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Foreign debt crisis

Why in news?

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The government liberalised some aspects of the ECB norms to the manufacturing firms recently.

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What are the measures?

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- External Commercial Borrowers who are in manufacturing sector can raise ECBs up to $50 million or its equivalent.
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- It will come with a minimum average maturity period of one year, compared to three years as previously required.
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- The relaxed norms for ECBs may attract short-term capital flows in the country.
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What is the status of foreign debt in India post-financial crisis?

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- The increase in ECBs can be traced back to some of the policies adopted by the developed countries to counter the financial crisis of 2006-08.
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- To come out of the recession, developed countries adopted accommodative and unconventional monetary policy tools.
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- These policies increased liquidity in the system and pushed interest rates

down to historically low levels in developed countries and international capital markets.
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- While these policies may have been effective in their domestic markets, the global fallout has been quite significant.
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- International investors began to encouraged the "carry trade", wherein they borrow money at a low interest rate in developed countries in order to invest in an asset in developing ones that is likely to provide a higher return.
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- This allowed firms from developing countries, including India, to borrow cheaply from international capital markets.
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- High growth rate and the comparative stability of the Indian economy made Indian firms relatively more attractive to international lenders.
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- Changes in domestic regulations also allowed Indian companies to access credit more easily from international markets.
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What does it result in?

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- Indian firms have borrowed a huge amount of money (over Rs 18 lakh crore, as per RBI data) from the international markets since 2007.
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- These ECBs are now facing a double whammy from increased interest rates and a sharply depreciating rupee.
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- A domestic firm borrowing from abroad usually pays a rate of interest which is a mark-up over some international benchmark rate like the LIBOR (London Interbank Offered Rate).
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- This mark-up or the spread is generally decided taking various risk factors associated with the borrower, which may also include the country risk.
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- A hike in US Fed benchmark rates results in higher international benchmark rates and so adds to the interest rate burden of the borrowing firms.
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- On top of this, any depreciation of the rupee also increases the debt burden of these borrowing firms in terms of domestic currency.
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- If this makes repayment more difficult, it will in turn add to the spread faced by the Indian borrower when turning over loans.
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Why the problem still persists?

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- The impact of depreciation will be less of a problem if the firm has earnings in foreign currency.
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- A firm is said to be ‘naturally hedged’ if foreign currency earnings of the firm can pay off its repayment cost of external borrowings.
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- Apart from the ‘natural hedge’, firms can also have a ‘financial hedge’ through derivative contracts with financial institutions.
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- Since 2016, the RBI has pushed Indian firms to hedge their foreign currency exposures, but it is not clear whether this has been successful.
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- A look at the balance sheets of the firms which have obtained ECBs shows that a large number of these firms have negative net foreign exchange earnings.
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- These firms are unlikely to have any ‘natural hedge’ against foreign exchange risks.
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- And as the rupee becomes more volatile, cost of financial hedging will ramp up significantly.
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What are the other related concerns?

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- From an investors' perspective when domestic interest rates rise, the risk-free returns go up as the government bond yields rise.
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- Also, corporate bonds offer better returns when the government yields increase.
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- In such an environment, investors will naturally opt for higher fixed rate of

returns rather than an uncertain and potentially lower rate of return from equities.
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- Hence, investors might be more willing to park funds into fixed income securities like bonds, fixed deposits etc., rather than equities.
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- Added with that, rise in oil prices, faltering health of public sector banks, increasing inflation among others may lead to the equity market finding new lows in the near future.
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What lies ahead?

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- Any unhedged foreign currency exposure faces significant risk due to the dual shock coming from exchange rate depreciation and the rise in global interest rates.
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- All signals from the recent US Fed meet suggest that the cycle of interest rate hikes will continue well into the 2019.
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- So, the Indian currency will be under pressure in the foreseeable future.
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Source: Business Line

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