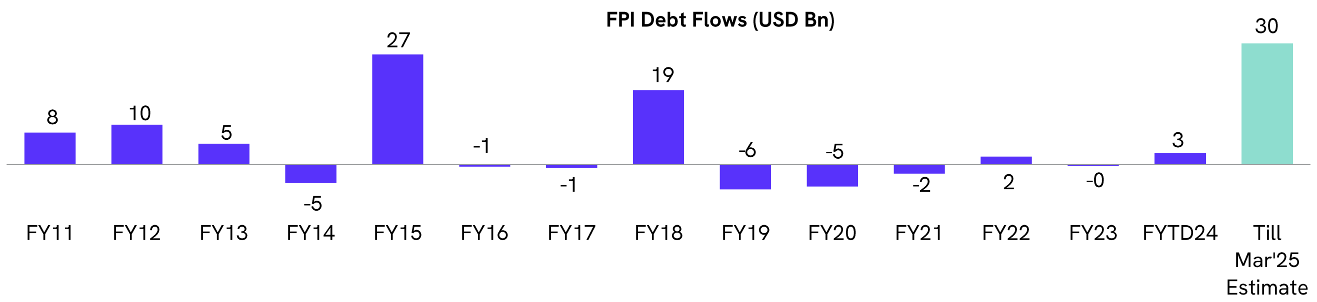
## India's Inclusion in Global Bond Index - A Structurally Constructive Move

JP Morgan has announced inclusion of Indian government securities in the Government Bond Index-Emerging Markets (GBI-EM) Global index suite. The JPMorgan GBI-EM indices are designed to track the performance of government bonds issued by emerging market countries. The GBI-EM consists of regularly traded, fixed-rate, domestic currency government bonds which international investors can access.

**Inclusion will be phased over a 10-month period**: India will be included in GBI-EM Global Diversified Index (GBI-EM GD) and other related indices with effect from 28th June 2024. India is expected to carry a 10% weight in the GBI-EM GD. The inclusion of the Indian bonds will be phased in over a ten-month period, with the weight increasing by 1% each month until March 31, 2025.

**Inclusion expected to drive significant inflows into Indian bonds:** The benchmarked AUM of GBI-EM family of indices is US$ 236 billion, out of which GBI-EM GD accounts for US$ 213 billion. Consensus anticipates around US$ 30 billion of inflows over the next 18 months. Bulk of the flows are likely to be passive and concentrated in the period of inclusion (June 2024 - March 2025). Some active anticipatory flows are also expected in the run-up to the actual inclusion.

**Chart 1:** Inclusion is expected to bring in a substantial $30 billion over the next 18 months




Note: FYTD24 flows till 25th September 2023
Source: NSDL, 360 ONE Asset Research

**Fully Accessible Route (FAR) securities eligible for inclusion:** 23 India Government Bonds (IGBs) under the Fully Accessible Route (FAR) with a combined notional value of approximately US$ 330 billion meet the eligibility criterion. Eligible instruments are required to have notional outstanding above US$ 1 billion (equivalent) and at least 2.5 years remaining maturity. FAR was introduced by RBI from April 2020 to enable non-resident investors to invest in specified Government securities without being subject to any investment ceilings. This was seen as a pre-cursor to India's inclusion in global bond indices.

**Opens up possibility for inclusion in other indices:** Indian Government Bonds (IGBs) might also get included in other indices such as the Bloomberg Barclays EM Global Bond Index and the FTSE EM Bond Index. However, the inclusion might be delayed on account of administrative issues related to withholding tax and Euroclear settlement.

There are wide ranging macro-implications of India's inclusion in GBI-EM indices. In the near term, it is probable that this will enhance India's balance of payments surplus, potentially result in an appreciation of the INR, and drive down yields on Indian government bonds (IGBs). Over the medium term, it will reduce the cost of capital, enhance macro stability, and boost long term growth. Let's delve deeper into the macro-implications of India's bond index inclusion.

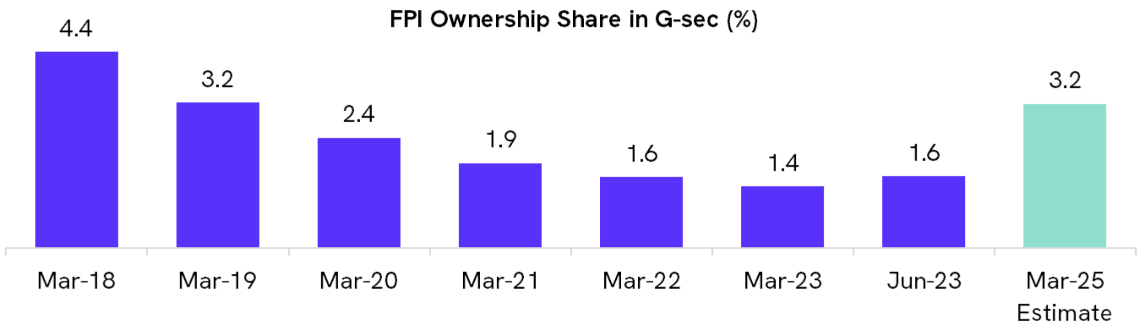
**Enhanced funding for the current account deficit to support INR:** Index inclusion offers an additional means of financing the current account deficit. A substantial portion of these inflows (passive) is likely to be concentrated during the inclusion period and will introduce an appreciating bias to the INR. Active inflows, however, are expected to begin much earlier. RBI is anticipated to intervene in the foreign exchange markets (by purchasing dollars in spot along with carrying out FX swaps) to prevent any significant volatility in the INR.

**Opportunity to build Fx Reserves**: RBI has the option to engage in foreign exchange spot interventions to augment its foreign exchange reserves. As of September 10, 2023, the RBI's foreign exchange reserves stand at approximately USD 594 billion, a decline of about US$ 48 billion from their peak of US$ 642 billion in September 2021. Thus, RBI is well-positioned to absorb a significant portion of incoming debt inflows to replenish and bolster its foreign exchange reserves.

**Inflows could improve domestic banking liquidity, may need to be neutralized:** RBI's foreign exchange spot intervention contributes to banking system liquidity. However, given the concerns surrounding inflation and potential financial stability risks arising from excess system liquidity, the RBI will need to offset surplus liquidity. While the RBI has a range of tools at its disposal for this purpose, it is highly probable that OMO (Open Market Operations) sales will be employed to address this situation.

**Expected to reduce government's borrowing costs**: The most significant impact of bond index inclusion will be a substantial increase in the demand for Indian government securities, potentially resulting in a decrease in yields. This decline in G-sec yields is expected to influence other markets as well since market interest rates are often anchored to the benchmark risk-free G-sec yields. It is worth noting that a portion of this increased demand is likely to be addressed through OMO sales by RBI.

**Chart 2:** Debt Inclusion to increase FPI's share in Indian government bonds




Source: RBI, 360 ONE Asset Research

**Support long term growth:** Index inclusion also promotes long-term growth by providing an additional funding source for the fiscal deficit. This frees up space for the domestic financial sector to meet the growing capital needs of the private sector. This move also leads to a reduction in financing costs for private borrowers. Additionally, a stable INR lowers the hurdle rate for foreign investors. Improved financing for twin deficits - fiscal and current account - enhances macroeconomic stability, boosts investor confidence, and thus, supports long term growth.

To summarize, India's inclusion in the bond index holds significant structural benefits for cost of capital, the balance of payments (BOP), the Indian Rupee (INR), and long-term growth. However, the inclusion could heighten susceptibility to external shocks. It is also expected to result in greater scrutiny of India's fiscal deficit, underscoring the importance of adhering to the committed path of fiscal deficit reduction.

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