Sovereign bonds aren't a great funding option

Factoring in exchange rate fluctuations will push up the cost of funds. And transmission of risk to the G-Sec market is likely

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The 2019-20 Union Budget has made one drastic deviation from the past by proposing to finance the fiscal deficit by borrowing foreign savings through floating of sovereign bonds. While this by itself is not new, as right now up to to 6 per cent of public debt is held by FPIs (foreign portfolio investors), what is concerning is issuing bonds in foreign currency.

Further, it is also not clear what the size of borrowing is; some Finance Ministry officials have put it at around $10 billion. There are a number of people arguing for and against this proposal, but most of them are against it. Former central bankers (Governors and Deputy Governors) say that there were such proposals in the past, too, but they were opposed.

The Finance Minister in her Budget speech proudly declared that India's external public debt is less than 5 per cent of GDP (about 3.8 per cent of GDP and one-fifth of external debt as at end-March 2019) and the least among emerging market economies. And, hence, the government presumes it has large space to borrow from foreign markets with much lower interest rates.

The argument in favour of this proposal is that domestic interest rates are too high and sticky and, hence, sovereign bonds could help in bringing down the overall interest rate structure in the economy. Another argument is, now that India is envisaging a $5 trillion economy by 2024-25, it requires continuous investment, and government borrowing from abroad would increase the pool of funds and ease credit availability for the private sector supporting GDP growth.

This argument comes from the detailed discussion on 'virtuous investments' made in Economic Survey: 2018-19. But is sovereign bond a solution? As many central bankers have argued, it may not be the best solution, and India is still not ready for floating sovereign bonds.

First, the fact that India's public debt has less than 5 per cent exposure to foreign savings is a hard-earned distinction earned over more than two decades of deliberate strategy. Second, the borrowing from abroad in foreign currency has its own implications — loan repayments are subject to exchange rate fluctuations.

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Market volatility

As may be noted in the chart, from 2013-14 to till now the volatility (read risk) in the domestic government securities market is much lower than that in the foreign exchange market. Now, opening up the new source for financing the fiscal deficit could mean transmission of such risks from the foreign exchange to the government securities market.

Rather, with the floating of sovereign bonds, the volatility in exchange rates could increase further and, ultimately, , the fisc would end up absorbing these risks. Further, if the exchange rate depreciates sharply (the Economic Survey assumed exchange rate could depreciate to 75 by 2024-25), the payout could increase substantially.

Grey area International experience does not provide any lead about the suitability of sovereign loans ISTOCK

The argument that borrowing from abroad could bring down the cost of capital domestically appears weak; any fund manager would know this. With the yield on 10-year US treasury bonds trading between 2.05 per cent and 2.12 per cent now and with the average spread of 1.7 per cent (based on similar rated countries such as Russia), India's sovereign bond is expected to be priced between 3.5 and 3.9 per cent.

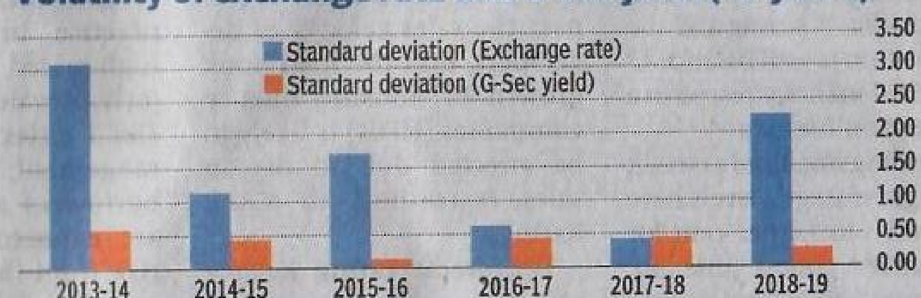
Now if we add forward premium on the USD-INR market, the actual borrowing cost could be between 7.5 and 7.9 per cent. This is much higher than the current market yield, which is in the range of 6.40 and 6.45 per cent and there are expectations that this could decline further. The important lesson here is 'easy money' now need not end up that way, and the uncovered risks could be manifold. It is also not clear how successful India would be in mobilising $10 billion, especially when the country is rated 'lowest investment grade' (BBB-).

On the macro front, as many former heads of the RBI have argued, the current account deficit of 2.1 per cent is not low and while the unanticipated risks are high, the repayment of sovereign loans might only aggravate the situation. Further, the international experience is mixed and do not provide any lead to emerging market economies like India. The Greece example only complicates our understanding. Hence, as they argue, the time may not be conducive to enter uncharted territory.

Now how do we augment investments for a $5 trillion economy? This is where the Economic Survey appears to have got it wrong. Empirics suggest that the high growth in India is actually domestic savings led.

Measures are needed to stimulate savings (even with a temporary fiscal cost), which in turn would boost investments.

In that sense there is a need to relook both the monetary and fiscal rules. One has to understand the intention of the original FRBM Act, 2003 and see if it has been diluted. Our view is, it has.



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