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India's Bond Index Inclusion: New Era in Debt Markets

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India G-Secs in JP Morgan Indices

After a long gap of nearly three decades when the country opened foreign participation in its domestic stock market, its sovereign bonds made a foray into the world of global bond indices. The Indian economy made a tryst with history on June 28, 2024, with JP Morgan including a special category of India g-secs in its GBI-EM (Global Bond Index – Emerging Markets) bond index with an entry level weight of 1% but increasing monthly by 1% until it reaches a cumulative weight of 10% in March 2025.

When the formal notification of India's maiden inclusion in global bond index was made in September 2023, the foreign portfolio investors held just 1.6% of outstanding g-secs. This was one of the lowest in emerging markets despite a reasonably well developed local sovereign bond market (in comparison, as of Sep-23, foreign ownership in local sovereign bond market stood at 7.5% for China, 10.9% for Thailand, 15.0% for Indonesia, 20.3% for Korea, and 22.9% for Malaysia). As of June 2024, the FPI ownership of outstanding g-secs is estimated to have already climbed up to 2.3% due to increase in foreign investors' positioning activity in last nine months ahead of the actual inclusion.

Near to Medium term Impact

With JP Morgan's GBI-EM index introducing India to the world of global bond indices, it is very likely that other global index providers will also follow suit (India's listing in one of the smaller Bloomberg EMBIs is slated for January 2025). There is a possibility that other major EM bond indices from FTSE, Barclays, Citibank, etc. would eventually include India in the coming years. This raises the possibility of FPI ownership of Indian g-secs witnessing a two-fold jump to around 5% in the coming years, which will clearly be a new high for the Indian debt markets.

From a near-term perspective, entry into the JP Morgan's bond index will potentially attract a cumulative foreign debt inflow of USD 25 bn by Mar-25. The actual inflow will depend upon the extent of front running (that few active investors might have done in anticipation ahead of the actual event) and investor's risk appetite (i.e., whether they choose to be under/over-weight on India).

From a medium-term perspective, the debt flows from passive investors or active investors tracking performance benchmarked against global indices, would continue at a steady and gradual pace since India's inclusion will offer diversification benefits (in recent years, Indian yields as well as its currency have been showing low correlation with the broad trend in EMs). With a structurally higher flow of foreign capital and higher demand for Indian g-secs, the bond yields are expected to soften in both the near and medium term.

How does India benefit from this?

Bond index inclusion for India has several embedded macro benefits, which would play out with different levels of gestation. At an immediate level, the initial gush of foreign investment will help in lowering g-sec yields, while it would also strengthen the funding scenario for India's current account deficit (and bridging the savings-investment gap to some extent), thereby fostering better rupee stability.

In addition, there could be gains in the form of:

- Diversification of market participation would unlock domestic capital in g-secs (esp. relevant for banks that have ~40% ownership of g-secs), which could find alternative avenues to fund other economic activities. This may result in a structural decline in interest rates in the economy via compression of the term premium and credit risk.

- Increased foreign ownership of g-secs would instil a sense of rules-based sound fiscal and debt management. Govt of India has to reinforce its commitment to fiscal consolidation and discipline to attract higher foreign debt capital.

- Higher participation of FPIs in Indian sovereign papers could also act as a precursor to a sovereign ratings upgrade by international rating agencies. S&P has already raised the outlook to "positive" on India's "BBB-" sovereign rating.

- The ancillary market for interest rate and FX derivatives would get a boost as some FPIs might explore hedging options.

- Additionally, FPIs' participation in the g-secs market may gradually percolate to the corporate bond market in search of higher yields. While such interest is likely to be only limited to the AAA/AA category (local scale), it can add some needed depth to the existing market and facilitate a pickup in secondary market activity for corporate bonds.

Risks and mitigants

Although the consensus opinion on India's bond index inclusion is highly constructive, policymakers would need to be aware of attendant risks. Higher foreign ownership of domestic bonds could potentially amplify episodes of global risk aversion via capital outflows, thereby fanning volatility in domestic financial markets.

However, since the economic upside from index inclusion is significant, one needs to embrace it wholeheartedly, with curated safeguards. In this context, it will be important to have an unwavering policy focus on domestic macro stability with fiscal discipline and impeccable monetary policy credibility. In addition, the central bank also needs to prudently keep building forex reserve buffer to enhance its firefighting capability and fine-tune money market liquidity conditions contingent upon its monetary policy stance.

India's entry into the global bond index space in Jun-24 has brought about excitement that is like a T20 cricket match. While excitement is contagious in the near-term, this seminal change has characteristics of a cricket test match. Keep patience, focus on fundamentals, and let the bond innings mature.

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