Comments and Discussion*

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I enjoyed reading this thought-provoking paper. Two of the authors (Patnaik and Shah) played a key role in drafting the Sahoo Committee Report, which pushed for a major liberalization of the complex framework that governs Indian corporations' foreign debt transactions. The report emphasized that the prevailing restrictions on borrowers/lenders, maturity, ceilings, etc., perhaps timely when promulgated, are anachronistic in the current context.

This paper succinctly parses the Sahoo report and explores the market failures arising from corporations in an emerging economy, issuing foreign currency-denominated debt under the restrictive environment of administered currency rates and incomplete markets. I want to use this forum to explore some of the issues raised in the paper.

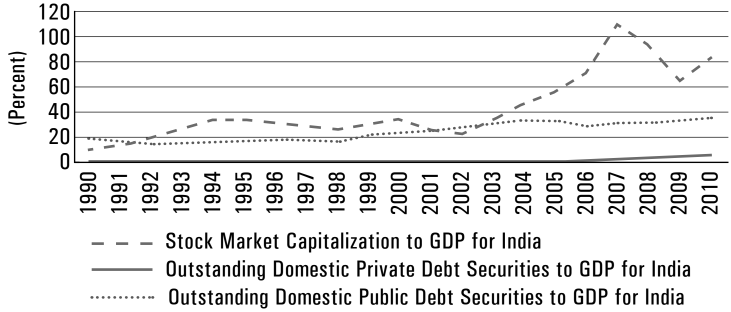
Figures 1 and 2 given below show the evolution of the Indian and US financial sectors post-1990 relative to GDP.[1] A striking difference is that while the magnitude of the corporate bond market in the USA is approximately equal to the stock market, the corporate bond market in India is insignificant. Figure 3 is a magnified plot of the miniscule corporate bond market in India, which at its peak was about 5 percent of GDP. What I find puzzling is Figure 1 titled "External Corporate Borrowing as a percent of GDP, 1991–2014" in the paper, which quantifies "external corporate borrowing"[2] at 7 percent of GDP. It suggests that external borrowing by Indian firms exceeds domestic borrowing!

* To preserve the sense of the discussions at the IPF, these discussants' comments reflect the views expressed at the IPF and do not take into account revisions to the original conference paper in response to these and other comments, even though the IPF Volume itself contains the revised paper. The original conference version of the paper is available on www.ncaer.org.

† I thank Jamal Mecklai for insightful comments. I am grateful to the participants at the India Policy Forum 2015 for a stimulating discussion.

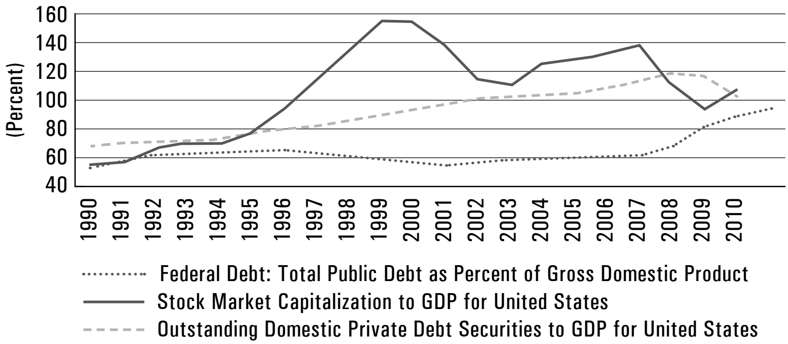
1. In 2014, India's GDP was approximately US$ 2 trillion. The US GDP was an order of magnitude more.
2. External corporate borrowing is the sum of foreign currency borrowing and trade credit.

FIGURE 1. Evolution of the Financial Sector in India: 1990–2011



Source: 2015 research.stlouisfed.org.

FIGURE 2. Evolution of the Financial Sector in the USA: 1990–2011



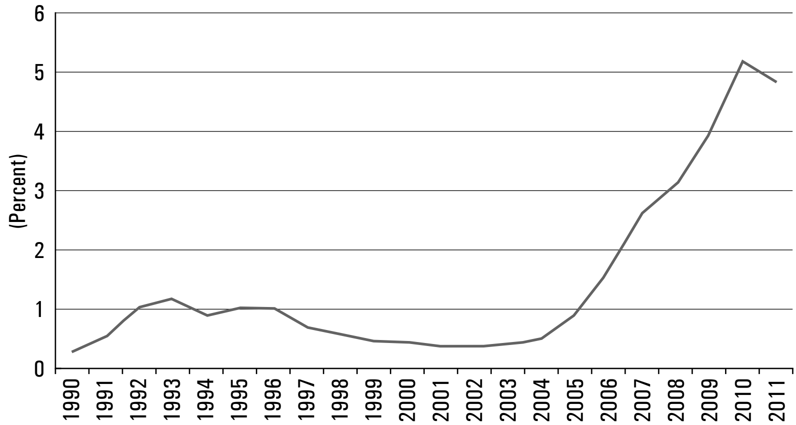
Source: 2015 research.stlouisfed.org.

Private Benefits vs Social Costs

Trade reforms gave Indian firms the ability to compete globally in both factor and product markets. Why not give Indian firms the ability to compete globally for financial capital? This will probably lower the cost of capital, increase investment, and consequently growth. This question cannot be answered in the abstract.

When a firm borrows in a foreign currency, its balance sheet is exposed to exchange rate fluctuations. The optimal response of a value-maximizing firm to this additional source of risk will depend on its perception of how the government will respond to exchange rate movements. The current

FIGURE 3. The Corporate Debt Market in India: 1990–2011



Source: 2015 research.stlouisfed.org.

government policy is an "implicit put," limiting exchange rate movements to a narrow ±5 percent range. This creates an incentive for individual firms to under-hedge their foreign exchange (FX) exposure. If numerous firms borrow internationally and do not optimally hedge their currency exposure, the probability of a correlated default increases in the presence of a large exchange rate movement. Idiosyncratic risk at the firm level manifests as an economy-wide systematic risk. The consequent negative externalities constitute a market failure.

A Suboptimal Response

Hedging FX risk is a component of the overall risk management strategy of a firm. A policy of forcing each firm to fully hedge its exposure is clearly suboptimal. It is isomorphic to costly domestic borrowing. More importantly, as is illustrated in the paper of Patnaik, Shah, and Singh, it does not take into account the FX exposure of an individual firm. A highlight of the paper is an example that shows that a domestic firm—the authors quote the case of an Airline Company—may have implicit FX exposure if import parity pricing holds in factor and product markets. Thus, unhedged international borrowing may actually reduce initial product risk for such a firm, without increasing the risk of contagion.

A Solution?

The authors, echoing the Sahoo Committee Report, propose scrapping the current archaic regulations in favor of a more nuanced, case-by-case approach. Firms would still be required to hedge a part of their currency exposure, net of any implicit hedges in place. The information requirements associated with implementing their proposals are nontrivial. An alternative would be to go beyond the Sahoo Committee recommendations and take steps to eliminate the source of the moral hazard. This will go a long way toward addressing India's fundamental need to access capital at competitive rates.

In April 2015, RBI Governor Raghuram Rajan commented, "We hope to get full capital account convertibility in a short number of years." Full capital account convertibility cannot be wished into being. The first essential step would involve reviving and rejuvenating India's moribund FX market.

In 2007, according to a Mecklai Financial study, the Indian FX market was one of the most liquid markets in the emerging markets. It ranked third out of 15 markets studied.

By 2013, the onshore Over-the-Counter (OTC) USD/INR liquidity had shrunk, relative to trade, by over 50 percent. In absolute terms, while global FX market liquidity increased by around 50 percent, onshore USD/INR trading volumes declined by 12.5 percent. In the global FX market, non-bank financial institutions (NBFCs; mutual funds, hedge funds, insurance companies, primary dealers) generate nearly 52 percent of the market volume. In contrast, in the Indian USD/INR market, non-bank entities make up just 26 percent of the market volume.

As a first step toward increasing liquidity and capital account convertibility, the RBI should permit NBFCs to access the domestic USD/INR market, even if they do not have any underlying FX exposures. This would add about US$ 10 billion to daily turnover, introduce a diversity of players and views, incentivize information-gathering, and lay the foundations for trading transparency and market efficiency. The consequent increase in average volatility would, in turn, motivate firms to endogenously adapt by increasing their hedge ratios to optimally hedge risk.

Concluding Comments

Over the past decade, India's external trade has doubled. However, FX transactions have not kept pace. This is largely because of the absence of non-bank transactions, which typically constitute 50 percent of all FX transactions. This paper is a well-articulated, timely reminder of much-needed reform in this area.