Indian firms face major foreign debt risk

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Owing to rising global interest rates and a falling rupee, cost of servicing foreign loans has risen sharply. ECBs are a risk factor

Hard times With inflationary pressures mounting, the RBI is likely to harden its stance in future

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The Federal Reserve of United States has raised short-term benchmark interest rates for the third time this year. With this increase, the benchmark rates have crossed the 2 per cent mark for the first time since 2008. The Fed has also given enough indications to suggest that there might be one more rate hike in December followed by a few more next year.

As job growth figures in the US are pointing towards historically low unemployment levels, and the GDP growth rate is expected to be more than 3 per cent this year, the Fed is gradually moving away from the accommodative monetary policy it followed since the recession of 2006-08.

For India, this rate hike is mostly bad news, as it may lead to more capital outflows, which will put more downward pressure on the rapidly weakening rupee. The impending sanctions on oil exports from Iran and Venezuela threatens to push up oil prices even more. This will further add to the pressure on the current account of the country.

Moreover, higher oil prices may have an inflationary impact on the economy. Higher international interest rates and growing inflationary expectations are already leading to hardening of bond yields. These may push the RBI to raise domestic interest rates in the near future. A rise in interest rate will increase the cost of capital and may adversely affect investment. Higher yields also reduce prices of fixed income assets, which in turn worsens the balance sheets of corporates and financial institutions holding such assets.

The combination of exchange rate depreciation and hike in global interest rates adversely affects many firms from India (nearly 10,000) that have borrowed a huge amount of money (over Rs 18 lakh crore, as per RBI data) from the international markets since 2007. 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. To come out of the recession, developed countries adopted accommodative and unconventional monetary policy tools. These policies increased liquidity in the system and pushed interest rates down to historically low levels in developed countries and international capital markets. While these policies may have been effective in their domestic markets, the global fallout has been quite significant.

As the gap between nominal interest rates between developed and developing countries widened, it encouraged the “carry trade” whereby international investors used arbitrage to benefit from this differential. It also 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.

A double whammy

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.

The impact of depreciation will be less of a problem if the firm has earnings in foreign currency. A firm is said to be 'naturally hedged' if foreign currency earnings of the firm can pay off its repayment cost of external borrowings. Apart from the 'natural hedge', firms can also have a 'financial hedge' through derivative contracts with financial institutions. Since 2016, the RBI has pushed Indian firms to hedge their foreign currency exposures, but it is not clear whether this has been successful.

A look at the balance sheets (from the Prowess database) of the firms which have obtained ECBs shows that a large number of these firms have negative net foreign exchange earnings. These firms are unlikely to have any 'natural hedge' against foreign exchange risks. And as the rupee becomes more volatile, cost of financial hedging will ramp up significantly.

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.

Risks from trade wars

Trade wars and rising tariffs in many countries may also dent some of the export earnings of the firms who have natural hedges based on their foreign currency earnings. Therefore, Indian firms will find it increasingly more difficult to service their foreign currency debts.

This makes the recent move by the government to liberalise some aspects of the ECB norms seem short sighted. Now, ECB borrowers who are in manufacturing can raise ECBs up to $50 million or its equivalent with a minimum average maturity period of one year, compared to three years as previously required.

While relaxed norms for ECBs may attract short-term capital flows in the country, international borrowing is becoming costlier, and will become even more so in the short to medium term. The increased burden of servicing foreign currency denominated debt will add to the vulnerability associated with foreign borrowing with inadequate hedging. Foreign debt servicing woes by individual firms will not only affect that firm but may also put greater stress on the financial sector of the country. The policy chosen to deal with the current instability in the currency market is unlikely to be of much help.

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