What is the Role of Inflation-Linked Bonds for Sovereigns?

Lior David-Pur
Head of Government Debt Management Unit
Ministry of Finance, Israel

2018 Sovereign Debt Management Forum
The World Bank
“The Name is Bond... Indexed Bond”
The Israeli Story

- On-The-Run Tenors: 10Y, 30Y
- Off-The-Run: All tenors use switch auctions
- Both principal and interest are CPI-linked
- Indexation: Calculated by Israel’s Central Bureau of Statistics
- No floor limit

Non-Tradable Debt = 29%

Tradable Debt = 22%

Source: Israel MOF
Fact #1

There is an **Increasing** Trend of Inflation-linked Bond Issuance Globally

Source: BIS as of end 2017  *only tradable bonds, US billions
Advantage #1

Supply-Side Consideration

Diversified Source of Funding*  Efficient Debt Portfolio

Source: Israel MOF, Only tradable issuances
Advantage #2

Demand-Side Consideration

Increasing Investor Base

- Bank of Israel
- Nonresidents
- Mutual funds
- Commercial banks
- Public
- Insurance companies
- Pension funds
- Provident funds

Long-term-saving holdings = 55%

Diversification

Correlation = -0.3

Source: Israel NOF and BOI, Holding in Israel tradable government bonds
Other Possible Advantages

Cyclical benefits
Correlation with government revenues?
Positive credibility feedback?
Inflation expectation?
Fact #2

Despite Increasing Trend, Share of Inflation-Linked Bonds Remains Relatively Low Globally

Amount Outstanding:
$22 trillion USD

For 14 out of 21 Countries, Share Of Linkers is Below 25%

Source: BIS as of end 2017, Local debt security markets, Israel: MOF data
So why don’t debt managers issue more inflation-linked bonds?
Disadvantages

Linkers are Less Liquid

Daily Volume of Israel Government Bonds

Volatility

Volatility in Interest Payment, Deficit, and Debt

<table>
<thead>
<tr>
<th>Volatility %</th>
<th>All period</th>
<th>10 Years</th>
<th>5 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>5.2</td>
<td>3.0</td>
<td>0.9</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Daily volume: Israel MOF
Other Possible Disadvantages

Cannibalization ?

Complexity (pricing, seasonality)

Index Reliability
Breakeven Inflation \approx \frac{1 + \text{nominal yield}}{1 + \text{real yield}} - 1

US

Israel

Difference (breakeven-inflation)

Difference (breakeven-inflation)