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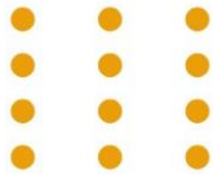
INDIA'S TRYST WITH GLOBAL BOND INDICES

Oct-2023



India's Inclusion in Global Bond Indices – An Impact Analysis

Finally after a long period of courtship of about 10-years, one of the global bond index providers (JP Morgan) has decided to include India in its family. While India allows foreign ownership of domestic bonds in a regulated manner, this act of global listing (within the Emerging Markets suite) would add a new dimension to India's appeal as a destination for foreign investment.

Chart 1: India is the last major EM country to get listed by a global bond index

Note: (i) India's inclusion will commence from June 2024, (ii) Map not according to scale.
Source: Public domain

To recall, India's bond index inclusion buzz has been around for almost four years now, coinciding with key events like PM Modi's meeting with Michael Bloomberg in Sep-19 in the US, JP Morgan and FTSE Russell putting India on a 'watchlist' in Mar-21 for a potential listing and exclusion of Russia from global bond indices post the outbreak of the Ukraine war in Feb-22. However, each time the buzz had fizzled out as talks hit a roadblock with respect to taxation (exemption of capital gains tax) and operational aspects like clearing of transactions (on Euroclear – a platform for global settlements).

It is noteworthy that despite India maintaining its stance of 'no tax exemption' and emphasis on 'domestic clearing', JP Morgan **suo moto**, decided to go ahead with the inclusion of Indian bonds in its EM index. This raises the likelihood of a similar act by other index providers like the FT Russell and Bloomberg-Barclays sometime in the near future.

Near-medium term impact: Sizing the quantum of potential inflow

As per the JP Morgan's Index Governance Review 2023, India will be included in the GBI-EM Global Diversified index suite and relevant derivative benchmarks, starting June 28, 2024, and is expected to acquire a weight of 10% in a phased manner by March 31, 2025 (translating into addition of 1% weight each month for 10 consecutive months).

- As of Aug 31, 2023, the total AUM for GBI-EM GD indices stood around USD 236 bn. With India projecting to garner a 10% weight in the index, this would amount to an estimated USD 23.6 bn of FPI debt investment flow between Jun-24 and Mar-25.
- For index inclusion, g-secs classified as FAR[1] securities by the RBI would be considered. As of Sep 21, 2023, the outstanding under FAR securities stood at USD 411 bn. Out of this, the potential pool of eligible securities (decided basis residual maturity and outstanding amount) is currently worth USD 338 bn.
- As of Sep 21, 2023, the FPIs held about USD 11 bn FAR securities, out of which, USD 9 bn is in securities that are index eligible.
- A portion of this USD 9 bn investment in FAR securities could already be tracking EM-India allocation from FPIs in anticipation of the index inclusion move. Hence, the incremental flow of account of JP Morgan's index inclusion could be somewhat lower than USD 23.6 bn.

Table 1: GBI-EM GD country weight projections with India's 10m phased inclusion

Country weights in JP Morgan's GBI-EM GD (%)											
Country	Current	Projected									
	Aug-23	Jun-24	Jul-24	Aug-24	Sep-24	Oct-24	Nov-24	Dec-24	Jan-25	Feb-25	Mar-25
India	-	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
China	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
ndonesia	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Mexico	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Malaysia	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	9.8	9.7	9.5
Brazil	10.0	10.0	10.0	10.0	10.0	9.8	9.6	9.5	9.3	9.2	9.0
Thailand	9.8	9.6	9.4	9.2	9.0	8.9	8.7	8.6	8.4	8.3	8.1
South Africa	8.1	8.0	7.8	7.6	7.5	7.4	7.2	7.1	7.0	6.9	6.8
Poland	7.6	7.4	7.3	7.1	7.0	6.9	6.7	6.6	6.5	6.4	6.3
Czech Republic	6.2	6.1	5.9	5.8	5.7	5.6	5.5	5.4	5.3	5.2	5.1
Colombia	4.5	4.4	4.3	4.2	4.1	4.1	4.0	3.9	3.8	3.8	3.7
Romania	3.8	3.8	3.7	3.6	3.5	3.5	3.4	3.4	3.3	3.3	3.2
Hungary	3.1	3.0	3.0	2.9	2.9	2.8	2.7	2.7	2.7	2.6	2.6
Peru	2.4	2.3	2.3	2.3	2.2	2.2	2.1	2.1	2.1	2.0	2.0
Chile	2.0	2.0	1.9	1.9	1.9	1.8	1.8	1.8	1.7	1.7	1.7
Egypt*	1.0	1.0	1.0	1.0	1.0	1.0	0.9	0.9	0.9	0.9	0.9
Turkey	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.6	0.6	0.6
Serbia	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.2
Uruguay Global	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Dominican Republic Global	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1
Philippines Global	0.1	-	-	-	-	-	-	-	-	-	-

Source: JP Morgan

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1 The RBI introduced the Fully Accessible Route (FAR) in March 2020. The FAR allows non-residents to invest in specific GoI dated securities without any ceiling limits. The RBI periodically notifies which g-sec are available for investment under the FAR.

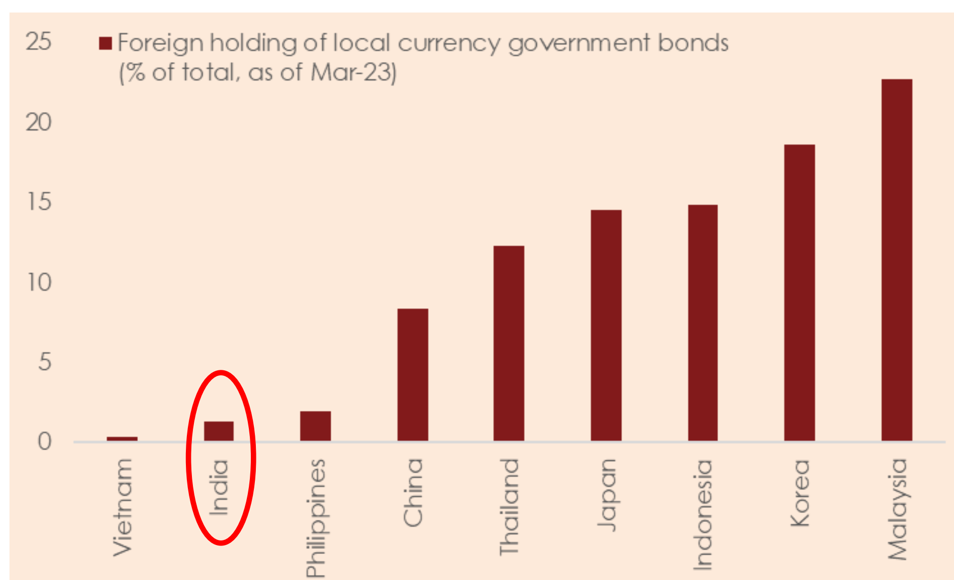
If other index providers, viz., FTSE Russell and Bloomberg-Barclays also follow suit over the next year, then market participants estimate scope for additional USD 15-25 bn of debt inflows, depending upon India's weight in these indices. Assuming India finds itself getting listed in all three major bond indices, there could be a potential FPI debt inflow of USD 35-45 bn staggered over a 1-2 year period (depending upon the time of listing by FTSE Russell and Bloomberg-Barclays).

Medium-long term macroeconomic impact

From a medium to longer term perspective, the most important benefit for India would accrue in the form of lower borrowing cost for the government.

- FPIs held only 1.4% of g-secs as of Mar-23. This is significantly lower than the median of 13.4% seen in case of most ASEAN+3 nations.
- The share of FPI ownership in g-secs could potentially jump to 4.1-4.9% by end of Mar-25 if the other index owners also make an announcement to include India in their respective bond indices.
- While this would still render India as one amongst the lowest degree of foreign ownership of local currency sovereign bonds, it would help leapfrog the FPI share to closer to 5% - one of the erstwhile guiding thresholds that the RBI has used while allocating investment limits for FPIs (that currently remains significantly underutilized).

Chart 2: India has one of the lowest foreign ownerships of government bonds in Asia

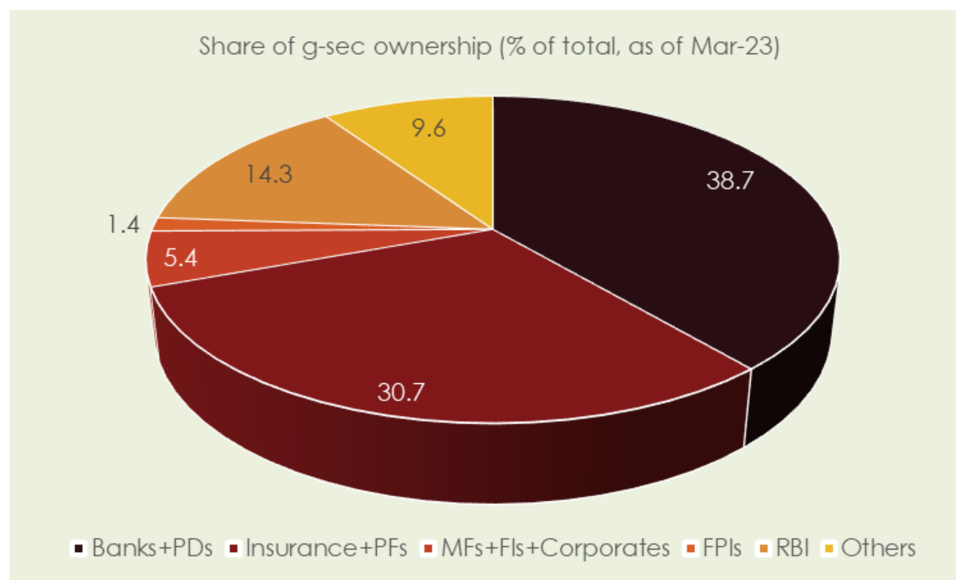


Source: RBI, Asia Bonds Online

- From the perspective of FY25, assuming the central government sticks to the path of fiscal consolidation and targets a fiscal deficit target of 5.4% of GDP (vs. 5.9% in the current financial year), this could then result in a net market borrowing requirement of approximately Rs 11.9 tn. If India can garner USD 35-

45 bn index related inflows by Mar-25, then would help absorb 24-31% of net g-sec supply in FY25. That is a substantial one-time relief for fiscal funding and is likely to be offset by lower participation by banks (will help to release funds for credit) and the RBI (likelihood of OMO sale, as explained later).

Chart 3: Pick-up in FPI ownership in FY25 to be offset by a decline in share of banks and RBI



Source: RBI

We believe the generation of additional source of fiscal funding via global bond listing is superior compared to raising foreign currency debt via Sovereign Dollar Bond. The latter can come to haunt as the 'original sin' during testing times, while in case of former, the issuer does not bear the currency risk.

Besides benefits for fiscal funding, there are other positive externalities too:

- Hedging requirement of FPIs would increase with index related flows. While the option of hedging offshore is available to them, domestic hedging market would nevertheless enjoy some degree of increase in participation.
- FPIs providing additional source of fiscal funding would free up resources for the domestic corporate bond market.
- This in turn would lower the cost of borrowing for domestic corporates, which could also boost their equity market valuations.
- From a macro perspective, the effectiveness of monetary policy is generally enhanced with increased access of FPIs to domestic bond market.

Policy implications and market reaction

The act of listing on international exchanges is likely to prod both monetary and fiscal policymakers to lean on the side of macroeconomic stability, prioritize rules-based policymaking over discretion, and keep the progress on the path of economic reforms.

From India’s medium-long term macro perspective:

- Return to a revised FRBM path will be critical along with sound debt management strategies to give confidence to debt investors on fiscal sustainability.
- On similar lines, unwavering focus on the inflation targeting mandate without unambiguous interpretations would ensure durability of foreign debt inflows.

From FY25 perspective, the policy implications would pertain to managing the liquidity implications of the sudden gush of anticipated foreign inflow. If India’s current account deficit remains broadly unchanged and prints at 1.5% of GDP in FY25 (somewhat higher than the 20-year median of 1.3%), the concomitant BoP surplus is unlikely to exceed USD 50 bn even if the other two index providers follow suit shortly with a similar announcement. We note that the RBI proactively managed FX intervention in FY20, FY21, and FY22 – recent years that saw a high BoP surplus of USD 59 bn, USD 87 bn, and USD 48 bn respectively – resulting in a net accretion to forex reserves. A similar strategy could be deployed to absorb one-time chunky foreign inflows. The central bank can choose to sterilize the same with OMO sales and/or issuance of MSS securities, in consultation with the GoI. The quantum of required net FX intervention (approximately 1.3% of GDP) in FY25 does not appear to be large by historical standards, when juxtaposed with the 20-year median BoP surplus of 1.2% of GDP. Hence, the deployment of sterilization tools to absorb rupee liquidity is unlikely to create market disruption in our opinion.

In the short term, i.e., the remaining months of FY24, there will not be any flow impact. However, few investors could font run positions ahead of the actual event beginning next financial year.

- This could raise the likelihood of reduction in g-sec term premium with 10Y yield potentially touching 6.90% before Mar-24.
- It could also lead to some flattening of the g-sec yield curve (as most index eligible FAR securities are likely to be in the belly of the curve) and a mild increase in SDL spreads.
- There is unlikely to be any meaningful impact on INR in the current dollar bullish environment that is likely to last for the next few months. Moderate positioning flows would be either absorbed by the current account gap or the central bank (to recoup lost reserves). As such, USDINR range of 82-84 is likely to hold until Mar-24.

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