Implications of Indian Governments' inclusion in Global Bond Index

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One of the most important events concerning the Indian markets has not received as much media attention as it deserves. It is the decision of including Indian Governments in the J P morgan Emerging Market Global bond index announced in 2023 effective from June 2024. The move is of great significance from the perspective of international investor's recognition of the maturity of the Indian bond markets as also from the future growth perspective of the bond markets in India.

The issue of including Indian government bonds in the global bond indices started receiving policy making authorities' attention more than a decade back in the wake of taper tantrum in 2013. In the aftermath of US Fed Reserve's Ben Bernanke making an observation that the US Fed may think of tapering off the QE (Quantitative easing) program (started in the midst of global financial crisis as an antidote to recession), the markets became jittery about impending tightening of global liquidity. The repercussion of this observation was felt more strongly in India as the Indian economy's macro parameters (like inflation, current account deficit) were none too healthy then and the market reacted very nervously to the US Fed Chairman's remark with the FPIs triggering an outflow of substantial magnitude in the period between May and October 2013. RBI attempted to arrest the outflows by employing monetary tools with interest rates being raised by 200 basis points. Actually, this move accentuated the nervousness in the markets. It is matter of history that this period coincided with the change in the incumbency at RBI and the RBI came out with several hurriedly thought out measures to stem the outflows during this period. It was at this time that the bond inclusion issue also started receiving attention at RBI. The index providers laid it down as a pre requisite that the limits relating to foreign investments in bonds will have to be completely dismantled if Indian Government bonds have to be included in the global indices. RBI was not comfortable with this idea as there was an apprehension that there would be a compromise on India's monetary policy independence if India's bonds were to be included in global indices. The idea got shelved then. The idea got reignited when RBI thought about the innovative framework of "Fully accessible route", under which certain bonds issued by the Government India were allowed to be accessed by foreign investors without any limits.

The purpose of this piece is not to get into an estimation exercise about the likely quantum of inflows in days to come with the Indian bonds getting included from the last week of June 2024 in the J P Morgan Emerging market Global bond index. Markets are coming up with estimates which are anywhere in the broad region of USD 25 billion to USD 60 billion. Our objective here is to examine the following implications/ consequences :

1. Will this measure be of help in developing the bond markets in India ?
2. Does it mean enhancement of India's image as an investment destination ?
3. Will the regulatory landscape undergo a change in India as a result of this measure ?
4. Are there any serious downsides to this measure ?

Most importantly, the measure is a stamp of faith on the credibility of India's fiscal consolidation efforts and that , irrespective of political dispensation at the Centre, the nation is intent on fiscal rectitude. The latest Union budget goes a long way in strengthening that impression by lowering the fiscal deficit target to 4.9 percent of GDP. Given the recent track record of several countries (including the developed ones), India's effort at fiscal rectitude seems to have grabbed international investor attention. Soon, the pressure will mount on the global credit rating agencies to revise the credit rating of India upward by at least two notches, if not more.

A well developed bond market is absolutely essential for a fast growing economy like India. While India is still a bank dominant economy, it is difficult to expect the banks to continue to do the heavy lifting (in the form of financing the corporates) all alone. With India projected to grow by more than 7 percent in the current year , the demand for capital will go up substantially. The infrastructure development efforts on the part of the government will create greater demand for long term capital. Bond markets will have to play a greater role in infra financing. India's inclusion will bring in more of foreign investors into the Indian government bond market and this should increase the activity levels and should usher in a market which is more vibrant and capable of better price discovery. While some critics may cry hoarse that this disintermediation process will stunt banking sector growth, it is difficult to buy this argument as India has a huge development potential still remaining untapped and this will provide a strong appetite for bank finance at least among the lower rated corporates.

With larger number of foreign funds entering the market, and with more domestic retail and institutional investors developing a taste for debt funds more from the perspective of healthy diversification, the regulatory approach towards bond markets will also have to undergo several significant changes. More of Government bonds will have to be moved into the Fully Accessible Category to enable more foreign investors to have a meaningful participation in Indian bond markets. A question that could arise once again is if India's bond markets should be moved to exchange traded platforms or should they continue in OTC. This question has always created a rift between SEBI and RBI, as it tantamounts to questioning the extent of regulatory span of RBI and SEBI . This is where policy makers have to rise much beyond the regulatory turfs and think in terms of market development in the country. A dispassionate observer would certainly veer round to an exchange traded model which offers much greater margins of safety to market participants compared to OTC. While an oft touted argument is that global bond markets are predominantly OTC, why can't India show a new path to the developed world ?

Let me now come to the most important question : Does this measure have any serious downsides ? If India's macroeconomic management falls short of international investors' expectations, there could be a reduction in India's weight in the index (as it has happened to China now), and this could trigger huge outflows from the country making both the exchange rate markets and the bond markets volatile. Even any monetary policy response in the form of steep hike in interest rates may not be able to stem the outflows as there are several passive funds which tend to mimic the index faithfully. Yes, this is a real threat to policy makers in terms of stabilizing the markets. But, we need to look beyond. Is not such a disciplining mechanism good for the country's economy? So, I would venture to say that this is a blessing in disguise. Viewed in totality, this measure acts as a potent force to shape the behavior of the political thought process, which cannot be achieved by other means in a freewheeling democratic framework.

RBI's job of containing volatility in forex and bond markets will be rendered more complex by this measure. RBI will have to deal with a large volume of foreign inflows to prevent the Rupee from appreciating heavily denting our export competitiveness. RBI has a time tested versatile toolkit to deal with this situation of excessive inflows. More challenging will be a situation of excessive outflows, when RBI will find it virtually impossible to stem the outflows unless RBI uses up the forex coffers very generously.