External Debt - The Risks

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What is the issue?

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- External borrowers in India are likely to face a turbulent future in the near term due to a depreciating rupee.
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- In this context, this write-up seeks to explore what constitutes external debt and what are the factors influencing it.
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What is external debt?

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- External debt is the money that borrowers in a country owe to foreign lenders.
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- **Denomination -** External debt may be denominated in rupee or any other foreign currency (most of India's external debt is linked to the U.S. dollar).
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- As of December 2017, about 48% of India's total external debt was denominated in dollars and 37.3% in rupees.
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- This means most Indian borrowers will have to pay back their lenders by first converting their rupees into dollars.
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- **Debt Profile -** External debt is classified as 'External Commercial Borrowing', 'Currency Convertible Bonds' and 'Government Borrowings'.
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- India's external debt was $513.4 billion at the end of December 2017, an increase of 8.8% since March 2017.
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- Most of it was owed by private businesses and other non-government entities (about 79%), which borrowed at attractive rates from foreign lenders.
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What are the risks?

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- **Interest Rates -** There is greater unpredictability and unexpected changes in the interest rates can result in defaulting of loans and precipitate a crisis.
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- The raising of interest rates by the U.S. Federal Reserve has already caused borrowing rates to rise in various countries.
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- This including in India where bond yields have shot up sharply (the yield on the 10-year government bond has risen by 1.5% in the last 6 months).
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- **Exchange Rate -** Unexpected changes in the exchange rates of currencies, like say a steep fall in the value of the rupee, for instance, is a big risk.
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- This can cause severe difficulties for Indian borrowers who will now have to shell out more rupees than previously, to pay back dollar-denominated loans.
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- Lenders generally take possible currency fluctuations into account when determining their lending rates, but currency predictions are prone to failures.
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- While there could also be gains from such fluctuations, emerging market currencies usually tend to depreciate when the world economy is reviving.
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- **Current Trend -** Over the past year, rupee has fallen about 7% against the U.S. Dollar, which is also in line with other emerging market currencies.
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- Such currency movements are due to the increasing dollar demand by investors who wish to sell their assets in emerging markets.
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- Such sell outs pull capital out from emerging markets to invest them in developed markets, as yield there has been rising there lately.
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What happens next?

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- **U.S. Factor -** The U.S. central bank, has already raised its benchmark interest rate twice this year, and is expected to further raise rates.
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- This is likely to cause more outflow of capital from the emerging markets, thus causing unexpected changes in borrowing rates and the value of the rupee.
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- Both government and non-government borrowers in India, who are exposed to foreign debt, could be in trouble in such a scenario.
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- **RBI Rescue -** The foreign exchange reserves, held by the Reserve Bank of India (RBI), were around $425 billion as on March 2018.
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- This is the firepower that the RBI can use to support the rupee and bail out borrowers who get into trouble.
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- RBI recently raised its benchmark interest rate (minimum rate charged on non-government securities) for the first time in more than four years.
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- While such a step could help to stem the capital outflow from the country and support the rupee, it could unleash uncertainty in domestic interest rates.
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Source: The Hindu

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