External Commercial Borrowings in India - An Overview

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INTRODUCTION

ECBs in India are raised for the purpose of import of capital goods, new projects, modernization/expansion of existing production units in real sector, micro finance, refinancing old loans and on-lending to power sector. This access of Indian companies to international capital markets reflects the deepening of global financial markets, transformation of corporate financing, and strong inter-linkages across markets and greater exposure of firms to foreign currency exchange. It is agreed that liberalization of economies and greater asset diversification by international investors has increased the connection between Indian firms and international capital markets.

The following proposal therefore establishes the idea in a descriptive manner as to whether external commercial borrowings are correlated with the current account and explores the factors that affect the Indian firms' preference to indulge in commercial borrowings. There are three factors that will be considered for this study: exchange rate between India and U.S., interest rate differential (it is defined as the difference between the prime lending rate and the average cost of borrowing overseas by corporates, i.e., 6-month LIBOR + all in cost ceiling imposed by Reserve Bank of India) and domestic activity (proxied by estimates of industrial and service sector).

All the above factors are among the many factors that affect the external commercial borrowings. The reasons for choice of these three determinants for my research are explained in further sections. The period of study 2003-2014 is an interesting time period for India because it is an ideal example of boom and bust where the first decade of the millennium witnessed respectable growth rates followed by anemic and uneven global financial crisis and then a sudden surge in growth from 2012 onwards.

REVIEW OF LITERATURE

I. EXCHANGE RATES

Jongwanich, (2013) in his study says it is beneficial for the emerging economies to experience a rise in capital flows, but at the same time it has unfavorable side effects of 'real exchange rate appreciation'. Regardless of the exchange rate regime a country follows, excess of capital flows always bring with it an appreciation of the domestic currency.

Sebastian Edwards (2012) in his study, examines the relationship among exchange rate, capital flows and crisis for the decade of 1990 and draws conclusions from the lessons learnt during the Mexican, East Asian, Brazilian and Russian crisis. A higher interest rate in domestic countries attracted a large amount of capital and portfolio investments in the early 1990s in many developing countries, which helped in financing major part of current account deficits.

II. INTEREST RATES AND INTEREST RATE DIFFERENTIAL

Calvo et al (2008) in his research provided evidence of lending and borrowing interest rates in Latin America and United States he estimates that a relatively high interest rate differential on Latin American assets during the above time period, attracted major rise in capital flows in that region. On the other hand, in Chile there was a less pronounced impact of inflows on the interest rate differential.

Bird and Rajan (2006) studied the East Asian case for their analysis where an interest rate advantage persisted. The authors concluded that financial liberalization led to an increase in the domestic interest rates and capital was 'pulled' and not 'pushed', in other words, the persistent interest rate advantage in favor of East Asian economies was related to rising domestic interest rates rather than falling world interest rates.

III. EXTERNAL COMMERCIAL BORROWINGS: THE INDIAN CONTEXT

The mechanisms from the previous studies are discussed below to show the different approaches and assumptions considered by researchers in testing various determinants of external commercial borrowings along with other proxies for capital flows. This section is more like the framework of studies conducted earlier.

Umanath Kumarasamy (2014) the central bank of the country that controls foreign exchange reserves by implementing the policies and procedures, which affects the valuation of currency. The exchange rate can be adjusted by demand and supply of the foreign currencies. External commercial borrowing also affects foreign reserves and exchange rate. This paper found that foreign reserves and external commercial borrowing have mutual relationship.

Mora Sowjana and D. Satish (2014) observed through the case study named Tata Steel's ECB- the payoffs that, with the initiation of liberalization policies, the Indian financial markets had experienced remarkable changes and Indian companies started borrowing and investing abroad. Many Indian companies have raised substantial amounts of external borrowings through ECB for their long term requirements.

Significance of the study

The curiosity in exploring this topic is attributed to the fact that in the era of financial development, the pattern of rise and fall of external commercial borrowings have been phenomenal, but the thirst remains to explore whether the factors assuredly affected the long run demand of Indian corporates' for overseas borrowings and in turn due to this, has the rise in capital flows offset current account deficit and balanced the balance of payments.

OBJECTIVE OF THE STUDY

- **To ascertain the factors responsible for growth of external commercial borrowings**
- **To analyze the impact of interest rate differential, currency appreciation, and domestic activity on ECBs.**

HYPOTHESIS OF THE STUDY

Hypothesis 1: Increase in interest rate differential induces corporates' to access cheaper external commercial borrowings.

Hypothesis 2: Appreciating domestic currency induces greater external commercial borrowings

Hypothesis 3: Greater real domestic activity implies higher external commercial borrowings.

DATA FOR THE STUDY

The main component of our entire discussion is external commercial borrowings, which is defined as foreign currency borrowings rose by companies of the domestic country from sources outside the country. The monthly data for this, from period 2003-2014 is available in terms of U.S. dollars on the website of Reserve Bank of India (the central bank of India).

The data for prime lending rate which is a component of the interest rate differential is taken from the official website of Organization of Economic Co-operation and Development (OECD). The data for 6-month LIBOR was availed from ICE Benchmark Administration Limited (IBA) and Federal Reserve Bank of St. Louis (FRED). Due to non-availability of actual interest rate on external commercial borrowing, it was computed by 6-month LIBOR plus all in cost ceiling imposed by RBI. The data for all-in the cost ceiling is available from the Handbook of Statistics on Indian Economy from RBI's website.

The dataset for monthly values of exchange rate (Indian rupee per unit of U.S. dollar) is obtained from Database on Indian Economy, RBI's Data Warehouse, the official website of Reserve bank of India. The monthly data that has been used is the value that prevailed during the beginning of each month. Preliminary value for the current month is provided even if not all daily values are available for the entire month. Exchange rates constitute as an important determinant of borrowing cost of companies. If the domestic currency is expected to appreciate then the effective cost of servicing the debt goes down and corporates' tend to borrow more in international markets.

ANALYSIS OF DATA

The graphs below show the scatter plots of key variables with external commercial borrowings.

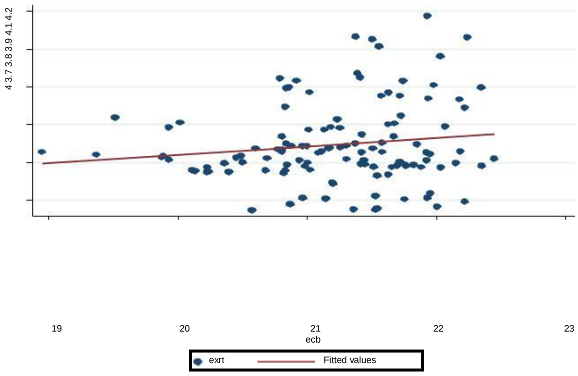
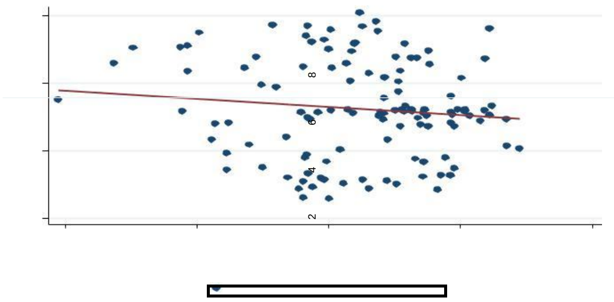


Figure 1: Scatter diagram showing 'ECB' and 'exchange rate'

Figure 2: Scatter diagram showing 'ECB' and 'interest rate differential'



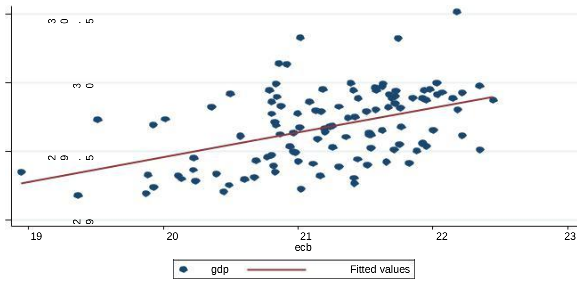


Figure 3: Scatter diagram showing 'ECB' and 'GDP'

The scatter plot that represents ECB on the x-axis and the other variables on the y-axis suggests a positive relationship between of exchange rate and GDP with ECB, however a negative relation between interests rate differential and ECB. Though as per the economic theory, a wider interest rate differential tends to induce commercial borrowings, which is in contrast to the data under study that shows a negative correlation.

INTERPRETATION OF RESULTS

Having gone through the results and impacts of external commercial borrowings through previous research and literature, it can be deduced that external commercial borrowings up to an extent are affected by the interest rate differential, real exchange rates and real domestic activity along with many other factors.

External commercial borrowings have matured since the last decade and they have grown at a brisk pace during 2003-04. As the data suggests, in the fiscal year 2007-09, the ECB inflow slumped in India due to the global slowdown and risk averseness among the foreign investors. In this phase of crisis, the economy was facing high inflation, exchange rate crisis, discouraging investment scenario and squeezing of liquidity conditions. However, in the following year, 2010-11, ECBs again picked up because of international liquidity and also relaxation of ECB norms by the Reserve Bank of India.

CONCLUSION

It can be concluded from the results that external commercial borrowings are overall affected by exchange rates, interest rate differentials and real domestic activity for India for the period 2003 -2014. The curiosity in exploring this topic attributed to the fact that in the era of financial development, the pattern of rise and fall in external commercial borrowings has been phenomenal and the data under study very well explains that. These results can be reasoned to some important perspectives. Firstly, due to an increasing share in the industrial and service sector of India, the use of ECBs for overseas investments has grown significantly. Second, the interest rate differential too have some effect on the demand for ECBs. Third, exchange rate is an important variable that explains changes in external borrowings, however there is scope to use a more detailed approach that would help to define a clearer picture.