

## *Integration of the Domestic Debt Market with the Forex Market*

---

*A.V. Rajwade<sup>1</sup>*

I will begin with one of the current clichés in corporate finance. Almost on a daily basis, newspapers report that some company or the other is restructuring its debt – i.e. replacing Rupee debt by foreign currency debt – and how this exercise will have a very positive impact on the company.

An enormous amount of integration already exists between exchange rate expectations and the debt market. One example of this is the cliché to which I just referred. Every company, whether it has a natural hedge for taking foreign currency borrowings or not, is considering such borrowings to reduce its nominal interest costs. However, this may not be the correct methodology, especially if a company does not have a hedge in its own cash flows. It is also difficult to believe that foreign exchange has become such a plentiful resource for our country that the cost of foreign exchange will, in the long run, be cheaper than the cost of Rupees. Though a lot of corporate finance today is driven by this particular belief, it is based on a number of assumptions.

---

<sup>1</sup> Managing Partner, A.V. Rajwade & Co., India  
*Paper presented in October 1997*

There are other examples as well, which again relate to exchange rate expectations – and not to the foreign exchange markets – which are driving the debt markets. I refer here to short term debt, and in particular, to trade finance. This depends mainly on exchange rate expectations of importers and exporters, and can have an enormous impact on the demand for Rupee funds from the banking system.

More specifically, the total current trade of the country is just about equal to the total outstanding bank credit – both are about Rs.2,70,000 crore. If trade is financed in rupees, it exerts a certain demand for rupee funds. However, when trade is financed in dollars, based on expectations on the exchange rate, the demand for rupee funds falls drastically. The changes in the demand for debt funds from the banking system, at the short end of the market, is being governed and influenced much more by exchange rate expectations, than almost anything else. There is an enormous ongoing arbitrage between the interest differentials and forward margin, and of course interest differentials and exchange rate expectations.

Another point which merits mention, is the need for a term money market in India. When we have a term interbank market – and I hope it will be sooner than later – and some more flexibility in terms of exchange control, for banks to borrow or deposit dollars in foreign markets, we would then have a far closer integration between the money market and foreign exchange market through the interest parity determining the forward margin on the exchange rate. The sooner it happens, the lesser will be the swings in demand for bank funds which can upset the totality of the situation very dramatically. The corporate and the banking sectors experienced this phenomena in the second half of 1995 - 96, when there was a substantial shift from Dollar finance to Rupee finance. We witnessed interest rates going to absurd levels, and, as a result, the primary equity market got killed. We have not had a manufacturing sector primary issue for a long time.

Therefore, the two essential foundations on which the forward margin based on interest parity will come in, will be the development of a 1/3/6 month interbank market and greater freedom for banks to borrow and deposit dollars in the markets abroad. The last credit policy freed this up to

## FUTURE DIRECTIONS

---

US\$10 million. One expects to see some further relaxation in the next few weeks.

Another issue of interest parity, and therefore of the integration between the money and the foreign exchange markets, is the regulatory apprehension in allowing banks to borrow dollars in markets abroad. This apprehension is well founded as it may lead to an increased short term debt. On the other hand, banks are free to borrow unlimited Dollars through the FCNR window. Therefore, while the FCNR window can be used without limitations on the amount of dollars that the banking system can borrow, there is a limitation of 10 million dollars per bank, in the interbank market. However, whether you borrow FCNR dollars or interbank dollars, the affect on the balance of payments is identical. Therefore, the interbank limit should be increased. However, it is regrettable that, despite some broad hints by the RBI on its willingness to consider raising the interbank limit of US\$10 million, not many bankers have taken advantage of it.

Therefore, the two essentials for an integration of the debt market and foreign exchange market are :

1. Development of the interbank term money market, and,
2. Greater freedom for banks to borrow and deposit dollars abroad.

This will bring about the full integration of money and foreign exchange markets, through interest parity in the forward margin. This is likely to take place over the next two or three years.

Another factor that merits further consideration, is the development of a long term forward market for dollars. For a long time, six months was taken to be the longest forward dollar available. Over the last one year however, the one-year forward market has become fairly liquid, though there is still scope for greater liquidity.

An important announcement in the April 1997 Credit Policy of the RBI was the permission to banks to undertake dollar-rupee swaps, either within their own open position books, or by off-loading the transaction on their corporate clients. A swap, is identical to a series of forward contracts and there is absolutely no difference, in present value terms, between a series of forward contracts and a currency swap. Some running on this particular front, was done by a few foreign and domestic private sector banks. A few

stray transactions, for two to three years swaps did take place, at rates akin to LIBOR, for 13% Rupees. However, the last few months have not seen much activity in this particular area. Though this is a step towards integration of the debt market with the foreign exchange market, it is surprising that the running on long term forwards, or Dollar-Rupee long term swaps, is being undertaken by banks with a relatively limited corporate client base. Large Indian banks, potentially the bigger players, do not appear very interested in playing a role in this particular area, though their corporate client base is perhaps 100 times larger than that of foreign or private sector banks. Unless the big players enter this area, it will not take off. There are important reasons, like hedging risks, for which a long term swap market is essential.

Another aspect of integration of foreign exchange and debt markets, is the feature of currency risk which, presently, is broadly overlooked by the corporate sector. I refer, in particular, to economic exposures to exchange rates. Most of us may be familiar with transaction exposures, typically arising out of import and export transactions, and translation exposures, arising out of foreign currency debt. Economic exposures arise even for companies with no imports, exports or foreign currency obligations of any kind. These are Indian companies like SAIL and TISCO, which produce commodity-type goods for domestic markets. The pricing of these goods including alloy steel, nonferrous metal, petrochemicals, basic chemicals, etc. – in fact almost everything that is under the OGL – is certainly governed by exchange rates. The price of Hindustan Copper's copper for the domestic market, is the multiplication of the LME price by the exchange rate. The domestic price can be determined by simply adding the import duty. If this is higher, the buyer would prefer to import the goods rather than buy from Hindustan Copper. Now, many of these companies – and these are very large companies – have an enormous amount of economic exposure to the exchange rate. Since economic exposures cannot currently be hedged in the forward market, these companies are natural participants in Dollar-Rupee swaps. The only hedge for economic exposures is in taking Dollar loans. However, if a company is already saddled with Rupee debt, the only way it can take that Dollar exposure, is by swapping a part of its Rupee debt for Dollar debt. This can be done either directly between two

## FUTURE DIRECTIONS

---

corporates, or with the intermediation of a bank. The larger banks and institutions have an important role to be played in this, as they have clients of both types i.e. clients with foreign currency borrowing, foreign currency debt, with little hedge in terms of their cash flows, and, clients with a huge economic exposure and little amount of hedge against that in the form of foreign currency debt. This is one area in the longer term foreign exchange market or the Rupee swap market, which needs to be awakened and enlivened. The larger financial intermediaries are the best placed to do this, and not the smaller ones – though they have done the running so far.

However, if larger players do not do the running, should the market remain dead, or very small at best? This thought prompts a case for allowing larger NBFCs or investment banks to undertake such swaps, and guarantee the two cash flows to counterparties. In any case, apart from the few foreign and private sector banks, other large entities need to do this running as this market has huge growth potential. A focus in this direction, will further integrate the foreign exchange market, exchange rate expectations and the behavior of forward margin, with the Rupee debt market and swaps. This is urgently needed and it is hopefully only a matter of time before it happens.

Enabling banks to undertake longer term swaps, rather than on a pure back-to-back basis, is going to be an even longer term project as it will necessitate further changes in the way we operate – both in the money market as well as the foreign exchange market. One such change would be in short selling of Government bonds, which is very much a part of any debt market. Short selling of Government debt and buying Dollars through the proceeds of such short sales, is in effect, a hedge for Rupee swap. In fact, that is the basic hedge for any currency swap transaction. Therefore, if banks are to be able to do longer term swaps, apart from finding two counterparties, with exactly matching and opposite requirements, they would have to take the swaps on their own books. They would hedge only from short selling bonds and depositing the money in Dollar deposits abroad.

In a number of areas, including pricing of commodities like steel, copper, aluminum and the other basic goods, the integration between international markets and domestic prices has come out of the OGL mechanism. The integration between the Rupee debt market, interest rates, forward margins

and foreign interest rates, would, in other words, become an Open General License as far as the money and exchange markets are concerned. Swaps and forward contracts are derivatives, and what derivatives ultimately do, is to transfer risk – from someone who cannot bear it to someone who can. Our markets need this integration, and it will be finally enabled by the development of the longer term forward market or the Dollar-Rupee currency swap market.