India’s First Overseas Sovereign Bonds

Why in news?

As a first, the recent Union Budget 2019 proposed funding the fiscal deficit partially by borrowing from international markets in foreign currency.

What is the decision?

- The government plans to raise as much as $10 billion from its first overseas sovereign bond.
- It would start raising a part of its gross borrowing programme in external markets in external currencies.

What are sovereign bonds?

- A sovereign bond is a specific debt instrument issued by the government.
- They can be denominated in both foreign and domestic currency.
- Just like other bonds, these also promise to pay the buyer a certain amount of interest for a stipulated number of years and repay the face value on maturity.
- They also have a rating associated with them which essentially speaks of their credit worthiness.
- The Yield of the sovereign bond is the interest rate that the government pays on issuing bonds.
- The Yield of the bonds are dependent on primarily 3 factors -
    1. creditworthiness - the issuing countries’ perceived ability to repay their debts; this can be obtained from rating agencies
    2. country risk - external/internal factors like unrest and wars tend to jeopardize a country’s ability to pay off their debts
    3. exchange rates- in cases where bonds are issued in foreign currency, fluctuations in exchange rate may lead to increased pay out pressure on the issuing government

What is the rationale?

- Public-sector borrowing is putting significant pressure on market rates, along with liquidity in the system.
- This, among other things, is affecting monetary policy transmission.
- The government is already resource-constrained and so large levels of local borrowings could drive up interest rates and crowd out the private sector.
- So, the next safe option is borrowing abroad, as the government can take advantage of low global interest rates.
- Also, India's sovereign external debt is less than 5% of its GDP, one of the lowest in the world.
- This makes the move seem relatively risk-free.
- The basic idea is that by shifting part of its borrowing abroad, the government will reduce the pressure on the domestic market.
- This will, in turn, help keep interest rates at lower levels.

What is the need for caution?

- The government should avoid going overboard because there are multiple inherent risks in the idea.
- **Currency risks** - Primarily, the government will be taking currency risk.
- A depreciation in the rupee will, in turn, increase the government's liability.
- On the other hand, the overall increase in the import of foreign capital could put upward pressure on the rupee.
- This could eventually affect exports and make currency management more difficult for the central bank.
- **Volatility** - Borrowing from international markets will increase the government's exposure to the vagaries of global financial markets.
- With borrowing through sovereign bonds, India's loan repayments would be subject to exchange rate fluctuations.
- Depending on the trend, India may have to repay more than it had originally taken as loan.
- **Investments** - The move could potentially discourage foreign investors from investing in rupee-denominated government bonds.
- This is because they will have the option of investing in hard-currency bonds and avoid the currency risk associated with the rupee.
- This, in turn, could lead to higher volatility, both in the debt and currency markets.
- This can further diminish the gains from accessing international markets.

- **Financial risks** - Forex markets are irregular, especially now, with US-China trade tensions.
- So, any adverse movement can throw off all calculations and make overseas borrowing even more costly than that from local markets.

- Moreover, the domestic bond market serves as a signaling mechanism for the government by making price adjustments in response to the supply of bonds.
- Large issuances in global markets can impede this process.
- In fact, the government will have an incentive to take more of its borrowing abroad because it will help keep domestic interest rates in check.
- Naturally, this will increase risks for financial stability.
- Traditionally, it has been observed that the accumulation of foreign-currency debt can lead to difficulties.
- **Sources** - The use of sovereign bonds indicates that the government may be running out of sources to borrow from within India.
- Notably, India had the second worst debt-GDP ratio among emerging markets.
- India's debt-GDP ratio stands at 68.4%, next only to Brazil.
- India's total debt has risen by almost 50% since 2014.

What is the way forward?

- It will be important for the government to explore and use this option carefully.
- In this context, the government could constitute an independent fiscal council, as was also recommended by the N K Singh committee.
- The council, which will evaluate fiscal management, can also advise the government on sustainable levels of foreign borrowing.
- At a broader level, the council will instil more confidence in the market and, gradually, help reduce borrowing cost in the system.

Source: Financial Express, Business Standard