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Impact of India's inclusion in JP Morgan bond index

After a long wait, India was finally included in JP Morgan's global bond market index. This will be undertaken over a period of 10 months, starting from 28 Jun 2024. India's weight in the GBI-EM Global Diversified Index (GBI EM GD), is expected to reach 10% by Mar 2025. The AUM of GBI-EM-GD stands at US$ 213bn. Additionally, India will also be included in other indices under the GBI-EM suite, with total AUM's of US$ 236bn. We expect inflows of US$ 20-30bn from India's inclusion in the index to begin with. In case India is also included in other indices such as Bloomberg and MSCI, inflows would be even higher. This can have a positive impact on domestic bond yields and INR in FY25, when the actual inflows materialize. However, as FPI flows tend to be volatile, it also leaves India vulnerable to greater financial sector volatility which will require regular monitoring and intervention by the RBI.

Introduction

India has been included in JP Morgan's global bond index-suite for emerging markets (GBI-EM). The AUMs benchmarked to the suite are worth US$ 236bn. Of this, almost 90% is earmarked to the GBI-EM global diversified index (GBI-EM GD), in which India is expected to have a weight of 10%. Only two other countries i.e. China and Indonesia have a weight of 10% in this index, and their weights have been kept unchanged. While their weightage in the index will see some reduction, Mexico, Malaysia and Brazil still have a weight of ~9% in the index. To accommodate India, Thailand, South Africa and Poland will see the most sizeable decline in their weightage in the index.

It must be noted that India had made remarkable progress in promoting foreign participation in the domestic market due to which India was put on the index positive watch. Some of these measures included introduction of fully accessible route (FAR) for investment in G-sec markets. A total of 23 Indian government bonds (IGBs) under the FAR are eligible with a notional value of Rs 27 lakh crores or US$ 330bn. Furthermore, the inclusion will take place over 10 months starting from Jun'24, at the rate of 1% per month over this period.

How much debt inflows are expected?

India is expected to receive about US$ 20-30bn index related inflows. While a major part of these inflows will come directly from India's 10% weight in the GBI-EM index, there might be additional inflows due to higher interest in government securities by foreign investors.

Despite government reforms, ownership pattern of government securities shows that the share of FPIs still remains negligible. The debt utilization statistics also show that the utilization rate by foreign investors is considerably lower. For the general limit (where RBI mandates FPI investment in G-sec and SDLs at 6% and 2% respectively) FPI holdings in Gsec is at 23.51% for general foreign investors and for long term foreign investors at 5.59% (as of 25 Sep 2023). Even for FAR holdings, the holding share in

outstanding is considerably lower. For the 23 securities which are eligible under the index, the holding ratio of outstanding position as of 25 Sep 2023 is in the range of 0.15-5.43%.

The inclusion of securities is obviously a game changer, leading to widening of investor base. This will give the desired push by increasing the demand for these securities and bringing down the cost of capital. This is just the first round impact. The second round impact will be felt as favourable yield on these indices will in turn attract security specific interest to the wider investor base.

Which part of the curve will notice change?

Tenor wise data shows that securities in the range of 5-10 years are likely to get the maximum benefit as in terms of the outstanding amount as of 25 Sep 2023, these bucket range within the FAR holdings have the maximum share. So we may witness downward shift of the entire yield curve in this segment.

If we look at the movement of India's yield curve post the announcement of India's inclusion in the global bond index, it is interesting to see that 5-7 year part of the curve noticed a drop in yield (between 1-4bps) as the share of this bucket range is maximum as explained earlier.

Table 1. Movement in India's Yield curve

Tenor	21-Sep-23	22-Sep-23	25-Sep-23
3M	6.79	6.86	6.81
3Y	7.15	7.17	7.16
4Y	7.15	7.18	7.18
5Y	7.15	7.11	7.18
6Y	7.17	7.15	7.18
7Y	7.16	7.12	7.18
10Y	**7.16**	**7.18**	**7.15**
20Y	7.23	7.23	7.24
30Y	7.32	7.34	7.34
40Y	7.32	7.31	7.34

Source: Bloomberg, Bank of Baroda Research

Going forward the impact on different tenor papers will be contingent on a host of other factors. Post inclusion, it will be important to see how the liquid the papers will be. As per CCIL data, major concentration in terms of liquidity is the 2033 paper. So while expanding the investor base is important, it is also necessary to ensure the liquidity of the papers to make this a successful venture.

For benchmark 10Y paper, already the initial drop in yield post the announcement has undergone a correction. We do not foresee much change in 10Y yield in FY24 and expect it to remain in the range of 7.15-7.25%. However, post FY25, depending on flows, a downward bias towards the 7% range seems feasible, ceteris paribus.

Impact on BoP and INR

FPI inflows into debt are expected to increase with India's inclusion in the JP Morgan GBI-EM index. Positive sentiments around the index inclusion could lead to some inflows in the remainder of FY23.

With current account deficit (CAD) expected in the range of 1.5-1.6% of GDP, these flows will help to augment India's BoP surplus.

However, actual inflows are expected only post Jun'24, when the bonds are formally included in the index. We expect inflows of US$ 20-30bn in FY24. These will be crucial as India's CAD in FY25 is expected to reach~2% of GDP, amidst a pickup in global and domestic growth and higher commodity prices. In such a scenario, index-related inflows will help in funding the higher CAD and buildup foreign exchange reserves. This will require more rigorous monitoring and intervention by the RBI, suggesting that some of the forex reserves accumulated due to index-related inflows will be required to keep the currency range-bound.

We expect USD/INR in the range of 82-84/$ in FY25.

Impact on Liquidity

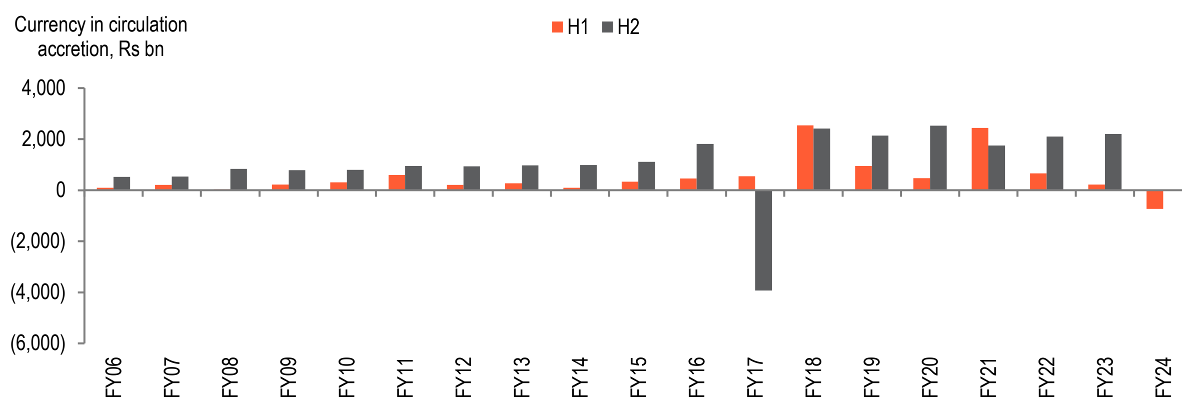
Pressure on liquidity is likely to persist in the near term. Currently, the gap between incremental credit and deposit is still around Rs 0.2 lakh crore. Apart from this, the drag would also come from higher pace of increase in currency in circulation (CIC). Historically, as well CIC picks up pace in H2. The actual comfort on liquidity would come in the medium term, post FY25. However, it remains crucial how RBI balances the same. OMO sales might be on the cards, if the inflows actual matches the desired expectation of US$ 20-30bn. Apart from this, for daily management, the frequency of higher tenor reverse repos might be increased.

What are the challenges?

The inclusion of India in global bond index will definitely be productive in terms of increasing domestic liquidity but it also comes at a cost of macro prudential risk. While higher foreign inflows are ceteris paribus positive for currency and bond markets, there are some caveats which need to be considered.

FPI flows tend to be volatile and are highly dependent on exogenous factors. In case of any adverse external shock, investors tend to move away from riskier EM assets which can lead to a capital flight. This will leave India's financial markets prone to heightened volatility. Both bond markets and the domestic currency will be impacted. Historically, there have been a few instances when capital outflows have resulted in a rapid depreciation in the rupee. Hence, inclusion in the index entails that we become susceptible to higher financial sector volatility. This would require robust monitoring and intervention by the RBI. As such, RBI will have its task cut out to ensure stability in the financial markets and prevent spillovers from financial markets in the real economy.

Fig 1. Currency in circulation has a tendency to pick up in H2



Source: Bloomberg, Bank of Baroda Research, data for H1FY24 till 15 Sep 2023

In conclusion

On the whole the inclusion of India in the bond indices is a positive development.

1. Once JP Morgan has included India in its indices, others like Bloomberg, Barclays etc, will follow. This is plain market logic.
2. Funds will also gauge relationships between components of the index and trade separately in them thus increasing the volume of demand.
3. Inclusion means more dollars coming in which is good for balance of payments.
4. More dollars means there is greater FPI participation in the bond market which will lessen pressure on domestic institutions.
5. As a corollary, there will be more to lend to companies at a time when investment cycle picks up.
6. Bond yields should ideally soften as demand for paper rises. But this will be contingent on the interest rate regime as well as the overall borrowing programme of the government – centre and states. Hence softening cannot be taken for granted, though is a distinct possibility.
7. While it will be good times for the country and economy, we must be cognizant that any withdrawal due to global factors not related to India can lead to volatility in the market.
8. The RBI will need to be on double vigil all the time.

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