How good or bad is the Budget decision to issue foreign currency debt?

India wants to internationalise rupee eventually – to make it a currency other countries will use.

By Raghuram Rajan

In her Budget speech, finance minister Nirmala Sitharaman said that India would start borrowing in external markets in external currencies. This is a marked change from the past when India issued government bonds in rupees, and borrowed in foreign exchange only from official lenders like the World Bank. Two possible rationales in the speech are that, first, “India’s sovereign external debt to GDP is among the lowest globally at less than 5%” and, second, this will “have [a] beneficial impact on [the] demand situation for the government securities in domestic market”.

The first is not really a rationale. India’s sovereign external debt is low precisely because past policymakers worried about the risks of issuing in foreign currency. Indeed, Arun Jaitley wrote in the finance ministry’s own status paper on public debt published in February 2018 that “Most of the debt is of domestic origin insulating the debt portfolio from currency risk. The limited external debt, almost entirely from official sources on concessional terms, provides safety from volatility in the international financial markets.”

The second rationale suggests the primary aim is to finance the public sector borrowing requirement. Optimistic budgetary projections and off-budget borrowing suggests this might yet be large despite the conservative stated deficit numbers. Yet even here the rationale is unclear. If the government wants to attract more foreign money to supplement domestic savings, it does not need to issue a sovereign bond, all it needs to do is to increase current ceilings on foreign portfolio investment into government rupee bonds. The effect is the same – more foreign inflows – but the government security is issued in rupees.

Moreover, there seems to be some confusion over whether a foreign dollar issuance will reduce the amount of domestic government bonds the domestic market will have to absorb. The reality is that if the RBI sterilises the foreign exchange inflows (as some commentators advocate) by buying dollars and selling its holding of government bonds, it will not reduce the domestic government bonds the market has to absorb an iota. So what is the real rationale for this adventurous move?
Foreign bankers often meet finance ministry officials, trying to persuade India to issue a foreign bond. In my experience, they usually started by saying that such borrowing would be cheaper because dollar or yen interest rates are lower than rupee interest rates. This argument is bogus – usually the lower dollar interest rate is offset in the longer run by higher principal repayments as the rupee depreciates against the dollar. Moreover, times when the rupee depreciates significantly (such as during the Taper Tantrum) are times when India’s image amongst international investors is bad, and the higher repayment requirement on dollar debt could lead to even greater market turmoil. For this reason, most countries issue government debt in foreign currency only when they are unable to issue in their own currency.

The bankers then switched to arguing that this will bring a whole set of new investors from abroad into Indian government debt – investors who simply do not want to bother with the hassles of registration in India. We should worry about the nature of such investors. Might they be short term faddish investors, buying when India is “hot”, and dumping us when it is not? Could the resulting volatility in India’s debt traded on foreign exchanges then transmit to our domestic G-Sec market? Would the foreign tail wag the domestic dog?

The bankers typically shifted arguments once again – this time to emphasise that foreign trading would enhance liquidity in government issuances. Perhaps, but if that trading were done in India (by encouraging those investors to buy and sell G-Secs in India), would not the liquidity of local trading increase yet more? Do we want stronger Indian markets or stronger foreign markets? Far better than issuing a foreign currency bond abroad (where we have absolutely no control over who invests) would be to relax our requirements for foreigners to register as foreign portfolio investors, or if we have absolutely no concern about who invests, eliminating these requirements entirely (in my view, a step whose time has still not come).

The bankers had one last try. They argued that Indian government foreign issuances at different maturities would create a yield curve that would allow foreign issuances of Indian corporations to be more easily priced. It is hard to imagine though that Indian government issuances abroad would be liquid enough to create a useful yield curve – except for the current 10 year bond, most government issuances even in India are not traded enough to establish credible prices. And if so, the issuances by quasi-sovereigns like SBI should give traders a pricing benchmark that is only modestly more inaccurate.

The bankers were only doing their job – trying to earn underwriting fees for their banks. But the government has to keep India’s safety and needs in mind when sifting through their proposals.

A small issuance will likely not be problematic. The concern is that once the door is opened, the government will be tempted to issue more, much more, with attendant risks – after all, all addictions start small. There is, however, another reason to avoid foreign issuances. In the past, India has stated its desire to internationalise the rupee eventually – to make it a currency that other countries will use. The first step has been to make the rupee more attractive by bringing down domestic inflation. Now that we have done that, why not focus on making rupee assets more desirable and liquid? If rupee internationalisation is still the intent, why do we want to create unnecessary competition for rupee assets and Indian markets by denominating India’s most sought-after financial asset, its government bond, in foreign currency?

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