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For months, India prepared for a remarkable milestone: getting its bonds listed on global indexes. Inclusion was perceived as a crucial step change for the $1 trillion market. Banks penciled in inflows of as much as $40 billion for a country that has long lagged behind peers in tapping global wealth.

The timeline seemed so final that Citigroup Inc. advised its clients to buy Indian debt in anticipation that key tax exemptions would be announced to facilitate the change. Policy makers and analysts predicted inclusion as early as April 1, the start of the new financial year.

So it came as a shock when Finance Minister Nirmala Sitharaman didn’t make any mention of it in her February budget speech. The sudden silence puzzled traders. Within a day, Citi reversed its buy-call. Local debt markets saw the sharpest sell-off in almost two years. It was as if a plan had never existed.

In interviews, Indian officials who were part of discussions described how politics and contentious tax negotiations intertwined to stall progress. Bankers worried about volatile inflows. Powerful Hindu nationalist groups raised eleventh hour concerns that exempting foreigners from taxes would lead to discrimination against domestic investors, according to the people, who asked not to be identified citing privacy rules.

Now, many believe inclusion isn’t likely for at least a year. Officials say a path forward isn’t possible until Group of 20 Nations reach a consensus on a country’s right to tax capital gains, another pressure point for India.

“From India’s perspective, we are losing an opportunity to tap a pool of liquidity and an investor base," said Nagaraj Kulkarni, Senior Asia Rates Strategist at Standard Chartered Plc in Singapore. “From a foreign investors’ perspective, India is one of the largest EM bond markets that is yet to be included in major bond indexes."

With inclusion shelved, “investors lose out on a relatively high-yielding market that also offers risk diversification benefits," he said.

An About-Face

The challenges facing India are partly structural.

Global investors want India to get its bonds on international clearing platforms, which help settle securities transactions. For that to happen, Euroclear, one of the major ones, has pushed India to exempt the transactions from taxes to avoid compliance issues. Other countries using the platform follow that policy.

In India, progress seemed steady. In September, a senior official from the finance ministry said most of the work had been done. Tax authorities appeared ready to exempt these transactions, according to a person familiar with the matter. Morgan Stanley predicted inclusion to some indexes as early as the second quarter of 2022. FTSE Russell put India on its watchlist.

Sitharaman was supposed to reveal the change in the Feb. 1 budget talk. Euroclear expected the tweak right up until the speech, according to a finance ministry official.

When she said nothing, Euroclear was caught off-guard, the official said. So was the market: Citi quickly reversed its buy-call on India long bonds. Traders called the ministry searching for answers.

Euroclear didn’t reply to multiple requests for comment. A spokesperson for India’s finance ministry didn’t respond to an email seeking clarification.

What Went Wrong

In hindsight, officials said India’s reversal connects to an October announcement from the Organisation for Economic Co-operation and Development, the Paris-based group that develops international fiscal policy.

To address tax avoidance issues, the OECD helped broker an agreement with 136 countries to implement a global minimum rate. India, which is a member of the group, took the position that countries had the right to tax capital gains based on the location of underlying assets.

That created an optics problem. In discussions about index inclusion, the finance ministry had carved out a path to exempt international bond transactions from taxes. Now, Indian authorities had put forward a different perspective at public OECD forums. Around the beginning of 2022, the tax department, worried about this contradiction, made a decision not to follow through with the exemption, people familiar with the matter said.

Meanwhile, in January, Hindu nationalist groups linked to Prime Minister Narendra Modi’s party met with senior government officials. They argued that it was unfair for foreigners to receive tax waivers when local investors did not get similar benefits.

These groups have enjoyed increasing clout since Modi rose to power in 2014, partly because they can influence local businesses -- his party’s traditional vote bank. Every year, they hold informal discussions with the government ahead of the budget, one person said. In 2019, when the groups opposed a plan to issue a dollar-denominated sovereign bond, the proposal was scrapped. Their opposition contributed to the transfer of a top bureaucrat who supported it.

“There is no reason why we should give advantages to foreign investors," Ashwani Mahajan, one of the leaders of Swadeshi Jagran Manch, a Hindu nationalist group, told Bloomberg a few days before the February budget speech.

Looking Ahead

For now, index inclusion appears all but impossible in the short term.

In an interview with Bloomberg last month, Ajay Seth, the secretary of India’s economic affairs ministry, said index providers made last minute requests. Other officials said Euroclear kept moving its goal post, including tax changes beyond the capital gains issue.

The inclusion delay has already impacted India’s bond market. In recent months, yields rose amid a surge in global crude prices. Key banks are adjusting interest rates to keep pace with inflation. That’s a concern for the government as it plans to borrow a record amount from the markets to bridge a wide fiscal gap.

“With a large supply looming, yields on government securities are likely to harden once next fiscal’s borrowing commences in April," said Aditi Nayar, chief economist at ICRA Ltd., the local unit of Moody’s Investors Service. “If there are concrete steps toward bond index inclusion during the year, it could help to cap yields."

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