Demystifying Inflation Indexed Bonds

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INTRODUCTION
The Government of India recently auctioned Inflation Indexed Bonds (IIBs) to all categories of investors through the Reserve Bank of India (RBI). The RBI sold Rs1000 crore worth Inflation Indexed Bonds at a coupon rate of 1.44% over Wholesale Price Index (WPI) for a fixed period of 10 years. The central Bank received 167 bids, mostly from big institutional investors like traders and insurance firms, since only 20% of the bonds was exclusively reserved for retail investors. ‘The Inflation Indexed Government Stock 2023’, as it was called, notified the amount of Rs 1000 crore through price based auction following uniform price method, out of which the above said 20% was allotted to eligible investors as per norms of non-competitive bidding facility in the auction of government securities. The government has so far raised Rs 20 billion in a set of two auctions as of June 2013. The government plans to secure 12,000-15,000 crore rupees through frequent auctions of Inflation Indexed Bonds (probably fortnightly auctions) benchmarking for retail investors. In this context, it is relevant to explore the financial instrument called Inflation Indexed Bonds, the context of its introduction and the purpose it is expected to serve.

WHAT IS INFLATION INDEXED BOND?
Theoretically, an Inflation Indexed Bond (also called linkers) is defined as ‘a bond that guarantees a return higher than the rate of inflation if it is held to maturity.’ Usually, an Inflation Indexed Bond links its principal or discovered yield (also known as coupon rate) to some index of inflation. Since the principal is linked to price rise in the economy, the investment is protected from inflation. Interest rate is applied to the increased amount eventually leading to an increase in payment over time. At maturity, the principal is paid at the inflated amount ensuring complete inflation protection. The context in which Inflation Indexed Bonds were introduced in India demand an understanding of the larger macroeconomic picture. The Indian economy went through persistent inflationary tendencies in the last few years post the sub-prime lending crisis of the US in 2008. Due to high inflation, investors were unable to get a decent return from bank deposits. Household savings dropped from 12% to 8% of the Gross Domestic Product and investment in assets increased from 11% to 14%. High inflation made existing financial instruments like mutual funds and capital market investments unattractive. Despite the widening Current Account Deficit (CAD), India imported 162 tonnes of gold in 2013, becoming the largest bullion importer and consumer in the world. The rage for gold was because of the belief that gold has consistently beaten inflation, gives capital gains, requires no documentation, confers anonymity and is benefited by the absence of Tax Deducted at Source.

The government has precisely taken the Inflation Indexed Bond route to wean away investors in gold and correct macroeconomic imbalances. From the perspective of the RBI, it is the function of the Central bank to develop government security market through instrument development, thereby meeting the investment and hedging needs of investors and market participants. IIBs are popular debt instruments in both developed and developing markets. The government issues such instruments to provide an alternative hedge against inflation, enhance credibility of anti-inflationary policies, provide an estimate of inflationary expectations and create an additional avenue for fund deployment (source: RBI website). Of all the different types of IIBs available, Capital Indexed Bonds (CIBs) are the most popular.
A BRIEF HISTORY OF INFLATION INDEXED BONDS

According to the monetary theory in economics, IIBs are used to analyse the state of the economy, assess the strength of certain macroeconomic theories and predict real variables. The first known IIB was issued by the Massachusetts Bay Company in 1780. The British government began issuing IIBs since 1981. The most popular IIBs are the Canadian Real Return Bonds (RRBs), The British Inflation Linked Gilts (ILGs) and the US Treasury Inflation Protection Security (IPS). The strategy of issuing linkers in developing economies was common as illustrated by the case of Brazil and Argentina in the 1980s. The Economist reported that ‘according to Barclays, as of February 2013, emerging economies issued $546 billion worth of linkers over the last three decades.’ In the last decade, the number has further increased threefold.

In the Indian context, the principal of inflation indexing is not new. Dearness Allowance (DA) is calculated using this principle. The Income Tax Department indexes long term capital gains to inflation. In 1997, the RBI issued Capital Index Bonds during inflationary times but failed to attract investor interest and revenue. The reasons were many- the securities were offered only to institutional investors, only the principal was linked to inflation and the coupon rate was left out. IIBs were a relatively new concept then. The latest effort differs from the previous one both in context and in structuring.

THE PROPOSED STRUCTURE OF IIBS 2023

a. Principal and Interest: The IIBs 2023 have a nominal principal value that is adjusted to inflation and a fixed coupon rate (interest rate) that is specified in real terms. This coupon rate is applied to inflation adjusted principal to calculate semi-annual coupon payment. At maturity, the inflation adjusted principal or the face value, whichever is higher is paid.

b. Tenure: The IIBs are issued for a 10 year period. Exit before that term can be done by trading in secondary market as is the case of any government security.

c. Method of Issue: The method of issue is auction conducted by the RBI in which competitive bidders bid in terms of desired real yield expectations expressed as a percentage.

d. Reference Index: The reference index is Wholesale Price Index or WPI. The RBI gives the criteria of index selection as follows- the index should fulfil the hedging requirements of both the issuer and the investor and track inflation, should be available to the public with a high frequency of release and should be a widely accepted index of inflation. WPI is available for all commodities (except commodity producing sectors), in all major groups and sub-groups and for individual commodities. It is released every week with a lag of a fortnight and is deemed to effectively capture demand and supply.

e. Reference WPI: Reference WPI for the first day of any month would be the weekly average of WPI of all commodities of the 6th preceding calendar month.

f. Indexation Process: The Indexation Process used by Canada is used rather than that of the UK owing to its smaller indexation lag. This has an impact on the level of inflation protection. Technically, IIB provides real value certainty to investors if all payments are perfectly linked to inflation. But practically, there are 2 kinds of lag that operate- one caused by delay in release of inflation figures and the other when bonds change hands. A smaller indexation lag gives a better real value certainty.

g. Tax Benefits: There are no tax benefits. The coupon is taxed at the investor’s tax bracket and the gain in principal is subject to capital gains tax. Bond sale also attracts capital gains tax.

h. Liquidity: Liquidity is rather low initially, but is likely to improve. It is completely dependent on inflation, i.e., a higher WPI offers higher returns.

i. Return Volatility: The return volatility is low. Coupon rate is fixed for the tenure, but annual payout and final amount depends on WPI of the holding period.

j. Risk: Risk is low since bonds issued by the government are completely safe.
POSITIVE FEATURES OF IIBS

i. The IIBs are an opportunity for investors to invest in debt instruments and hedge against inflation.

ii. IIBs offer capital protection and real returns.

iii. In a high inflation situation, fixed income security diminishes the purchasing power of investor due to low returns. IIBs yield high returns during inflation.

iv. While being traded in the secondary market, government securities have inflation risk that IIBs do not have.

v. From the point of view of the government, it is an instrument used to maintain optimal inflation rate and low debts. Besides, the 10 year tenure allows revenue accumulation that can be invested in infrastructure.

NEGATIVE FALLOUTS OF IIBS

i. Over-indexing could reduce availability of funds at negative real interest rates at the bottom of the economic cycle. This could hamper the ability of the economy to rebound.

ii. Indexing could fuel inflation as was the case of Latin Americas of the 80s. Issuance of IIBs led to inflation shooting up to 100% over a week.

iii. From the point of view of the investor, linking IIBs to WPI offers lower returns. CPI has been consistently higher than WPI by close to 5%.

iv. During periods of deflation, returns on IIBs could be low. But deflationary tendencies in India are exceptions, rather than the rule.

v. The dynamics of secondary market trading is yet to be seen.

### Comparisons between IIBs and other financial instruments during high inflation

<table>
<thead>
<tr>
<th>Other Financial Instruments</th>
<th>Inflation Indexed Bonds (IIBs)</th>
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<tbody>
<tr>
<td>Fixed Deposits - Due to the pre-determined static interest rate, loss in real terms during inflation.</td>
<td>As principal is adjusted to WPI, gains during inflation.</td>
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<tr>
<td>Debt Oriented Mutual Funds - These instruments have less capital protection.</td>
<td>Complete capital protection; but the dynamics of secondary markets yet to be seen.</td>
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<tr>
<td>Gold - Gold is a good hedge against inflation, but no capital protection due to price volatility.</td>
<td>Complete capital protection.</td>
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Source: *The HINDU Business Line, 2013*

CONCLUSION

Considering the macroeconomic situation of high inflation and high CAD in India, IIBs are logical instruments used to wean away the shimmer of gold. Due to low risks and higher returns, they are a good bet for investment. But retail investors, who are the real players, would have a chance to explore them only in the coming days. How this will play out in the secondary market remains to be seen.

Reference


   