Title:Want to Hedge Inflation?Borrow & Spend your money now.

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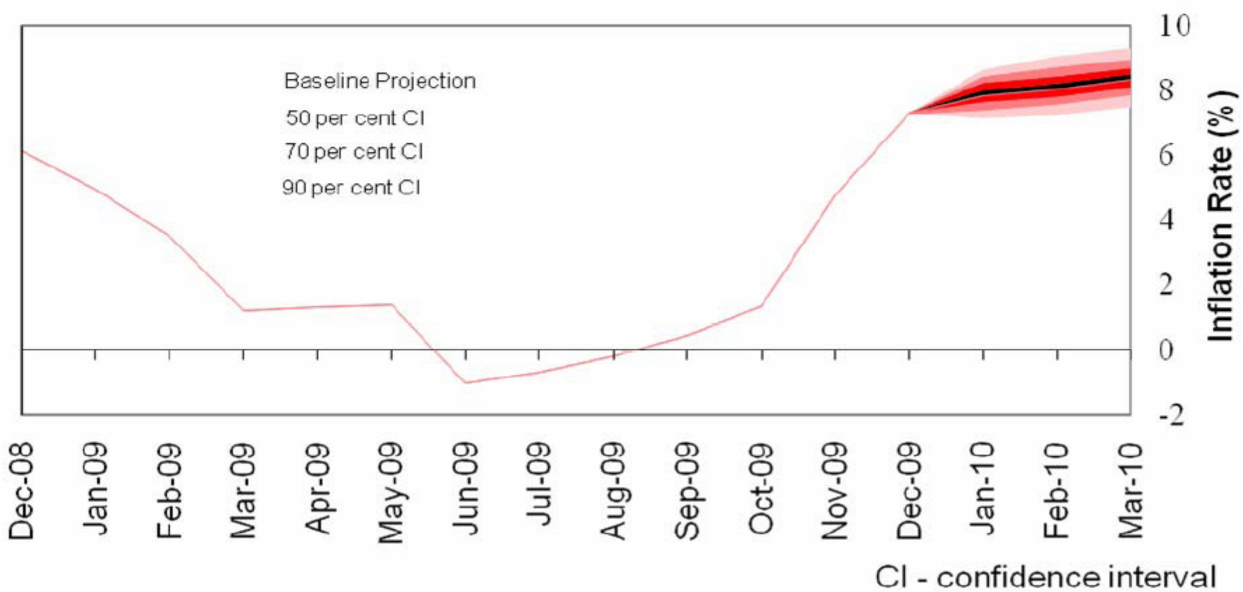
The recent Monetary Policy released by RBI laid its thrust on controlling the spiraling inflation, especially the food price inflation. One of the reasons behind the CRR hike was to "curtail the rising inflationary expectations (higher expected price trends)". Rather than the current inflation which is historical, the inflationary expectations are more important in influencing the current saving, consumption and investment patterns of households, corporates etc. RBI did raise its March 2010 projection of inflation to 8.5% yoy. RBI rightly was concerned about the spill over of food driven inflation to general inflation in the economy. And RBI also voiced its concern on the nexus between higher capital flows and inflation.

Chart I: The Projected Path of Inflation WPI as per RBI



Source : RBI 3Q Review of Monetary Policy 2009-10.

What's this Inflation all about? If Inflation is say 5% pa, it implies that something which was costing Rs 100 exactly a year ago is now costing Rs 105. If we go back say in 1980's a movie ticket would have cost you not more than Rs 10 but now at INOX multiplex in the business district (Nariman Point) of Mumbai, it would cost you Rs 250. The cost going up by more than 25 times in around 29 years is nothing but inflation. I wish we had futures contract on movie theatres tickets traded on exchanges, I would have hedged my future movie tickets expenditure, viz the Inflation, back in 1980. *Many of us would not even realize the fact that when you hold hard currency notes like Indian Rupees with you, what you are doing is giving an "interest free loan to the government".*

And what does higher inflation do? It erodes the purchasing power of paper currencies like Indian Rupee, viz after a few years you just can't buy the same amount of goods with same amount of rupees. In fact, when you hold a currency note for a while at home, not only you give an interest free loan to the government, but you also lose purchasing power on account of higher inflation. So holding currency notes during rising inflationary times is as good as losing bits of the notes every day in form of loss of purchasing power.

Higher Inflation in general is an economic peril since it brings in monetary instability, stunts real economic growth and pushes interest rates higher. In general it also results in mis allocation of resources in the economy. Inflation may be demand driven or cost driven, as it is for now in India.

Inflation unknowingly plays a very important as well as a strange role in everyone's life. As discussed earlier, higher inflationary expectations alter the saving, spending & investment patterns of people. If everyone is expecting higher inflation, people will tend to spend and invest now, rather than save money for future and vice versa. Anyone who has borrowed money will gain vis a vis the lender, if inflation rises and the interest rates are not high enough to compensate the lender. So the best hedge for inflation is "*BORROW & SPEND YOUR MONEY NOW*". Use your credit cards to spend and manage your repayment cycles. If Inflation rises before you repay, you will repay less in real terms and save yourself from price rises too.

Zimbabwe is a classic example of how Inflation can create havoc in an economy. The annual inflation in Zimbabwe is expected to be at some crazy figure (Chart II) followed by more than 100 zeros. Imagine a scenario where you move out of your house to buy a loaf of bread and it becomes more expensive by the time you reach the bakers place. *In fact in Zimbabwe at current inflation rates, the prices double in roughly 24 hours and a currency note is issued in denomination of ten trillions of Zimbabwean Dollars, since smaller denomination ones did not fetch anything and so were redundant long time ago.*

Chart II: The Highest Inflation Rates in History.

Country	Month with highest inflation rate	Highest monthly inflation rate	Equivalent daily inflation rate	Time required for prices to double
Hungary	July 1946	1.30×10^{16}%	195%	15.6 hours
Zimbabwe	Mid-November 2008 (latest measurable)	79,600,000,000%	98.0%	24.7 hours
Yugoslavia	January 1994	313,000,000%	64.6%	1.4 days
Germany	October 1923	29,500%	20.9%	3.7 days
Greece	November 1944	11,300%	17.1%	4.5 days
China	May 1949	4,210%	13.4%	5.6 days

Source: Prof. Steve H. Hanke, February 5, 2009.

Inflation also impacts the future expectations of returns from assets. For instance bonds or stock prices will fall if the inflationary expectations are higher. Investors would expect higher returns to compensate for the higher expected inflation, which is better known as Inflation Risk premium. If stocks have returned say 10% and the inflation has been 5%, the real return is only 5% (10%-5% inflation). But there is also a silver lining to higher inflation. It does boost nominal GDP growth rate and so the corporate revenues and so the profits, which will hopefully boost the stock prices too.

In the past RBI has been concerned about the fact that a common man does not have any protection against rising prices, viz No Inflation Hedge. The common man has to rely on traditional but inefficient methods to hedge the real inflation risks, such as Gold and real assets such as commodities or real estate or even excessive stocking of goods. In fact for reasons aforementioned in the above paragraph, stocks can also hedge inflation in long run.

In developed markets like US, the government has issues "Treasury Inflation Protected Securities" known as TIPS. Globally more than USD 1 trillion worth inflation linked bonds must be outstanding. These securities give an opportunity to market participants and investors to hedge against inflation. The coupon (interest rate) of TIPS is fixed but the underlying principal would move in tandem with the inflation levels in US. At redemption of the securities the higher of the value (adding inflation) thus arrived or face value is paid off. Banks and Financial Institutions usually buy wholesale and create retail market for such securities. With right access a US retail investor can easily buy such securities to protect himself from inflation.

The Indian Government (GOI) so far have not issued any significant amounts of inflation linked bonds. One Capital Indexed bond was issued by GOI way back in late 1997 which matured in 2002. The bond did not get enthusiastic response from market participants, since the coupons on it were not inflation hedged, though the principal was. The pricing in secondary markets was an issue too. Any new issues by GOI in future should have the coupon hedged too.

But the government should reconsider issuing Indexed linked bonds in these times when inflation is on the rise. And there are ample benefits for the government for the same:

1. The inflation linked bonds can make the governments accountable for higher inflation since the cost of borrowings will be linked to inflation (if coupon paid is inflation hedged). Rising inflation will also raise the repayment of inflation linked bonds.
2. It will help government to broaden the investor base by offering inflation linked bonds at the retail level, where the participation now is minimal.
3. Government can diversify the debt service costs in a deflationary (falling prices) scenario.
4. It is very likely that the existence of inflation linked bonds might reduce the inflation risk premium embedded in government bonds.
5. For the inflation linked bonds to be an effective hedge GOI should ensure that the underlying inflation index is representative of real or actual inflation on the streets.

For the Central Bank (RBI) inflation linked bonds would be of great help:

1. RBI can precisely quantify & control the inflationary expectations embedded in the economy as well as in the markets. RBI can use inferences from trading in such bonds in formulating its monetary policy stance
2. The onus on monetary policy tools such as interest rates, to contain inflation will reduce if RBI can guide or influence the inflationary expectations through the demand/supply of inflation linked bonds and with an excellent communication policy.
3. The stability of inflation reinforces the anti inflationary credibility of a Central Bank.
4. Sovereign inflation linked bonds can be part of the foreign exchange reserves investments of the Central Bank.

For Investors in general, inflation linked bonds would provide distinct advantages:

1. It allows investors to hedge the purchasing power (inflation) risk. The capital is inflation risk protected and the income (coupon) can be structured that way too.
2. Inflation linked bonds universally are regarded as a separate asset class & would provide diversification benefits to a portfolio due to its negative co relation with returns from traditional asset classes.
3. Such bonds provide positive risk reward relationship too.
4. Inflation linked bonds are effective vehicle for hedging risks for institutional investors, where the long term liabilities are inflation linked or linked to future wage levels or banks who face the inflation risk on there assets side due to there GOI Bond holdings.
5. Access of FIIs to the inflation linked bonds can allow them to hedge there inflation risks in India which are currently expressed in the currency markets. The USD/INR (currency) volatility can hence come down hence.

So issue of Inflation linked bonds by the Government would be a Win Win situation for everyone. Government and RBI can take steps to ensure awareness, education (especially on pricing) and liquidity (active secondary markets or allowing ETFs) on inflation linked bonds at retail level for them to be a success. And both principal as well as coupon of such bonds should be inflation hedged.

Its time that retail investors and market participants can express there views on inflation as well as hedge it with help of investments in Inflation Linked bonds.

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