

India: Steadfast amid rising geopolitical challenges

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Author

Carlos Casanova

Senior Economist, Asia



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Steadfast amid rising geopolitical challenges

Key takeaways

- 1 India is navigating a high-stakes balancing act, refraining from aligning exclusively with either the United States or China
- 2 Trade tensions with the United States (50% tariffs on India exports) have negatively impacted market sentiment but remain manageable at macro level
- 3 Despite uncertainties on trade, the growth outlook has been revised up (6.9% in 2025; 6.5% in 2026), in line with strong long-term potential
- 4 Fiscal buffers support short-term growth and domestic demand, while allowing for further monetary easing
- 5 Sustained nominal growth and structural changes in India support the consensus views in favour of double-digit EPS growth in 2026

Rising geopolitical tensions: India seeks a third way

Deterioration of US–India relations

India was once regarded as one of the primary potential beneficiaries of a hypothetical Trump 2.0 presidency, but much has changed since then. Previously, the Biden administration had retained Trump-era tariffs on China and fully embraced the Indo-Pacific strategy, positioning India as a key supplier and strategic defence partner under the Quadrilateral Security Dialogue (Quad) alongside Australia, Japan, and the United States (US). This alignment was designed to counterbalance China's growing military influence in the region.

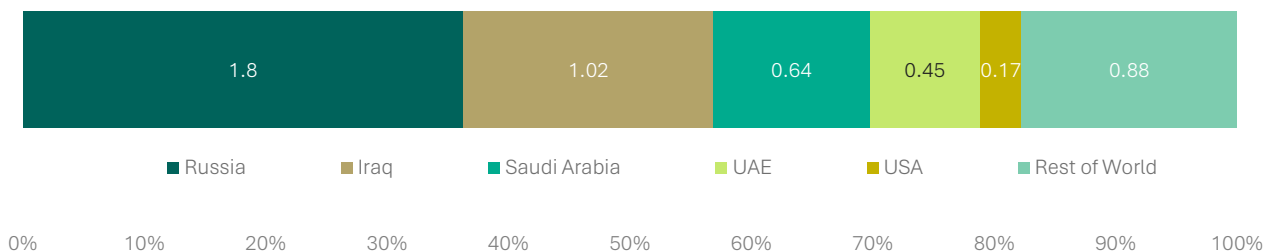
Fast forward to August 2025 and the geopolitical landscape in the Asia-Pacific region has become increasingly fragmented. US President Donald Trump announced a significant escalation in tariffs on Indian goods, raising rates to 50% – second to those imposed on China, and alongside those on Brazil – which came into effect on 27 August.

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India enjoys a trade surplus with the US, making it a target under Trump 2.0. This surplus reached USD 40 billion in 2024, equivalent to 1.0% of its GDP, and is driven by exports of pharmaceuticals, textiles, auto parts, and IT services. Similarly, India maintains a trade surplus with the European Union (EU), estimated at around USD 26 billion, or 0.7% of its GDP in 2024.

Trump justified the additional 25% levy (compounding the existing 25% reciprocal tariffs on Indian products announced in April) by citing India’s continued purchase of Russian oil – a claim not without basis. Russia became India’s largest oil supplier in 2022, a shift driven by the geopolitical fallout of the Russia–Ukraine conflict. As Western economies imposed sanctions on Russian oil, Moscow began offering steep discounts, which India capitalised on to meet its growing energy demands. By late 2022, Russia had overtaken traditional suppliers such as Iraq and Saudi Arabia, providing crude oil at discounts of up to USD 20 per barrel below market prices. This strategic energy partnership has now become a flashpoint in US–India relations, adding yet another layer of complexity to an already fraught geopolitical environment.

CRUDE OIL IMPORT SOURCES 2024
(MILLION BARRELS PER DAY, SHARE OF TOTAL)



Source(s): Customs of India, UBP

While opportunities for de-escalation remain, the dynamics have grown more intricate, requiring all parties to tread carefully in safeguarding their core strategic interests, while avoiding any pitfalls. Both sides stand to benefit from a thaw in bilateral relations and should seek to sign an agreement in 2026. For India, the compromise will likely be Russian oil imports, which should be less attractive in an environment of weaker energy prices under Trump. India can also commit to increasing its purchases of US defence materiel, Boeing aircraft and machinery, as that should also help the country’s development. Opening up parts of its consumer market to US firms can also help to sweeten the deal for the US.

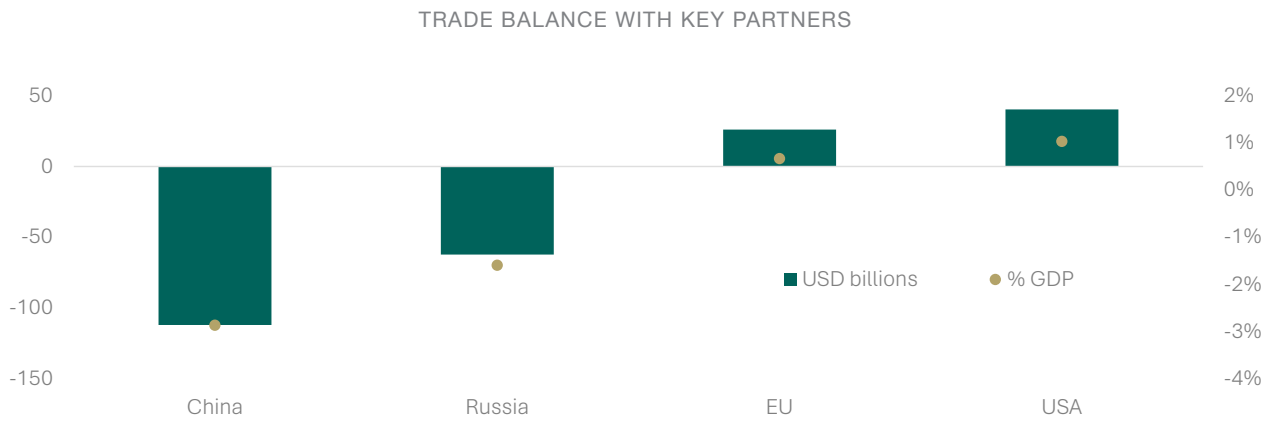
Although we do not expect tariffs to return to below 25%, this level would be low enough to enable India to absorb the impact of Trump’s trade policies, while simultaneously biding itself some time to advance its domestic agenda, and without severing ties with its other strategic partners.

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Navigating strategic alliances with a range of partners

Both the United States and China play significant roles in India’s economic prosperity. Prime Minister Modi, alongside Russian President Putin, attended the Shanghai Cooperation Organisation (SCO) security forum in Tianjin on 31 August, where they voiced their support for Chinese President Xi Jinping’s vision of a new global security and economic order prioritising the ‘Global South’. Modi’s ability to pivot from aligning with Trump to standing alongside Putin and Xi almost overnight underscores the notion that New Delhi was never fully aligned with Washington. In recent weeks, the optics have undoubtedly placed India–Russia relations on a strong footing. However, this marriage of convenience is largely dependent on Russian energy imports remaining significantly cheaper than market rates for oil, a situation that may not persist if energy prices remain subdued. At current rates, Russian oil imports may only offer a USD 2–3 per barrel discount relative to traditional sources like Saudi Arabia. In other words, 50% tariffs appear to be a bigger problem for Modi than more expensive energy imports, even if these stoke inflation modestly in 2026 (our baseline scenario).

In contrast to the US, India faces a substantial trade deficit with China, totalling some USD 112 billion in 2024, or 3% of its GDP. China is a key supplier of electronics, machinery, and chemicals, while Russia only provides crude oil and fertilisers. When combined with Russia, the trade deficit rises to approximately USD 170 billion, or 4.5% of India’s GDP. A trade deficit is not inherently bad, particularly when it is driven by imports of capital goods that contribute to long-term economic growth by expanding production capacity, which is precisely the case in India’s long-term story. Furthermore, India’s trade deficit is primarily financed through foreign direct investments and other capital inflows, rather than through borrowing.



Source(s): UN Comtrade, IMF, UBP

Why is this important? While China provides access to essential components for India's expanding manufacturing sector at cost-effective prices, fostering a growing bilateral trade relationship with other markets in North America, the EU, and Asia can help stabilise India’s current account in the long term. This, in turn, can support the rupee and bolster domestic demand by ensuring stable imported inflation.

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For instance, while trade with the US remains more substantial, trade with the EU has grown more rapidly in recent years, bolstered by foreign direct investment. India is not facing a binary choice between the US and China, but rather a high-stakes balancing act involving several key partners. We expect that higher foreign investment from the EU and other Asian countries could help to partially offset a decline from the US.

Safeguarding a sustainable medium-term outlook

Short-term shift to domestic market protection and countermeasures

The direct impact of these US tariffs seems manageable. India's economy is primarily consumption-driven, with exports to the US accounting for less than 2% of its GDP. Additionally, not all sectors are affected: textiles, gemstones, and chemicals are included, while electronics, pharmaceuticals, steel, and aluminium are excluded and subject to separate, lower, sectoral tariffs. Exports of services remain out of scope, and the phased implementation of tariffs on pharmaceuticals has helped mitigate immediate risks.

In response to these challenges, India's Ministry of Commerce and Industry is actively working to support exporters by diversifying into new markets, particularly across Asia and Africa, while expanding the range of exported products. This approach is not new, but India is now also focusing on exporting to emerging markets and transitioning to exporting value-added manufactured goods like smartphones. India has also entered into free trade agreements (FTAs) with Australia, the United Arab Emirates (UAE), Mauritius, the United Kingdom (UK), and the European Free Trade Association (EFTA). Additionally, deregulation in key sectors, such as lucrative business services and manufacturing, is being pursued to further incentivise foreign direct investment from a range of sources.

More importantly, India is leveraging the size of its massive economy and doubling down on domestic consumption, which accounts for approximately 70% of its GDP. On 15 August, Prime Minister Modi announced plans to simplify the four-tier goods and services tax (GST) structure to two rates by early October, reducing the GST on most goods taxed at 12% to 5% and those at 28% to 18%. This move aims to boost domestic demand while offsetting the impact of US tariffs on GDP via weaker exports. Additionally, the reform is expected to create a one-off decline in consumer prices, creating room for the Reserve Bank of India (RBI) to consider additional rate cuts, which should further support domestic demand in 2026.

Resilient H1 2025 and upward revisions to our outlook despite uncertainties

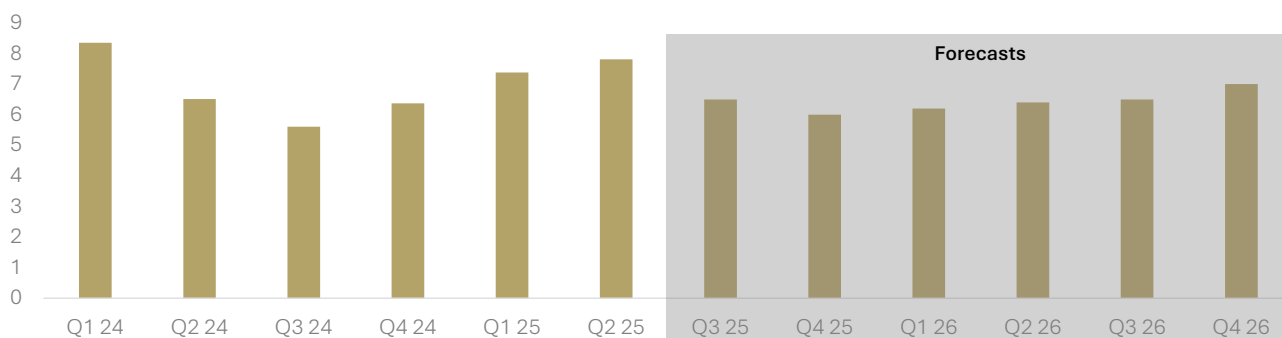
India's GDP outperformed expectations in Q2 2025, after an already strong Q1 2025, driven by favourable cyclical factors such as low inflation and rate cuts by the RBI. Real GDP accelerated to 7.8% y/y in Q2 2025, up from 7.4% in Q1 2025 and exceeding expectations of 6.7% y/y. That brings the average for H1 2025 to 7.6% year-to-date y/y. Meanwhile, nominal GDP came in flat at 8.8% y/y.

In terms of components, private final consumption expenditure remained steady at 7.0%, while government final consumption expenditure rebounded significantly to 9.7%, up from 4.0% in Q1 2025, as the government invested in several megaprojects ranging from airports, the Delhi–Mumbai Expressway and digital infrastructure. On the industrial front, strong growth was observed in manufacturing (7.72%), construction (7.56%), and financial and business services (9.48%).

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This robust performance in H1 2025 should lead to stronger average growth in 2025, and we have revised the outlook upwards from 6.4% to 6.9%, marking a significant return to the trend of above-potential growth seen during 2021–2023, with a brief hiatus in 2024. We have also revised our 2026 GDP growth forecast upwards from 6.3% to 6.5%.

INDIA: GDP GROWTH FORECASTS (2025-2026)



Source(s): CSO, Bloomberg, UBP

Inflation has eased significantly, with the consumer price index (CPI) falling for the ninth consecutive month in July to 1.55% y/y, marking the lowest level since 2019, and well below the RBI's tolerance range of 2–6%. This decline was primarily driven by a -0.85% y/y drop in food prices, which account for 50% of the CPI basket. Food price deflation is expected to persist into Q3 2025, supported by normal monsoon rainfall.

As a result, we have revised our average CPI forecast for 2025 down to 3.1%, with inflation likely to remain below target in the near term and rising to 4–5% in 2026, which is still within the RBI's tolerance band and not an issue for consumption. The RBI has already implemented three rate cuts in 2025, including a notable 50-basis-point reduction in June, bringing the total to 100 basis points. A further 2–3 rate cuts are anticipated by the end of 2026. The next monetary policy decision is scheduled for October and a 25-basis-point reduction is highly probable. Favourable monsoon conditions could also lead to further rate reductions in December, assuming inflation remains subdued.

Fostering long-term growth trends and enhancing financial stability

In 2026, growth is expected to be supported by lower taxes to boost consumption, and sustained public investment in infrastructure, with the impact of Trump's tariffs gradually phasing out in H2 2026.

However, the fiscal backdrop will be less accommodative in the medium term after a temporary boost over the coming quarters. Finance Minister Nirmala Sitharaman introduced tax exemptions for 10 million households during her latest budget, while also increasing government spending on infrastructure, thus modestly reducing the pace of fiscal consolidation in 2025.

However, fiscal policy remains constrained by India's commitment to reducing the budget deficit to improve its medium-term outlook. The strategy is paying off. On 14 August, S&P Global upgraded India's long-term sovereign credit rating to BBB from BBB-, marking the first such upgrade since 2007.

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This trend is likely to continue driving inflows into Indian assets, particularly bonds, thereby offsetting some declines arising from geopolitical tensions. Furthermore, stronger fundamentals could enhance foreign direct investment in key sectors such as manufacturing and business services, especially if accompanied by reforms aimed at liberalising these industries for foreign investors.

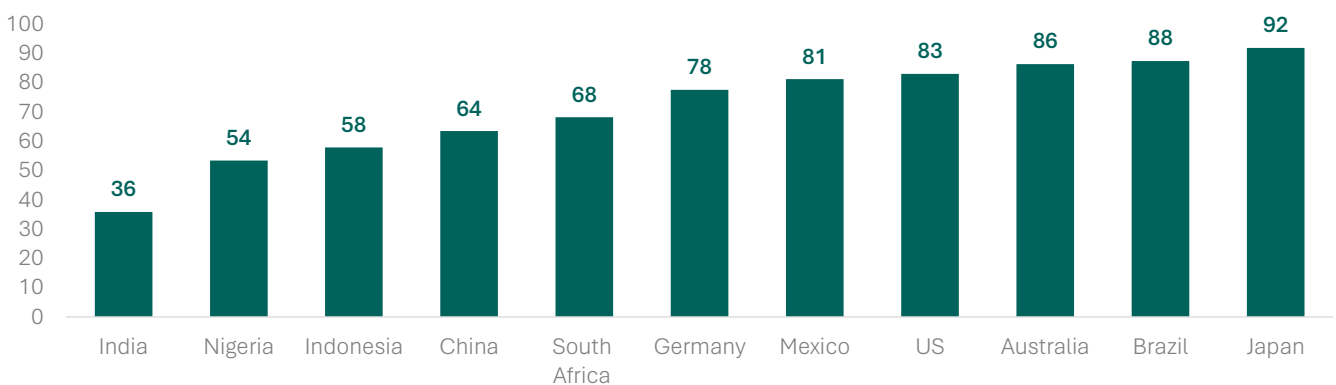
The US and the EU hold significant intellectual property in sectors such as technology and pharmaceuticals, where India is well positioned to serve as a supplier. Additionally, China is contemplating the relocation of some of its lower-value-added manufacturing and assembly operations, offering expertise in supply chains, particularly in electronics and electric vehicles, at a lower cost. Notably, the tariffs imposed during the Trump administration may, in the long term, prove beneficial if they incentivise India to pursue necessary reforms and diversification.

Implications for investors

The long-term investment outlook for India remains unchanged and structurally positive. We anticipate India’s potential growth rate to remain in the range of 6.5–7.0% over the coming decade. Furthermore, the nation is projected to become the world’s third-largest economy by 2030, surpassing Germany and Japan. India is also set to become the fourth-largest consumer market in 2027, after the US, China, and the EU, but featuring the fastest consumer growth trends of them all.

It is important for investors to recognise that, in relative per capita terms, India lags significantly behind many of its emerging market peers. This underscores the need for substantial investments in urbanisation and infrastructure, which are expected to underpin sustained growth rates in the decades ahead. There is plenty of low-hanging fruit, and we expect that the government will seize these opportunities, rather than squandering them, ensuring they translate into sustainable progress.

URBANISATION RATE (% OF TOTAL POPULATION)



Source(s): World Bank, UBP

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Historically, equities in India have demonstrated a strong positive correlation with GDP growth over the long term, a trend not consistently observed in other emerging markets. However, the performance of the MSCI India Index has been relatively flat year-to-date, reflecting a 3.7% return alongside an approximate 3.0% depreciation of the rupee. While this figure does not account for dividends, it nonetheless lags behind other global indices.

Indian equities are currently trading at a forward price-to-earnings (P/E) ratio of 22.5x, marginally above their 10-year average of 21.3x. Over the past six months, listed Indian companies have experienced widespread earnings downgrades, driven by flat nominal GDP growth, which has resulted in muted top-line growth. Many sectors have also faced margin pressure, leading to a decline in the earnings per share (EPS) growth estimate for the current fiscal year from 19% in January to 13% now.

While the tariff issue does not pose a direct threat to most listed companies, it significantly impacts small and medium-sized enterprises (SMEs), likely affecting employment and sentiment. Despite these challenges, the combination of monetary and fiscal easing has led analysts to forecast a recovery in earnings growth to 16% in 2026. However, this optimism hinges on improvements in sales growth and margins across most sectors, which remain to be seen.

Last, the Indian rupee (INR) has become one of Asia's weakest-performing currencies this year, influenced by the RBI's rate-cutting cycle, which has diminished interest rate differentials with the US, alongside portfolio outflows stemming from weak sentiment. However, as the US Federal Reserve resumes rate cuts in the second half of 2025, this may alleviate some pressure on the INR, potentially providing moderate support for Indian assets.

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