation Act, 1949, § 21, No. 10, Acts of Parliament, 1949 (India).
[2753] Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 204-06 (2008)
[2754] EMILIOS AVGOULEAS, GOVERNANCE OF GLOBAL FINANCIAL MARKETS: THE LAW, THE ECONOMICS, THE POLITICS 45-52 (Cambridge Univ. Press 2012).
[2755] Reserve Bank of India, *Financial Stability Report* (June 2023), https://www.rbi.org.in
[2756] R.K. Garg v. Union of India, (1981) 4 S.C.C. 675 (India).
[2757] BALCO Emps.' Union v. Union of India, (2002) 2 S.C.C. 333 (India).

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corporate distress and reinforcing creditor discipline.[2758] Under Section 7 of the Code, financial creditors may initiate corporate insolvency resolution proceedings against defaulting debtors.[2759] The IBC was enacted in response to mounting non-performing assets and is designed to facilitate time-bound restructuring, thereby stabilising credit markets. Its logic, however, assumes that distress originates within the credit cycle rather than from external policy shocks.

Recent economic episodes illustrate the sensitivity of credit systems to sectoral stress. For example, elevated non-performing assets in infrastructure and steel sectors during prior downturns required substantial provisioning and capital infusion by public sector banks.[2760] While these stresses were multifactorial, they highlight how concentrated exposure to vulnerable sectors can transmit macroeconomic shocks into systemic banking strain.

Similarly, trade interventions may indirectly affect credit stability. In July 2023, the Government of India imposed a ban on the export of non-basmati rice to address domestic price concerns.[2761] Although framed as a supply-stabilisation measure, such decisions can affect export-linked enterprises and their financing arrangements. Where banks maintain concentrated exposure to export-dependent industries, sudden revenue compression may translate into restructuring requests, asset downgrades, and heightened provisioning obligations.

Yet despite these observable linkages, the statutory design of banking regulation does not expressly incorporate trade-policy volatility as a discrete risk variable. Stress testing frameworks primarily model interest rate risk, liquidity shocks, and macroeconomic contraction scenarios. The institutional framework presumes that financial instability originates within the credit system itself rather than through external policy instruments such as tariff escalation or export prohibition.

This structural separation reveals the central tension of this article. India's banking law framework is sophisticated in its monitoring of endogenous credit risk but comparatively silent on exogenous trade-policy shocks. As an export-integrated and credit-leveraged economy, India faces a regulatory landscape in which trade discretion and financial supervision operate in parallel rather than in coordination. The implications of this design become evident when trade volatility migrates from border intervention to corporate distress and ultimately into systemic banking turbulence.

IV. From Tariffs to Turbulence: The Transmission Mechanism

The interaction between trade policy and banking stability is neither accidental nor episodic; it follows an evident transmission pathway. Contemporary systemic-risk scholarship emphasizes that financial instability frequently emerges from correlated sectoral exposures rather than isolated institutional failure.[2762] When trade interventions affect revenue streams in export-linked industries, the consequences propagate through credit relationships that bind firms to banks.

The first stage of transmission is revenue disruption. Tariff escalation, retaliatory duties, or export prohibitions alter price competitiveness and market access. For firms operating on thin margins and high fixed costs, even temporary trade restrictions can generate liquidity stress. Economic governance literature underlines that global trade integration has increased the vulnerability of domestic industries to abrupt policy shifts.[2763] In export-intensive sectors, revenue compression may therefore occur rapidly and simultaneously across firms.

[2758] INSOLVENCY AND BANKRUPTCY CODE, *supra* note 11
[2759] Insolvency and Bankruptcy Code, 2016, § 7, No. 31, Acts of Parliament, 2016 (India).
[2760] RESERVE BANK OF INDIA, *supra* note 17, at 42-47
[2761] THE HINDU, *India Imposes Export Ban on Non-Basmati Rice*, July 21, 2023.
[2762] STEVEN L. SCHWARCZ, *supra* note 15
[2763] Dani Rodrik, *The Globalization Paradox*, 91 FOREIGN AFF. 8, 12-15 (2012).

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The second stage involves leverage amplification. Where firms are financed through bank credit, reduced earnings impair debt-servicing capacity. Steven Schwarcz's analysis of systemic risk highlights how correlated exposures magnify distress when multiple borrowers face simultaneous financial strain.[2764] Banks with concentrated lending to affected sectors experience rising restructuring requests and asset quality concerns. The Reserve Bank of India's *Financial Stability Report* regularly identifies sectoral concentration as a structural vulnerability within the banking system.[2765] Trade-induced stress may not be explicitly categorised as such, but its effects manifest in deteriorating asset performance.

The third stage unfolds at the level of banking balance sheets. Prudential frameworks require provisioning against impaired assets, reducing profitability and eroding capital buffers. Scholarly literature argues that macroprudential regulation must account for interconnected economic shocks that originate outside the financial sector but transmit inward through credit linkages.[2766] In the absence of coordinated risk anticipation, trade volatility may be absorbed reactively rather than pre-emptively by the banking system.

The fourth stage activates systemic feedback. As non-performing assets rise and capital adequacy pressures intensify, banks respond by tightening credit standards. In a system where public sector banks continue to account for a substantial share of industrial lending, such tightening may also carry fiscal implications through recapitalization pressures. Andrew Crockett's articulation of financial stability as a public policy objective highlights the importance of preventing procyclical contraction triggered by external shocks.[2767] Credit tightening affects not only export-oriented enterprises but also domestic firms reliant on working capital financing. What began as a border measure thus culminates in broader credit contraction.

Recent empirical observations reinforce this dynamic. Episodes of sectoral stress, particularly in infrastructure and manufacturing, have previously contributed to elevated non-performing assets and provisioning burdens within Indian banks.[2768] While such stress may be multifactorial, trade-policy disruption can operate as a catalyst where sectoral exposure is concentrated. The institutional design of trade governance does not currently require assessment of these downstream financial implications.

This transmission mechanism reveals a structural oversight. Trade discretion is exercised with flexibility and speed; financial supervision operates through calibrated monitoring and containment. When these domains intersect through export-dependent leverage, regulatory compartmentalization obscures systemic vulnerability. Recognising this pathway does not imply curtailing trade authority. Rather, it suggests that in an interconnected economy, trade volatility should be treated as a variable within financial stability analysis.

V. Integrating Trade Volatility into Financial Regulation

The transmission pathway outlined above exposes a regulatory asymmetry: trade governance privileges executive flexibility, while financial regulation emphasizes stability through structured supervision. Addressing this asymmetry requires not merely coordination but conceptual expansion. Financial stability, as contemporary scholarship increasingly suggests, is a function of legal architecture and institutional design rather than purely monetary control.[2769] If law shapes markets, it must also anticipate the distribution of risk across them.

[2764] STEVEN L. SCHWARCZ, *supra* note 15
[2765] RESERVE BANK OF INDIA, *supra* note 17, at 42-47
[2766] EMILIOS AVGOULEAS, *supra* note 16
[2767] Andrew Crockett, *Why Is Financial Stability a Goal of Public Policy*, 1997 FED. RES. BANK KAN. CITY ECON. REV. 5, 8-10.
[2768] RESERVE BANK OF INDIA, *supra* note 17, at 35-40.
[2769] KATHARINA PISTOR, THE CODE OF CAPITAL: HOW THE LAW CREATES WEALTH AND INEQUALITY 3-10 (Princeton Univ. Press 2019).

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Legal frameworks play a central role in constructing capital markets, and fragmented regulatory structures often create systemic blind spots.[2770] Where trade policy is insulated from financial supervision, the law effectively fragments economic risk into separate administrative domains. Yet in export-integrated economies, sectoral trade shocks are rarely confined to commercial actors alone; they travel through credit contracts, balance sheets, and capital buffers.

Indian banking scholarship similarly warns against static exposure assessment. Viral V. Acharya's work on banking sector vulnerabilities emphasizes the dangers of concentrated credit exposure and delayed stress recognition.[2771] While his analysis focuses on domestic credit cycles, the logic applies equally to exogenous trade shocks that impair sectoral cash flows. When export-linked industries face sudden revenue contraction, banking fragility may arise not from speculative excess but from correlated policy exposure.

International macroprudential literature reinforces this point. Regulatory frameworks must internalise macro-financial linkages that extend beyond traditional credit metrics.[2772] Similarly, it is important to anticipate non-financial triggers capable of destabilising leveraged systems.[2773] Trade-policy volatility fits squarely within this category of external yet systemically relevant shock.

Recalibration, however, does not require a statutory overhaul. It requires anticipatory coordination. Sectoral exposure mapping could be integrated into periodic financial stability reviews, especially where banking concentration in trade-sensitive industries exceeds prudential comfort levels. Such integration would not constrain trade discretion but would ensure that financial regulators are institutionally alerted to potential spillovers. This could take the form of structured consultation between trade authorities and financial supervisors where proposed tariff adjustments materially affect export-dominant sectors.

The objective is not to subordinate trade sovereignty to financial conservatism. Rather, it is to recognize that in a credit-intensive and globally integrated economy, border measures may operate as domestic risk multipliers. Regulatory design must therefore evolve from compartmentalization toward calibrated coordination. Trade volatility need not be treated as an anomaly; it should be treated as a variable within systemic risk analysis.

VI. Conclusion

Trade policy and banking regulation have long been treated as distinct spheres of economic governance, one outward-facing and strategic, the other inward-looking and prudential. Yet in a globally integrated and credit-intensive economy, this separation is increasingly artificial. Tariffs, export restrictions, and retaliatory duties do not end at the border; they reverberate through corporate balance sheets and, ultimately, into banking stability.

This article has argued that trade volatility operates as a transmission channel of financial risk. While India's trade statutes prioritize flexibility and executive discretion, and its banking framework emphasizes prudential containment and systemic resilience, the two regimes remain institutionally compartmentalized. The result is not a regulatory failure but a regulatory incompleteness: trade-policy shocks are absorbed reactively within the banking system rather than anticipated in financial stability analysis.

Recognising this interdependence does not require constraining sovereign trade authority. It calls for calibrated coordination, an expanded understanding of systemic risk that includes policy-induced sectoral exposure. As India

[2770] *Id.*
[2771] Viral V. Acharya, Banking Sector Reforms in India, 49 ECON. & POL. WKLY. 8, 10-13 (2014).
[2772] Claudio Borio, The Macroprudential Approach to Regulation and Supervision, BIS Working Paper No. 128, at 4-7 (2003).
[2773] Markus K. Brunnermeier et al., Macroprudential Regulation and Financial Stability, 64 INT'L J. CENT. BANKING 1, 5-9 (2012).

deepens its participation in global markets while relying on bank-led credit growth, the architecture of economic governance must evolve accordingly. Financial stability in the twenty-first century requires not only sound banks but also an awareness that decisions at the border can shape turbulence behind the balance sheet.

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