

## India's Budget 2019: The Proposal to Issue US Dollar Bonds

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### Summary

*The proposal in the Indian Budget to issue foreign currency bonds as a means of alleviating fiscal pressures has elicited considerable interest. Is the timing for such a bond issue ideal? What are the merits of the proposal?*

The proposal by Nirmala Sitharaman in her first budget speech as Indian Finance Minister to raise up to US\$10 billion (S\$13.6 billion) from overseas sovereign bond issues elicited a great deal of interest among investors, bond market participants and observers of the Indian economy. The purpose of the bond issue is to ease pressures on domestic bond markets, increase the pool of funds available to the corporate sector and develop a yield curve for dollar bond issues.

The government borrows nearly 80 per cent of total savings in the economy, crowding out the private sector. Consequently, competition among private companies for the remaining funds drives up interest rates. The government's foremost priority is to revive growth in the economy. For that to happen an increase in the supply of funds to the private sector is essential. Hence the decision to issue hard currency government bonds.

The finance ministry expects that funding through hard currency sovereign bonds will not exceed 10-15 per cent of total borrowing, or about US\$10 billion (S\$13.6 billion). Placement of these bonds is not likely to be an issue given the appetite for Indian government securities.

The announcement comes against the backdrop of shrinking options for financing infrastructure spending: tax revenues have been falling, domestic bank credit to the corporate sector has slowed as banks deal with the large overhang of non-performing loans and lending by non-bank finance companies has been sluggish after the failure of Infrastructure Leasing & Financial Services Limited, one of the largest non-bank lenders.

At just six per cent of gross domestic product (GDP) in 2017, India's stock of public and publicly guaranteed external debt is amongst the lowest for developing countries, although the rupee-denominated general government debt is significantly higher than the average for emerging markets. India's total United States (US) dollar bond market issues are approximately US\$85 billion (S\$115.6 billion) – low by international standards for a country of its size.

## **Potential Benefits of Overseas Bonds Issue**

Several Indian corporations have borrowed in hard currencies, at interest rates lower than on domestic rupee denominated debt. The argument that a sovereign issue will help price corporate debt better, holds only if the market for sovereigns is deep. Indian government bonds are thinly traded. Deriving benchmark yields for dollar denominated Indian government bonds is a distant reality as it would require a sustained series of issues across the maturity spectrum with heavy trading in the secondary market.

Officials see the bond sale as an opportunity to reduce interest costs by borrowing abroad at lower rates: With India's sovereign credit rating in the stable range (BBB-), India could borrow US dollar funds at about 3.2 per cent, but hedging charges would raise that price. The liquid 10-year government bond offers a yield of 6.33 per cent. A low inflation rate, comfortable levels of currency reserves, and low external debt, lends credence to the case for external issues.

## **What are the risks?**

The timing of the bond issue may not be ideal as emerging markets are not out of the woods yet. Uncertainty is high; the perilous situation in the Persian Gulf poses serious risk to India – inelastic oil imports account for over a third of the import bill. Export earnings have been declining with prospects for a quick turnaround bleak. India has not been able to capitalise on shifts in global value chains in manufacturing. All of this will add to uncertainty in exchange rates and interest rates, and raise the costs of hedging currency risk, negating the benefits of low interest rates.

Mere accessibility to funds doesn't make US dollar borrowing an ideal choice. Bond investments are 'hot' portfolio flows, easily reversible with the potential to cause destabilising changes in exchange rates and interest rates during periods of uncertainty. The government will in any case need to sterilise the foreign currency inflows, leading to a stronger rupee, and adversely impacting exports. Conversely, a rupee depreciation would impose significant costs making it more expensive for India to repay its external debt.

## **Risks: Of Twin Crisis**

India is growing at six per cent, sluggish by recent standards. The external environment poses more uncertainty than promise for India. While the risk of a twin banking and currency crisis of the sort that plagued emerging market economies through the 1980s and 1990s is remote, uncertainties in the short-term that may well continue in the absence of structural reforms and an improvement in the macro-climate. It is also worth considering that although the volume of non-performing loans has stabilised, unless growth picks up, and fiscal discipline is maintained, the vulnerabilities will persist.

While external debt is low, internal debt has been rising in recent years. Notwithstanding government pressures, till recently, the RBI adopted a cautious approach to monetary easing, letting exchange rates absorb the shock of market turbulence.

India is not likely to be viewed as a risky proposition by the international markets. It is on a more stable path than Latin American economies were during the 1970s and 1980s. The level of indebtedness is low, external borrowing has been prudent. The timing, however, is not ideal, with the environment fraught with uncertainties along the horizon.

Government policies have been more prudent since the Global Financial Crisis of 2008. Rather than borrow externally, the government is borrowing more in local currencies.

It is a moot point whether the net benefits of a bond issue at this juncture are significant. While a US\$10 billion (S\$13.6 billion) issue may offer some fiscal relief and ease pressures on credit markets, a sustainable solution requires addressing the origins of constraints within the banking system that will enable banks to raise funds themselves and regenerate much needed growth in credit.

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