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Foreign Portfolio Investment Flows

India's inclusion in J.P. Morgan GBI-EM Global index to lead to inflows of at least $18-22 billion in FY2025, auguring well for G-sec yields and INR

SEPTEMBER 2023

Highlights

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Net FPI inflows of at least ~$18-22 billion are expected during Jun-Mar FY2025, after inclusion of Indian G-secs in J.P. Morgan GBI-EM Index

Such inflows would imply an additional demand for G-secs of ~Rs. 1.4-1.8 trillion during June 2024-March 2025, even as the supply for G-secs in FY2025 is expected to dip slightly

This could lead to some easing of G-sec yields once inflows on account of inclusion begin starting June 2024

- Indian Government bonds would be included in the J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM) Global Index suite from June 2024, with a maximum weight of 10% in the GBI-EM Global Diversified Index (GBI-EM GD). The allocation of weights would be staggered over a 10-month period starting June 28, 2024, till March 31, 2025 (i.e., inclusion of 1% weight per month).
- Based on the assets under management (AUM) of funds tracking the J.P. Morgan GBI-EM family of indices ($236 billion), this inclusion could result in FPI inflows of at least $18-22 billion into Indian G-secs through the fully accessible route (FAR) during Jun-Mar FY2025, assuming that India reaches a weight of 7-9% in the GBI-EM Global Index by the end of this period.
- The FPI's share in ownership of GoI's dated securities has witnessed a sustained decline over the last six years, from the peak of 4.5% at end-Sep 2017 to just 1.6% as at end-June 2023. With the index inclusion, the outstanding investment in dated securities would more than double by end-Mar 2025, which would also push up the FPI's share in the ownership of the GoI's dated securities.
- The expected FPI-debt inflows of at least $18-22 billion could potentially finance a quarter of India's expected CAD in FY2025, thereby providing some comfort around funding a larger CAD, particularly in the event of shocks to other capital flows. This augurs well for the USD/INR cross rate.
- Such inflows would imply an additional demand for G-secs of ~Rs. 1.4-1.8 trillion during June 2024-March 2025, even as the supply for G-secs in FY2025 is expected to dip slightly, compared to the budgeted amount for FY2024, as per ICRA's estimates. An additional source of demand amid lower supply of G-secs would aid in financing the fiscal deficit and would augur favourably for such yields.
- ICRA believes that the index inclusion announcement would provide a cap on yields in the interim and could lead to some easing of yields once inflows on account of inclusion begin starting June 2024. A downward shift in the yield curve, aided by ICRA's expectations of a shallow rate cut cycle starting from Q2 FY2025, could also impart a softening bias to corporate bond yields.

Indian G-secs to be included in J.P. Morgan's GBI-EM Global Index from June 28, 2024 onwards

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As per an announcement by J.P. Morgan Chase, Indian government bonds will be included in their benchmark emerging-market index i.e. Government Bond Index-Emerging Markets (GBI-EM) Global Index suite starting from June 28, 2024.

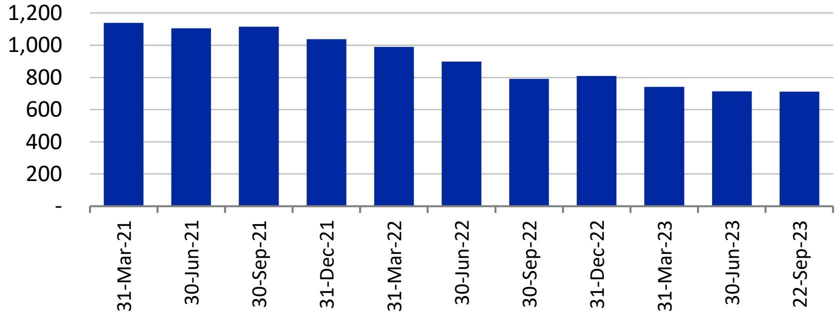
Additionally, it mentioned that India is expected to reach the maximum weight of 10% in the GBI-EM Global Diversified Index (GBI-EM GD). The GBI-EM indices tracks local currency bonds issued by emerging market governments. GBI-EM GD accounts for $213 billion of the estimated $236 billion AUM that is benchmarked to the GBI-EM family of indices.

Furthermore, it stated that currently 23 Indian Government Bonds (IGBs) with a combined notional value of $330 billion are index eligible (only IGBs designated under the Fully Accessible Route/FAR are index eligible). As per the '10/10 rule' for country inclusion in the J.P. Morgan EM indices, inclusion of IGBs will be staggered over a 10-month period starting June 28, 2024, till March 31, 2025 (i.e. inclusion of 1% weight per month). This could result into inflows of at least $18-22 billion into FAR G-secs during Jun-Mar FY2025.

Moreover, in addition to inclusion in the GBI-EM, J.P. Morgan said that India will be added to the Asia (ex-Japan) local currency bond index (JADE Global Diversified) over the same time frame as the GBI-EM GD with a likely weight of 18.48%.

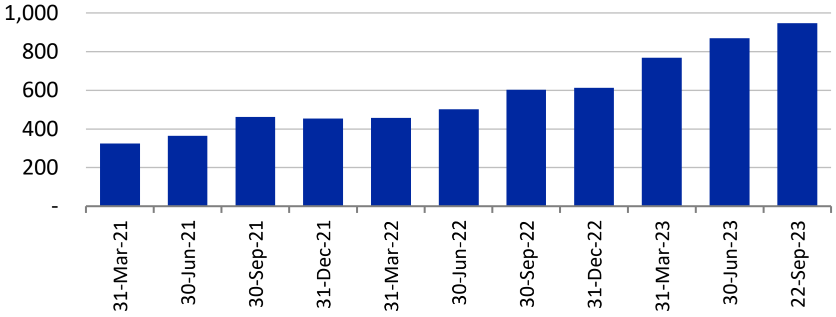
FAR was introduced in April 2020 to facilitate bond index inclusion; FPI holdings under this route to rise substantially through FY2025

EXHIBIT: Central government securities held by FPIs under General Investment Route (Rs. Billion)



Source: CCIL; ICRA Research

EXHIBIT: FAR holdings (Rs. Billion)



Source: CCIL; ICRA Research

- To facilitate inclusion in global bond indices, the Government of India (GoI), in the Union Budget for 2020-21, had announced that certain specified categories of government securities would be opened fully for non-resident investors. Following this, the RBI had introduced a separate channel, called the Fully Accessible Route (FAR), in April 2020 to enable foreign investors to invest in specified government securities without being subject to any investment ceilings*.
- As many as 31 GoI dated securities are specified securities under the FAR at present, as against just five when this channel was introduced in April 2020. With the increase in the number of specified securities under the FAR, and such securities being excluded from the General Investment route (which is subject to limits prescribed by the RBI), the outstanding G-sec holdings of FPIs under FAR have been rising while those under General Investment route have been falling.
- Currently, as per data released by the CCIL, FPI holdings in G-secs under FAR stood at Rs. 947.1 billion as on Sep 22, 2023, i.e. less than 1.0% of outstanding G-secs. **With the above-mentioned index inclusion, this amount could rise substantially by end-FY2025. Additionally, the continued expansion of the list of specified securities, as seen in the past, would augment FAR holdings.**

**Restrictions applicable on FPI investments in Government securities under the General Investment route will not apply to investments made under FAR.*

FPI inflows into debt of at least $18-22 billion expected during Jun-Mar FY2025

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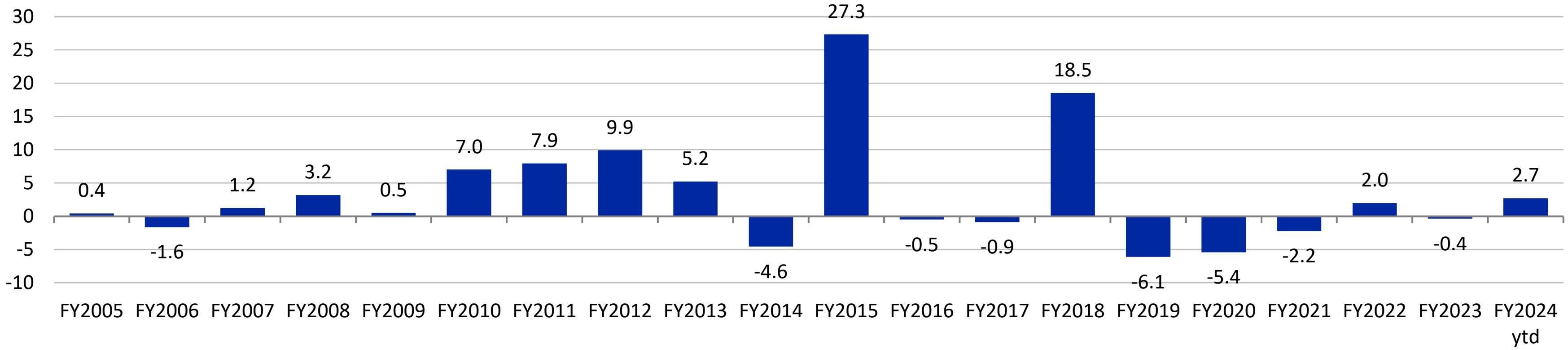
EXHIBIT: Trends in debt FII flows ($ billion)

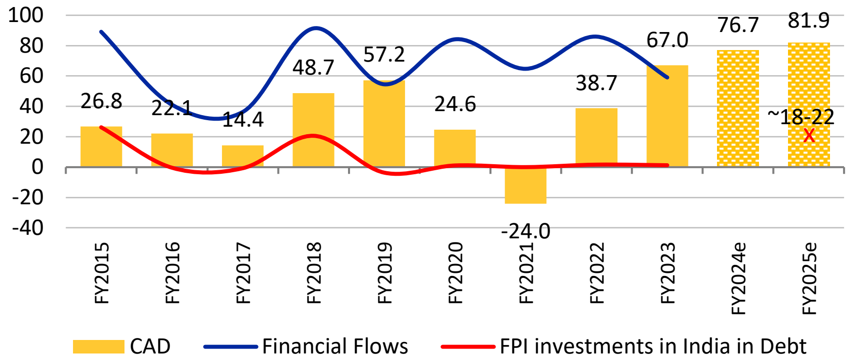


FY2024 YTD: Up to Sep 22, 2023; Note: This also includes debt flows via the VRR segment; Source: NSDL, CDSL; CEIC; ICRA Research

- India had largely witnessed net FPI outflows from the debt segment (including VRR) during FY2019-23 (barring in FY2022), cumulatively amounting to $12.2 billion. So far in FY2024 (till Sep 22, 2023), FPIs have turned net buyers in the debt segment, with total inflows amounting to $2.7 billion.
- The AUM of funds tracking the J.P. Morgan GBI-EM family of indices amount to $236 billion. **Based on this, the inclusion of Indian government bonds could result in FPI inflows of at least ~$18-22 billion into FAR G-secs during Jun-Mar FY2025, assuming that India reaches a weightage of 7-9% in the GBI-EM Global Index by the end of this period. This implies steady monthly inflows during this period, as India's weight in the Index rises in a staggered manner at the end of each month starting June 28, 2024, thereby leading to an improved visibility on this set of capital flows.**

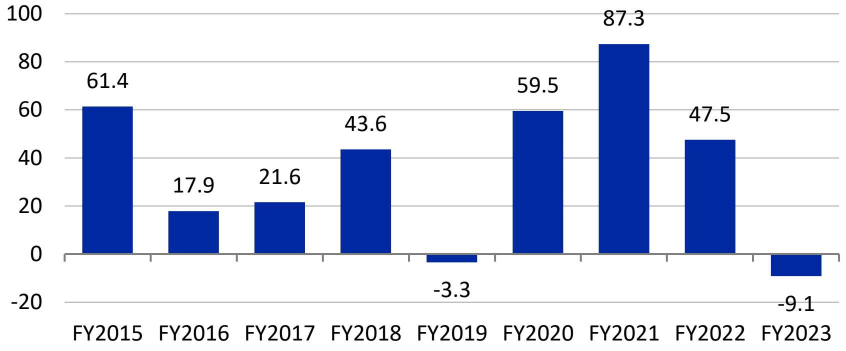
Substantial expected FPI-debt flows to provide comfort around funding larger CAD in FY2025

EXHIBIT: Trends in current account deficit and net financial flows ($ billion)



Financial flows includes FDI, FPI, financial derivatives, and other investment; Source: RBI; CEIC; ICRA Research

EXHIBIT: Trends in net Balance of Payments (BoP) position ($ billion)



Source: RBI; CEIC; ICRA Research

- India’s current account deficit (CAD) had risen to a decadal high of $67.0 billion (2.0% of GDP) in FY2023 from $38.7 billion (1.2% of GDP) in FY2022. However, net financial flows declined to $59.0 billion (1.8% of GDP) in FY2023 from $85.9 billion (2.7% of GDP) in FY2022. This had resulted in a reserve drawdown amounting to $9.1 billion in FY2023, in contrast to the accretion of $47.5 billion seen in FY2022.
- **ICRA expects the CAD to widen to ~$76-78 billion (2.1% of GDP) in FY2024 and further to $81-83 billion (while remaining stable at 2.1% of GDP) in FY2025.**
- **Although FPI-debt flows have not aided in the financing of the CAD during FY2019-23, this situation is set to change materially in FY2025, following the inclusion of Indian Government bonds in the GBI-EM Index from June 2024. The expected FPI-debt inflows of at least ~$18-22 billion in FY2025 could potentially finance a quarter of India’s expected CAD during that fiscal, thereby providing some comfort around funding a larger CAD, particularly in the event of shocks to other capital flows (such as FPI-equity). Overall, this may augur favourably for India’s net BoP position in FY2025.**

Index inclusion to have positive long-term implications for the USD/INR rate

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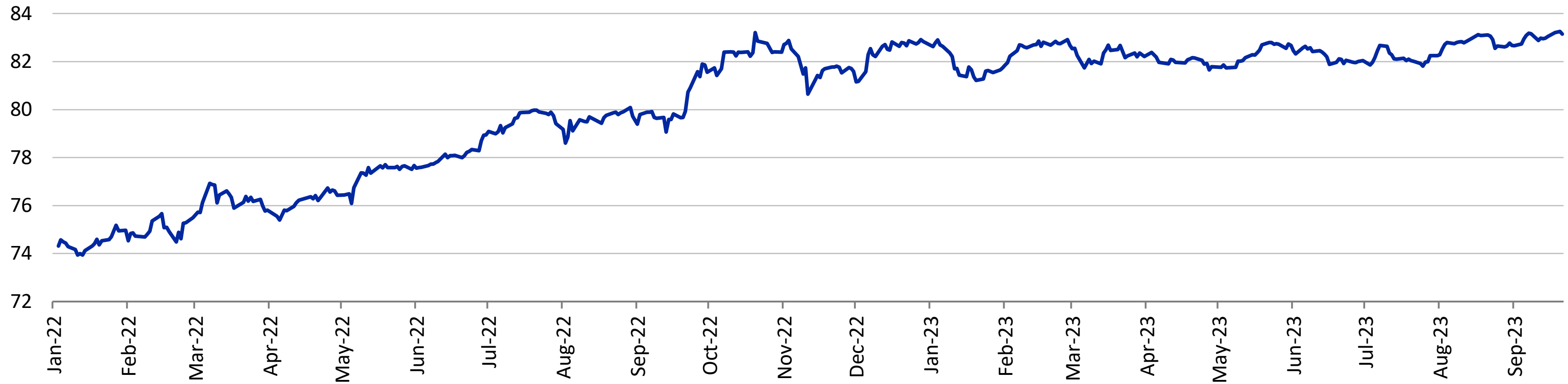
EXHIBIT: Trends in USD/INR Reference Rate

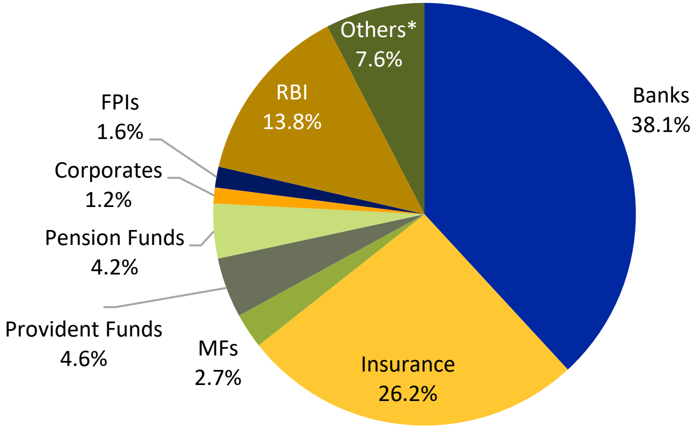


Source: RBI; ICRA Research

- After trading at above 83/$ levels in the previous week, the USD/INR rate appreciated to 82.95/$ on Sep 22, 2023, post the announcement. However, the rate has depreciated, trading at above 83/$ levels intraday on Sep 25, 2023, with crude oil prices ruling above $90/bbl. The bond index inclusion is likely to favour the USD/INR rate in the near to medium term and has positive implications from the medium-term perspective, amid expectations of increase in the FPI inflows, and a likely improvement in external account position. Steady monthly inflows during June 2024-March 2025, as India's weight in the Index rises in a staggered manner, would aid in reducing volatility in the USD/INR pair during this period.
- Nevertheless, other factors like the trends in DXY, international crude oil prices, geopolitical tensions, as well as intervention by the Central Bank would continue to impact the USD/INR rate in the immediate term. We expect the INR to trade between 82.0-83.5/$ in the remaining part of CY2023.

FPIs share of ownership in government debt quite low at 1.6% at end-June 2023; expected to rise following bond index inclusion

EXHIBIT: Ownership pattern of GoI dated securities as on June 30, 2023



Others includes non-bank PDs, financial institutions, state governments, etc. ;Source: RBI; ICRA Research

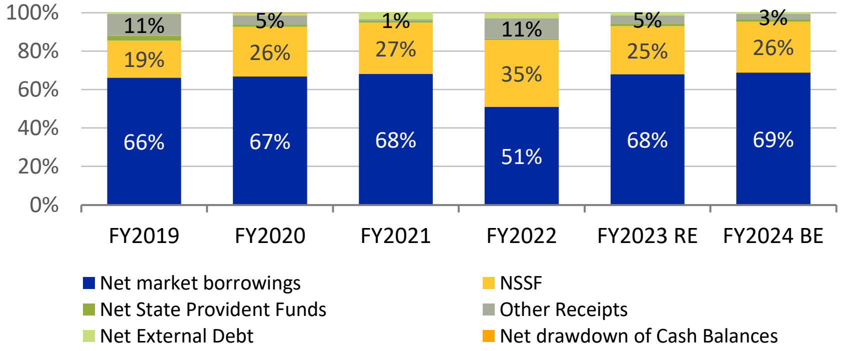
EXHIBIT: Share of FPIs in ownership of GoI dated securities

Source: RBI; ICRA Research

- The FPIs share in ownership of the GoI's dated securities stood at just 1.6% as on end-June 2023, implying an outstanding investment of Rs. ~1.6 trillion in G-secs (outstanding GoI dated securities as on end-June 2023: Rs. 99.0 trillion).
- This share has witnessed a sustained decline over the last six years, from the peak of 4.5% that was seen at end-Sep 2017, amidst FPI debt outflows from the country. The outstanding investment of FPIs in the GoI's dated securities has declined by 44.2% between end-Sep 2017 and end-Jun 2023, even as the total stock of such securities has risen by 87.5% during this period.
- **However, with the expected FPI-debt inflows of at least $18-22 billion during FY2025, the outstanding investment in dated securities would more-than double from the end-June 2023 levels by end-Mar 2025. This would also push up the FPIs share in the ownership of the GoI's dated securities.**

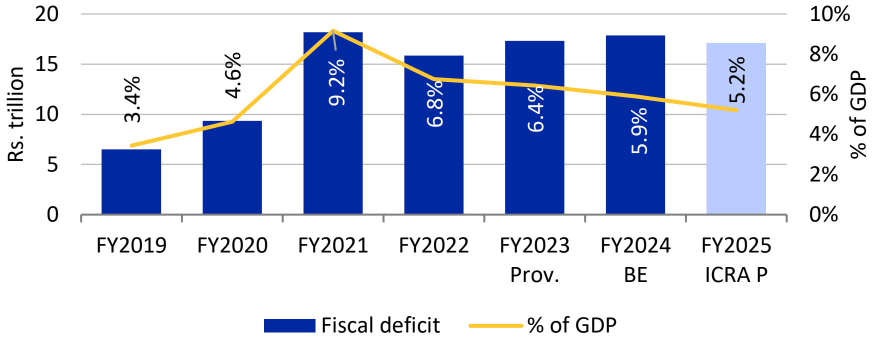
Bond index inclusion to create additional source of demand for G-secs, thereby aiding in absorbing the supply of such securities

EXHIBIT: Composition of Sources of Financing the Fiscal Deficit



RE: Revised estimates; Source: Union Budget; ICRA Research

EXHIBIT: Annual Trends in Fiscal Deficit



Actuals up to FY2022; Prov: Provisional estimates; BE: Budget estimates; P: Projected; Source: Union Budget; CGA; ICRA Research

- Based on the historical trends, a large proportion of the Centre's fiscal deficit is financed by the net market issuances, with a share of 65% in the total fiscal deficit on an average between FY2019 (Actuals) and FY2024 (BE), followed by funds from the NSSF at 26%.
- Given our assumptions for the fiscal deficit (at 5.2% of GDP) and nominal GDP growth for FY2025, and the historical average proportion of net market issuances, ICRA estimates the net and gross market borrowings of the GoI at ~Rs. 11 trillion and Rs. 15 trillion, respectively (with redemptions amounting to Rs. 3.9 trillion as on Sep 20, 2023). This is slightly lower than the budgeted levels of Rs. 11.8 trillion and Rs. 15.0 trillion, respectively, for FY2024.
- **FPI-debt inflows amounting to at least $18-22 billion, owing to index inclusion, would imply an additional demand for G-secs amounting to ~Rs. 1.4-1.8 trillion during June 2024-March 2025, even as the supply for G-secs in FY2025 is expected to dip slightly as compared to the budgeted amount for FY2024. An additional source of demand amid lower supply of G-secs would aid in comfortably financing the fiscal deficit and would augur favourably for such yields.**

Increased demand for G-secs to aid in some easing of G-sec yields, which could also impart downward bias to corporate bond yields

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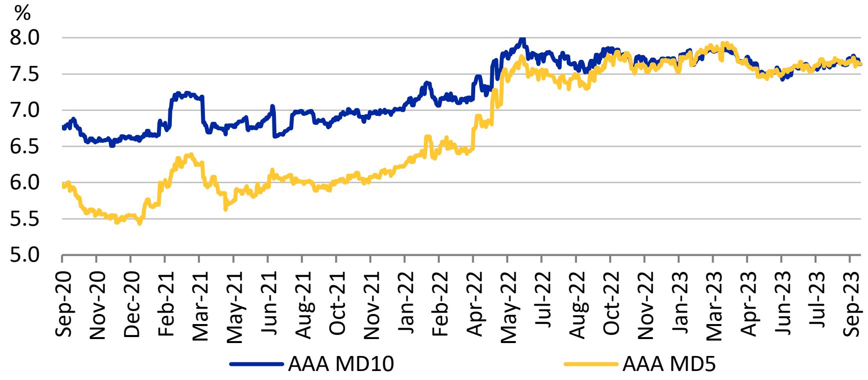
EXHIBIT: Trends in India 10-year Benchmark Yield

Source: Bloomberg; ICRA Research

EXHIBIT: Trend in India's Corporate AAA Bond Yields (MD 10-year and 5-year)



Source: Bloomberg; ICRA Research

- As on Sep 22, 2023, the 10-year G-sec yield (7.18 GS 2033) opened at 7.07%, ~6-7 bps lower than the previous day's close of 7.14% post the announcement of the bond index inclusion, before rising to 7.16% by the end of the day. ICRA believes that the index inclusion announcement would provide a cap on yields in the interim and could lead to some easing of yields once inflows on account of inclusion begin starting June 2024. Nevertheless, movements in crude oil prices and global bond yields would continue to impact moves in the 10-year G-sec. ICRA expects the 10-year G-sec yield to trade between 7.00-7.25% in the remaining part of CY2023.
- Additionally, following the inclusion of India's G-secs in the J.P. Morgan EM Bond index, the softening in Government bond yields across tenures could lead to a downward shift in India's yield curve, aided by ICRA's expectations of a shallow rate cut cycle of 50-75 bps starting from Q2 FY2025. This could also impart a downward bias to corporate bond yields, thereby auguring favourably for corporate borrowers.

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Thank You!