India in depth: A costly flirtation with 'linkers'

India is set to join the small but growing club of nations whose governments issue inflation-indexed debt. But evidence from the United States suggests that offering these securities in small quantities - as India currently intends to - can become an expensive fiscal hobby. A bolder commitment could reduce borrowing costs. That's the direction in which New Delhi needs to go.

Finance Minister Palaniappan Chidambaram is probably not thinking about costs and benefits right now. His immediate motivation in offering so-called "linkers" to domestic savers - a big chunk of these bonds will be reserved for their exclusive participation - is to wean them off their addiction to gold.

Double-digit inflation over the last few years, a result of the government's own excessive spending, has undermined the rupee's purchasing power. Indians have responded by looking for a hedge in gold, stepping up their purchases of the imported yellow metal to an annual $60 billion pace. That's one of the reasons the current account deficit widened to an unsustainable 6.7 percent of GDP in the final quarter of 2012.

The citizens' gold habit irks the government and the central bank. While Chidambaram has now pledged to reduce the budget shortfall, he has no way of knowing if people will view his promise as trustworthy. After all, his boss Sonia Gandhi wants to launch a costly entitlement programme that would guarantee the poor's access to heavily subsidized food ahead of the 2014 general elections.

In theory, "linkers" can enhance the credibility of the government's commitment to low inflation. That's because New Delhi's borrowing costs will rise if it allows prices to spiral out of control after selling inflation-protected securities. But suppose a surprise pickup in inflation does happen and the government ends up paying 2 percentage points more on its inflation-linked debt than on conventional bonds. This year's planned 150 billion rupee ($2 billion) issuance, if maintained at the same level for a decade, will increase the treasury's yearly interest costs by 0.5 percent. That can hardly be expected to force a major change in the government's bad fiscal habits.

The U.S. experience with Treasury Inflation Protected Securities (TIPS) suggests that flirting with these bonds can be expensive. In contrast, a genuine commitment to developing them as an independent asset class can save taxpayers money.

The United States came 15 years too late to TIPS. The ideal time to launch the securities would have been in the early 1980s, which is when Britain started to offer them. Back in 1981, the U.S. Treasury was issuing 20-year bonds with 15.75 percent coupons because that was what investors demanded as compensation for the 9 percent inflation that they were facing.

By 1994, inflation had fallen below 3 percent, lifting the real annual cost of the bonds to the U.S. government to 13 percent. The U.S. Treasury felt so silly writing cheques for its high-cost borrowings of the 1980s - a 30-year bond with an 11.25 percent coupon still exists - that it finally launched TIPS in 1997.

Like India, however, the United States made a hesitant start, and the product bombed. In 2001, the U.S. Bond Market Association called for a demise of the illiquid securities, condemning them as an "expensive adjunct" to Treasuries, the most liquid market in the world. It was only in 2004 that TIPS became sufficiently liquid, removing the need for taxpayers to compensate bondholders for the liquidity risk of holding the securities. Last year a study by San Francisco Federal Reserve economists estimated that taxpayers would eventually save billions of dollars on TIPS issued since 2005.

Lowering sovereign borrowing costs should be an important goal in India, too. About 42 percent of the federal government's projected tax revenue this fiscal year will be spent on interest alone. But to harvest the potential of "linkers" the Indian government first needs to draw a clear roadmap that indicates what proportion of its future annual borrowing will take this form. Without such a plan, buyers of the 10-year inflation-linked bond at its first auction on June 4 will have very little idea of how liquid the market will be when they eventually try to sell.

Simple math suggests the market could be illiquid for a long time to come. TIPS account for about 7.5 percent of all U.S. government-issued bills and bonds. India, which is starting with a share of less than 0.5 percent, would need to expand its issuance of inflation-linked debt by 30 percent a year to reach the U.S. level by 2023. That's assuming that India's nominal GDP grows by 10 percent a year on average between now and then, and that the federal government's local debt-to-GDP ratio remains unchanged at 37 percent.

"Linkers" have an important side benefit. They allow policy makers to calculate expectations of future inflation, by subtracting the market yield of these securities from that of nominal bonds. Here again, liquidity is important. An illiquid inflation-protected security will give erratic signals to the central bank and could lead to wrong decisions.

India's decision to offer small savers a real inflation hedge is a far better strategy than raising import duties on gold and telling banks not to finance speculative purchases of the yellow metal; such draconian measures, which India has already taken, only enrich smugglers. But the new product won't serve any of its several useful purposes if the government does not come up with a strategy to make "linkers" more liquid in the not-too-distant future. A commitment to meeting a sizeable chunk of annual budget shortfalls by issuing inflation-linked securities would help tremendously. Chidambaram has taken the first step. He shouldn't stop there.

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