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CPI-Bonds in India: A Troubled Take-off

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Introduction of CPI-Bonds

On 23 December 2013 the Reserve Bank of India (RBI) introduced the Inflation National Savings Securities-Cumulative (IINSS-C), or CPI-indexed bonds. The deadline to buy these bonds was 31 December 2013 and they could be availed of at any State Bank of India (SBI) branch, associate banks, nationalised banks, the three private banks (HDFC, ICICI, and AXIS) and Stock Holding Corporation of India Ltd. (SHCIL). The range for investment is between Rs 5,000 and Rs 500,000. The interest rate on these bonds is linked to the combined-CPI (Base 2010 = 100) and comprises two parts: the fixed rate (1.5%) and the CPI

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inflation rate, based on 3-month lag CPI, which will be compounded with the principal on a half-yearly basis. The principal amount will be adjusted with the CPI inflation rate and then interest is calculated on this adjusted principal using the coupon rate of 1.5%. The tenure is fixed at 10 years and the full amount will be paid only at the time of maturity.

This was a move aimed at safeguarding the savings of individual investors (middle-class and poor savers) from the impact of inflation, and dissuading them from buying gold. India's insatiable thirst for gold, as a safe hedge against inflation, is partly responsible for the huge current account deficit and a tumble in the rupee. In case of deflation, the principal does not go below the issue amount. And anyway, looking at India's current economic situation, that is a far cry and not something the investors need to worry about. It is also part of the government's borrowing programme.

It mainly targets the retail investors, institutions like banks and Foreign Institutional Investors (FIIs). Although such bonds have been used for a long time, world over, to attract small retail investors, India has only now introduced it in the local market. Countries have usually issued such bonds when faced with double- or triple-digit inflation rate. Israel issued such bonds in 1955 in response to double-digit inflation rate. The British government first issued them in 1981. United States (1997), Australia (1985), Canada (1991), France (1998), New Zealand (1995), Japan and many others have all issued such bonds in the past. In 2008 alone, government-issued bonds constituted US$ 1.5 trillion in the international debt market.[2] India, however, did make an earlier attempt, last year, to dissuade people from buying gold.

Introduction of WPI bonds

On 4 June 2013, RBI launched inflation-indexed bonds (IIBs) where the bonds were linked to the Wholesale Price Index (WPI)[3] and would earn interest on the adjusted principal. The WPI with a lag of four months is used to adjust the principal, and then a fixed coupon rate of 1.44% is applied on this adjusted principal for the interest, which is compounded half-yearly.

[2] Prerna Katiyar, "Remember inflation-indexed bonds?" *The Economic Times,* June 30, 2008. Available at: http://epaper.timesofindia.com/Repository/ml.asp?Ref=RVRELzIwMDgvMDYvMzAjQXIwMTIwMA==&Mode=HTML&Locale=english-skin-custom

[3] In India, the wholesale price index (WPI) is based on the wholesale price of a few relevant commodities of over 676 commodities available. The indicator tracks the price movement of each commodity individually. Based on this individual movement, the WPI is determined through the averaging principle.

These bonds were an enhanced version of the first-issue of IIBs, the capital-indexed bonds, in 1997. However, there was lukewarm response for these bonds, both in primary and secondary markets. The reasons cited were the complexities involved in pricing of the instrument and it was argued that these bonds provided inflation protection only for the principal and not the interest.[4]

Even with the WPI-linked bonds, the response was dismal and the reason cited was that retail investors would be more interested if the bonds were actually linked to the Consumer Price Index (CPI) instead.[5] However, the RBI places more importance on WPI than CPI for calibrating its monetary policies. This is in contrast to other countries' central banks and governments relying on CPI inflation. While WPI measures variation in producer prices, what is more important to consumers is the Consumer Price Index (CPI) which gives a more accurate measure of inflation because it takes into account increase in costs of education, food, transportation, housing and medical care. In WPI, the emphasis is mainly on the prices of traded goods and services. As is clear from Table 1, in India the CPI on an average has been higher than the WPI.

Year	CPI[6]	WPI[7]
2000	3.48 %	7.2%
2005	5.57 %	4.3%
2008	9.70 %	8.0%
2009	14.97 %	3.6%
2010	9.47 %	9.6%
2011	6.49 %	8.9%
2012	11.17 %	7.6%
Average	**8.69%**	**7.02%**

Table 1: CPI and WPI trend over the years.

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[4] RBI Publication, "Capital-indexed bonds". Available at: http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/53629.pdf

[5] "Inflation indexed bonds: How they work" *NDTV Profit*, June 7, 2013. Available at: http://profit.ndtv.com/news/your-money/article-inflation-indexed-bonds-how-they-work-323080

[6] "Worldwide inflation data". http://www.inflation.eu/inflation-rates/india/historic-inflation/cpi-inflation-india.aspx

[7] Economic Survey 2010-2011

Figure 1 shows the monthly WPI and CPI in 2013. Now consider June 2013, the WPI was 5.16% while the CPI was 11.06%. A WPI-linked bond would have fetched a pre-tax return of 8.96% while a CPI-linked bond would have fetched 12.74%. Hence, it is a move in the right direction by the RBI to attract more investors, by indexing the bonds to CPI instead of WPI.

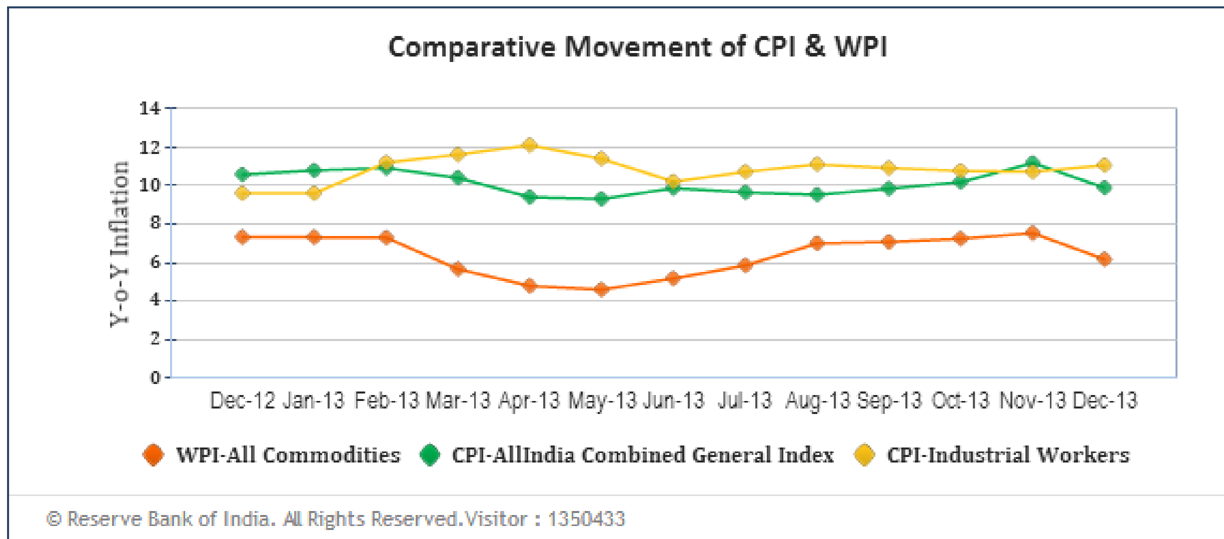

Figure 1

These are the first type of bonds that provide protection against inflation not only for the principal but also for the interest. Also, IIBs have the advantage that after the initial auction, they can be traded in the secondary markets and they can also be pledged to get a loan. Popular investment options like fixed deposits of banks are not inflation-proof. So how do these bonds compare with other investment options in the market?

Other Investment Options

Public Provident Fund (PPF), which is issued by the Government of India, offers an assured return of 8.7% and that too tax-free for both the interest and the principal amount. There is also the option of making the investment in installments. However, upon premature withdrawal, these bonds get taxed and lose their advantage over other options. Other tax-free bonds offer similar returns. Returns on debt mutual funds range from around 8-10%, depending on the institution, and are taxable. Fixed deposits of banks are also taxable and give returns similar to debt mutual funds.

Figure 2 shows yield on government bonds over a period of past 10 years.

Figure 2

Why CPI-Linked Bonds are not working?

1. **Lack of awareness**. Apart from lack of awareness, currently, investors have a poor understanding of how these bonds work, and it might take some time for investors to gain confidence in such products. Constant readjustment of the principal amount leads to complication of its calculation, and hence people rather opt for the usual bank deposits or PPF. A check at branches of SBI, ICICI and Axis Bank in Mumbai, Chennai and Kolkata also showed that banks themselves are not marketing these bonds, and some employees are not even aware of this product.[8] This could probably be because nothing particularly attracts them about these bonds, especially because the RBI does not give any commissions for marketing them. Another reason could be, as mentioned in the RBI *'technical paper on IIBs',* that the downward risk of these bonds is that it may turn out costly for the issuer if the ex-post inflation is higher than the ex-ante inflation rate, hence banks prefer selling safer, more attractive financial instruments to the public.

2. **Long tenure of the bond**. The full amount will be paid only at maturity. Logically, senior citizens would not want to go for an option that delivers returns after 10 years. Pre-payment is allowed, but only after three years for ordinary citizens and one year

[8] Saikat Das, "Most banks like SBI, ICICI and Axis Bank, fail to push RBI's CPI-linked bonds", *The Economic Time, Dec 30, 2013.* Available at: http://articles.economictimes.indiatimes.com/2013-12-30/news/45711282_1_branches-inflation-indexed-national-savings-securities-cumulative-axis-bank

for senior citizens, however, the investor will be only paid 50% of the previous year's interest.

3. **No special tax advantages**. When adjusted for tax, there might be better options in the market than CPI-linked bonds. For example, say CPI is at 9%, an investor investing Rs 100 will get Rs 10.5 as interest and have to pay a tax of Rs 3.15 (assuming he is in the highest tax bracket). Then the tax-free interest return actually comes to Rs 7.35 or 7.35%. For someone in the 20% tax bracket, Rs 2.10 tax gives him final return of 8.4%. The PPF, in comparison, still proves to be a better option.

4. **Understated CPI**. There is a general notion that CPI is understated by the RBI. CPI has been on the decline for many months (and WPI on the rise) even though food inflation is on the rise.[9] The reason stated for WPI rise was the rise in food inflation; but food items have a weightage of only 24% in WPI, compared to 45% weightage in CPI. This calls into question the RBI's credibility in announcing a CPI that reflects the actual inflation in the economy. A true (maybe higher) CPI would cost the government more in this case.

5. **Lack of depth in bond market**. An economist at Union Bank of India said that only highly risk-averse people may invest in these bonds unless there is an active secondary market in which these IIB can be easily bought and sold.[10] However, compared to the stock market, bond market is not well developed in India and institutions are not yet confident about trading here.

6. **Volatile interest rate**. Though in real terms, these bonds provide a steady interest throughout, people are discouraged when the interest rate is not stable. And looking at the recent trend in the decrease in CPI rate announced by the RBI, the attraction of these bonds will be less. Also, psychologically, people may still hold that gold is more valuable than bonds in safeguarding against inflation.

[9] Indivjal Dhasmana, "Is WPI Inflation overstated and CPI understated?" *Business Standards*, September 24, 2013. Available at: http://www.business-standard.com/article/economy-policy/is-wpi-inflation-overstated-and-cpi-understated-113092400919_1.html

[10] Anant Vijay Kala, "Is New RBI Bond as good as gold?", *Wall Street Journal*, Dated Oct 31, 2013. Available at: http://blogs.wsj.com/indiarealtime/2013/10/31/is-new-rbi-bond-as-good-as-gold/

Hence, as expected, the response by investors to the CPI-linked bonds was dismal as these bonds did not offer anything significantly different from or better than existing options; especially since the interest rate is not stable, sometimes the return may even be worse. These bonds may be a better option than some FDs but not PPF or tax-free bonds (especially for people belonging to higher tax brackets). There could also be status quo bias; even if, on an average, these bonds provide a slightly better return over the entire period, people would not want to make the switch from their current options, until the difference in return is significantly evident.

Recently, RBI increased the repo rate for banks. Most financial experts agree this will not lead to much change in bank deposit rates. But these rates are expected to go higher with RBI's inflation targeting, driven by the belief that quelling inflation is a pre-requisite for growth. The Urjit Patel Committee Report states that inflation based on the CPI should fall below 8% by January 2015 and below 6% by January 2016.[11] With RBI focusing primarily on reducing inflation rate in the economy, there will be monetary policies in the near future that will reflect in the reduction of the CPI index. Though a reduction in inflation will be a great relief for the people, it will further decrease the shine of the CPI-Bonds and hence affect their demand.

For now the initial deadline to buy these bonds has been extended to 31 March, 2014, given that the response was not very enthusiastic till now. The RBI has revealed that changes will be announced, in the near future, that will make the CPI Bonds more attractive to investors.

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[11] Bodhisatva Ganguli, "With RBI Governor Raghuram Rajan's hawk eye on inflation, rates may keep rising through 2014", *Economic Times*, dated Feb 10, 2014. Available at: http://economictimes.indiatimes.com/news/economy/indicators/with-rbi-governor-raghuram-rajans-hawk-eye-on-inflation-rates-may-keep-rising-through-2014/articleshow/30124977.cms