

## 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.
- This allowed firms from developing countries, including India, to borrow cheaply from international capital markets.
- High growth rate and the comparative stability of the Indian economy made Indian firms relatively more attractive to international lenders.
- 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.
- These ECBs are now facing a double whammy from increased interest rates and a sharply depreciating rupee.
- 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).
- This mark-up or the spread is generally decided taking various risk factors associated with the borrower, which may also include the country risk.
- 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.
- On top of this, any depreciation of the rupee also increases the debt burden of these borrowing firms in terms of domestic currency.
- 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.
- 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.

## What lies ahead?

- 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.
- All signals from the recent US Fed meet suggest that the cycle of interest rate hikes will continue well into the 2019.
- So, the Indian currency will be under pressure in the foreseeable future.

**Source: Business Line**