The Bond Rush in Indian Markets*

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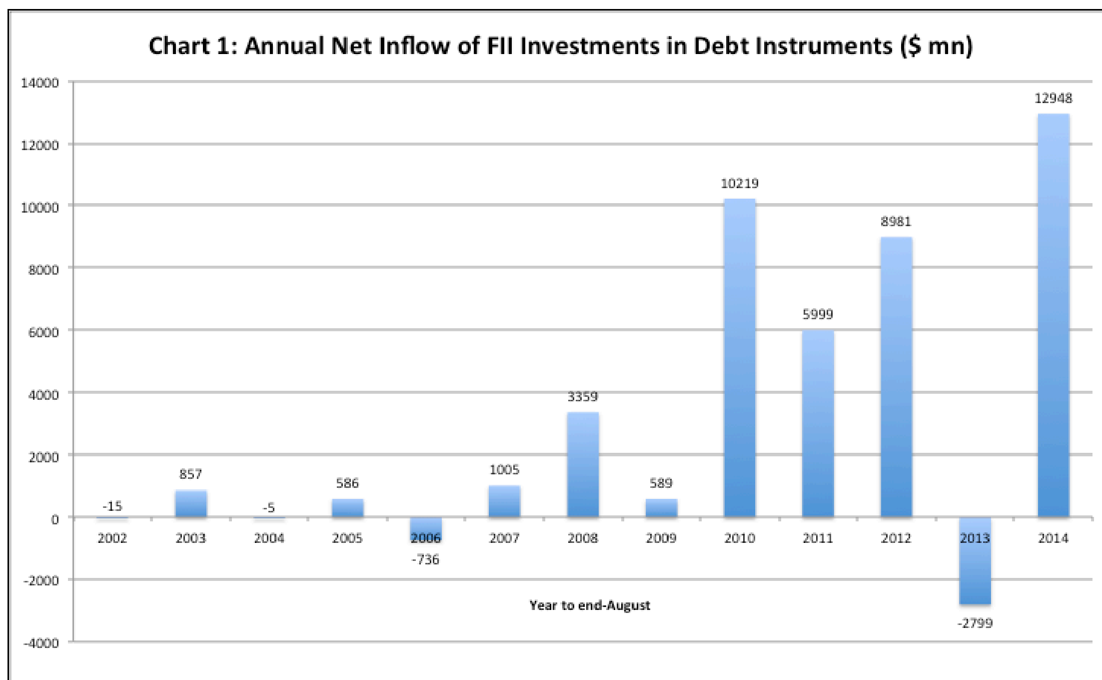
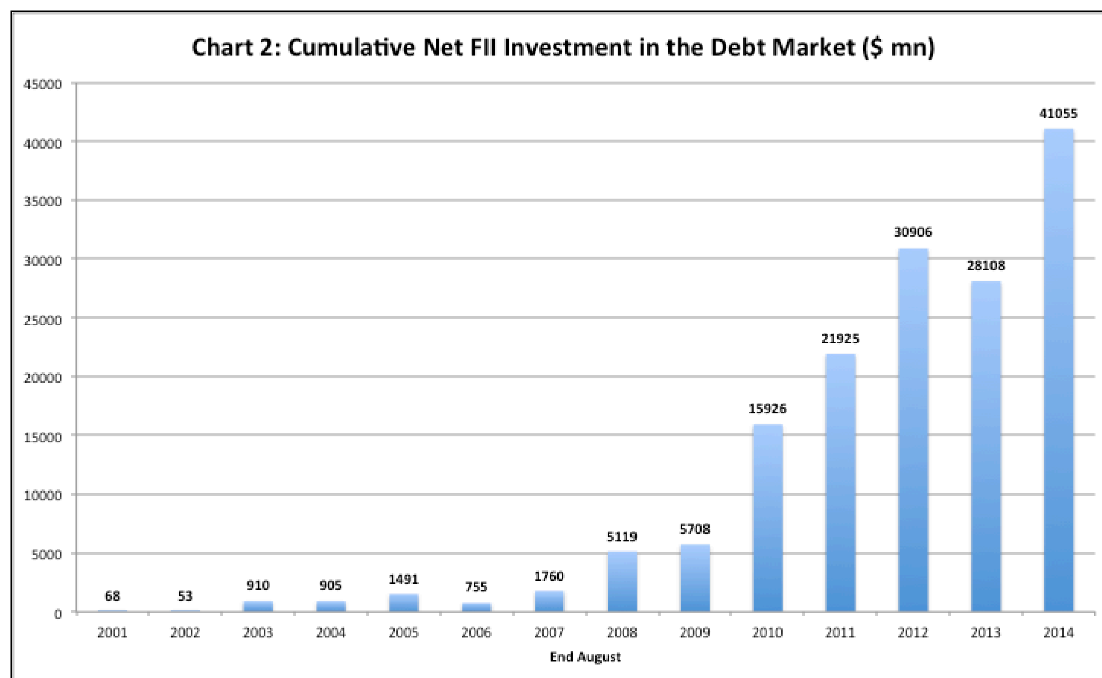
On 27 August, India's National Securities Depository Ltd. reported that foreign portfolio investors (FPIs) had acquired an additional $16.7 worth of bonds in the country during 2014, after netting for sales. This near-8 month record compares with net sales of bonds totalling $8 billion in 2013 and net purchases of $6.6 billion in 2012. What is remarkable is that the inflow over the three-month period starting June 1 this year amounted to a huge $9.1 billion. As much as $2.65 million came in on one day, August 21. This does reflect an unusual and speculative surge of FPI flows into Indian bonds.



Foreign investor presence in India's debt markets has increased considerably after the global financial crisis. Annual inflows over the years ending August (Chart 1) peaked at $3.4 billion in 2008, fell to less than $600 million in the immediate post-crisis year 2009, and rose sharply to $10.2 billion in year-ended August 2010, $6 billion in year-ended August 2011 and $9 billion in year-ended August 2012. The year to August 2013 was unusual inasmuch as there were net outflows of $2.8 billion, to be followed by a surge to $12.9 billion in the year to August 2014.

The collapse in flows and the exit of FPIs from the debt market in 2013 were clearly related to the fears of a liquidity squeeze generated by talk of the "taper" in the US. The exit of portfolio capital weakened India's rupee considerably, worsened sentiment and accelerated the outflow. A corollary of this relationship between expectations of the state of international liquidity (influenced by the policy stance of the US Federal Reserve), the direction of movement of the rupee and the volume of inflows into debt markets, is that the post-crisis expansion of foreign presence in India's debt markets must be seen as the result of the sharp increase in liquidity in the international financial system as a result of the monetary and fiscal policies adopted in response to the crisis. Interest rates in India are much higher than in international

markets, and if the assessment of exchange risk is that it is low (or that the rupee will not depreciate by 'abnormal' margins), investment interest in the Indian debt market would be high.

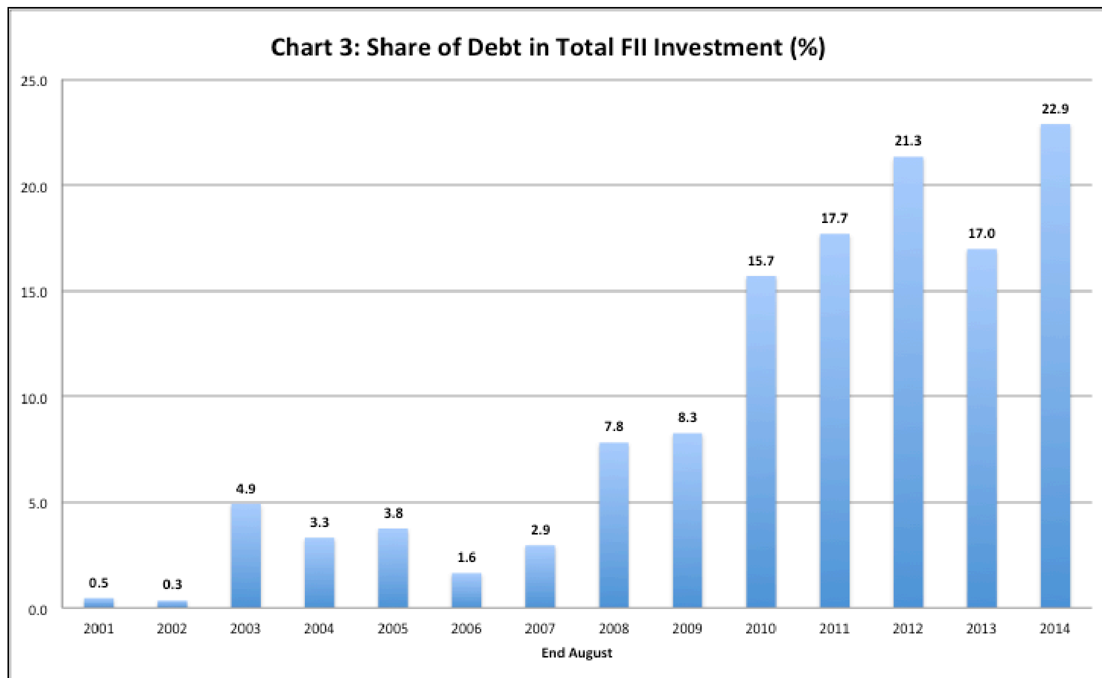


The result has been that despite the reversal in flows in 2013, cumulative net investment by FPIs in India's debt markets has risen from less than a billion dollars in 2006 to $30 billion at the end of August 2012 and $41 billion on August 27, 2014 (Chart 2).

One reason for the growing foreign investor interest in Indian debt was the liberalisation of policy with regard to permitting foreign portfolio investment in the debt market. It was in 1995 that the Securities and Exchange Board of India permitted FIIs to invest in debt markets, subject to the 70:30 rule, which specified that 70 per cent of an investor's exposure should be to equity and only 30 per cent to debt. The cap on total FII investment in debt was set at $1-1.5 billion. Soon thereafter, in 1996, a category FIIs that were allowed to invest only in debt instruments were permitted into the country's capital markets, with 100 per cent exposure to debt securities (including corporate bonds) subject to the aggregate ceiling of $1-1.5 billion. In 1998, such investment was permitted in unlisted securities as well or through the private placement market. Even as recently as 2004 the limit on aggregate debt was at $1 billion, with a cap of $100 million for investments under the 70-30 route and $900 million under the 100 per cent route.

From the end of that year, however, a process of continuous liberalisation began. By January 2007, the limit on FPI investments in debt markets had reached $4.6 billion, with that for government debt being set at $2.6 billion and that for corporate bonds at $2 billion. In 2008, the distinction between the 70:30 and 100 per cent debt FIIs was done away with and between January 2008 and February 2009 the ceiling on corporate bond investments was raised in three steps from $2 billion to $20 billion with the ceiling on government debt investments kept at $5 billion as on June 2008. By the end of 2012 the figures had touched $20 billion for government securities and

$46.5 billion for corporate bonds with separate sub-ceilings for bonds of different maturities and lock-in periods. Recently, the ceiling has been raised to $30 billion for government securities, which includes a sub-quota of $5 billion for sovereign wealth funds.



Two conclusions can be derived from these trends. The first is that the government has been following the market in terms of policy, raising the ceiling on FPI investments in debt securities as and when the appetite of such investors for debt increases. Second, in recent years the government has been aggressively opening up the corporate debt market to foreign investors. Moreover, the government has incentivised foreign investors in various ways. Thus, in May 2013, when FPI interest in debt securities seemed to be waning for reasons outlined above, the withholding tax on interest earned on investments by FPIs in government securities and bonds issued by Indian companies was slashed from the prevailing 20 per cent to just 5 per cent. This concession was to apply prospectively but on all interest income on such investments accruing between June 1, 2013 and May 31, 2015, irrespective of when the investment had been made. That is, even those who made investments assuming that the withholding tax applicable on interest income was 20 per cent were given the benefit of the concession, and rewarded with a hike in net return.

The net result of all this has been a sharp increase in the share of debt in total FPI investments, from 3 per cent of the total in 2007 to 23 per cent at the end of August 2014 (Chart 3). There are three possible and related explanations for this trend in policy. The first is that the widening of the current account deficit on India's balance of payments during the years preceding 2013-14, when the restriction of gold imports improved matters, had made the thirst for foreign capital in post-liberalisation India insatiable. The second is the evidence that, if the effort is to attract a continuous flow of foreign capital, it is not enough to incentivise only foreign investments in equity capital. Even though there has been a surge in foreign equity investment to emerging markets including India, the government is fearful that inflows into the equity market would be inadequate to quench its thirst for foreign capital. So debt flows need to be

incentivised too. The third is evidence that foreign investors are showing an appetite for debt.

The consequent sharp rise in India's debt does impose costs on the nation. Unlike the case with investments in equity, where returns are linked to performance, interest and amortisation commitments on debt have to be met irrespective of the returns obtained in or foreign exchange earned by the investments they finance. The debt being in foreign currency, these binding commitments have to be met in foreign currency as well. So if the there is a surge (as recently experienced) in FPI investments in the debt market, outflows on the current account because of interest payments would rise as well. These would rise even faster if the interest rate that has to be offered to foreign financial investors in India's increasingly uncertain environment also increases.

Moreover, inflows are not being limited to investments in long-term bonds, such as those used to fund infrastructure. This is increasing the share of bonds with shorter maturities in the total. Attracting short term debt inflows is a sure way of increasing vulnerability to sudden capital outflows that can precipitate a balance of payments crisis, as India's experience in 1991 and Southeast Asia's in 1997 illustrated. In fact, the recent volatility in debt flows is ominous.

Besides, relying on foreign currency debt to finance domestic expenditures has important implications for the viability of borrowers. Rupee depreciation increases the local currency or rupee cost of servicing foreign debt, imposing an additional and undefined burden on the borrower. Firms exploiting increased foreign investor interest are likely to over-borrow. In more difficult times, they can find themselves unable to service foreign debt without courting losses and even bankruptcy.

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