

FOREIGN CURRENCY BORROWINGS

Open Doors, Don't Get Blown Away



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This weekend, in a Times of India article (bit.do/eZUt4), University of Chicago professor of finance and former RBI governor Raghuram Rajan highlighted the perils of the budget announcement of GoI's plan to start raising a part of its gross borrowing programme in external currencies.

There are two issues regarding India's foreign borrowing. One, the quantum of borrowing and debt. While multilateral and bilateral debt is welcomed, India has been conservative in the matter of external commercial borrowing (ECB) ever since the balance of payment (BoP) crisis of 1991-92. After that, annual caps were imposed on additional borrowing, particularly on short-term debt, and the end use of external commercial borrowings was restricted. What that experience taught was that short-term debt could not be rolled over, since panic gripped the markets, aggravating the crisis of liquidity.

ECB policy has been liberalised over the years, although RBI is, by instinct, conservative. India's external debt remains within prudent levels, at 21% of GDP and 150% of foreign currency reserves in 2018-19.

Nirmala Sitharaman's budget speech does not propose relaxing quantitative limits on ECB.

Two, ECB raised directly by GoI as sovereign debt. GoI has in the past pushed public sector utilities (PSUs) to borrow from external markets for fiscal and BoP support, and foreign portfolio investors (FPIs) are allowed to buy domestic government bonds denominated in rupees. But it has so far avoided borrowing directly on its own books from international financial markets. The budget announcement marks a structural shift in policy.

So, should GoI borrow directly from external financial markets?

Another former RBI governor, C Rangarajan, doesn't think so — and for good reasons. "The proposal... does not appear to be correct. This essentially means the exchange risk is borne by GoI, unlike the situation in which foreign investors are allowed to invest in government bonds in rupees," he wrote in ET on the budget (bit.do/eZUt4), adding, "Second, there is certainly no need for government to borrow as the foreign inflows are adequate."

There are, however, four compelling arguments for the proposal.

One, global interest rates are at historic lows. This has intensified what former chair of the US Federal Reserve Ben Bernanke called a 'global savings glut'. India, with a deficit of savings over investment, could tap into this glut. The cost of hedging against forex risk would be countervailed by the saving in the coupon rate.

Two, direct borrowing by the sovereign is always cheaper than for any other entity. As long as the policy shift simply means that overall ECB limits remain unchanged, with GoI borrowing more and the corporates less in international financial markets, there would be net welfare gains for the economy.

Three, the sovereign is the best credit in the country. As such, sovereign bonds set the lowest possible benchmark for Indian borrowers in international financial markets. Instead of relying on the sovereign bond yields of other similarly rated developing countries, they would now borrow at spreads above Indian sovereign bonds, controlling for tenure of the loan and credit rating. GoI can lower the yields on its own sovereign bonds through good macroeconomic management.

Four, India has a huge infrastructure deficit. Global experience is that most of this investment would need to come directly or indirectly from government. Private enterprise can

play only a marginal role, in view of the higher risks, lower returns and longer gestation periods of the underlying investment. Such investments generate large externalities, indirectly benefitting the larger economy much more than the investor directly. As the case of China illustrates, first-class infrastructure lowers the cost of overheads, making the economy more efficient, productive and hence more internationally competitive.

GoI would need to scale up its borrowings on the margin to scale up investment in infrastructure. The unpleasant arithmetic arising from this could raise interest rates and crowd out private investment. India's savings have declined, but so has private investment, as a result the deficit — the current account deficit — has remained more or less constant. As and when the animal spirits of private investors revive, it would be a good thing to have an enabling provision to avoid such crowding out in the domestic debt market.

As long as extant borrowing limits are not breached, direct borrowing by the sovereign in external commercial markets may not be a bad idea. The provision needs to be, of course, used judiciously. Without this caveat, India's demographic dividend can well turn into a demographic nightmare.

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Ready the welcome committee

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