India’s Inclusion in JPMorgan GBI-EM Index

For Prelims: India’s Inclusion in JPMorgan GBI-EM Index, Government Bond, Sovereign Bonds, **Fiscal Deficits**, **Yield Curve**, **Reserve Bank of India.**

For Mains: Significance of India’s Inclusion in JPMorgan GBI-EM Index and Challenges.

Source: IE

Why in News?

Recently, JPMorgan Chase & Co. will include India in its **Government Bond Index-Emerging Markets (GBI-EM) index from June 2024**, anticipating significant inflows to India. This move is expected to widen the investor base and **potentially lead to the appreciation of the Rupee.**

What is the JPMorgan Government Bond Index-Emerging Markets (GBI-EM) index?

- **About:**
  - The JP Morgan GBI-EM is a widely followed and influential **benchmark index that tracks the performance of local-currency-denominated Sovereign Bonds** issued by emerging market countries.
  - It is designed to provide investors with a **representative measure of the fixed income market** within emerging market economies.
  - It Includes government bonds issued by various emerging market countries.
  - The composition may change over time based on eligibility criteria.
- **India’s Inclusion:**
  - JPMorgan has identified **23 Indian government bonds with a combined nominal value of USD 330 billion** as eligible for inclusion in the GBI-EM.
  - India's weight is expected to reach the maximum weight threshold of 10% in the GBI-EM Global Diversified, and approximately 8.7% in the GBI-EM Global index.
  - India's **local bonds will become part** of the GBI-EM index and its suite of indices, which serve as **benchmarks for approximately USD 236 billion in global funds,** as per JPMorgan.

What is the Significance of India’s Inclusion in GBI-EM Index?

- **Enhanced Investment Attractiveness:**
  - India's inclusion in the GBI-EM index positions India as a **coveted investment destination.**
  - It can attract global investors seeking opportunities in emerging markets, potentially **resulting in substantial inflows of USD 45-50 billion** over the next 12-15 months.
- **Economic Stability and Financing Ease:**
  - It can **ease financing constraints** related to **India's** Fiscal **and current account**

deficits by providing an alternative source of funds.
  - It structurally lowers **India's risk premia and funding costs**, fostering economic stability.
    - Risk premia refers to the amount by which the return of a risky asset is expected to outperform the known return on a risk-free asset.
    - Equity market exposure is the best-known risk premium, rewarding investors for taking exposure to **long-only equity investments.**
- **Positive Impact on Various Sectors:**
  - **Corporate Sector:** The inclusion is expected to **lower the entire Yield Curve,** reducing the **cost of financing for the corporate sector.** Narrower corporate bond spreads will **stimulate investment and business growth.**
    - The **Yield Curve** is a graphical representation of the interest rates on debt for a range of maturities.
  - **Banking Sector:** With lesser pressure to absorb government bonds, **banks can allocate more resources for lending** to the private sector, promoting economic expansion.
  - **Infrastructure Development:** India's ongoing infrastructure development initiatives receive a **boost as the inclusion provides a sustainable source of long-term financing** through government securities.
- **Currency Appreciation and Stability:**
  - The inclusion will lead to **an appreciation of the Indian rupee** due to increased investor confidence.
  - A **stable exchange rate enhances** the attractiveness of investing in India.
- **Market Development and Innovation:**
  - Integration into global markets, supported by ongoing reforms and increased market access, propels market development and **encourages long-term capital inflows.**
  - It sets the stage for the **introduction of innovative financial products.**
- **Par with other Countries:**
  - India is expected to reach a **maximum weightage of 10 %** in the GBI-EM Global Diversified Index, putting it at par with others like **China, Brazil, Indonesia and Malaysia.**

What are the Challenges of India's Inclusion in GBI-EM Index ?

- **Market Fluctuations:**
  - Inclusion may introduce **volatility in local debt markets,** especially during global economic turmoil or uncertainty, requiring the **Reserve Bank of India (RBI)** to manage and stabilize the markets effectively.
  - The RBI will **need to carefully manage its** monetary policy **decisions** to balance the impact of increased foreign investment while also ensuring domestic economic stability and growth.
- **Geopolitical Risks:**
  - High foreign holding of debt exposes Indian markets not **only to external macro-economic shocks but also to geo-political risks.** The recent experience of how Russia was ousted from international currency markets and the **SWIFT (Society for Worldwide Interbank Financial Telecommunications)** is a cautionary tale of how geopolitics can impact financial flows and hence economic well-being.
- **Currency Management:**
  - The inclusion may impact the **domestic currency's value**, posing challenges in managing exchange rates and ensuring the rupee remains competitive to support exports.
- **Transparency and Fiscal Responsibility:**
  - It may subject India to **increased scrutiny regarding government finances,** necessitating greater transparency and fiscal responsibility in managing the **fiscal deficit.**
- **Taxation Challenges:**
  - Unresolved tax treatment for **foreign investors may deter potential investors,** necessitating clarity and favorable tax policies to attract foreign capital into Indian government bonds.
  - The behavior of **foreign investors, especially during global economic shifts,** could result in sudden surges or withdrawals of funds, impacting market stability and capital flows.

Way Forward

- There is a need to work on **resolving operational challenges** related to custody, settlement, and tax implications to facilitate smooth participation of foreign investors.
- Strengthen the regulatory environment to ensure market integrity, transparency, and investor protection, encouraging long-term participation.
- Strengthen India's economic fundamentals to better withstand global economic shifts and fluctuations, minimizing risks associated with external factors.