Unhedged foreign currency exposures

Last week, the Reserve Bank has further liberalised the regulations governing external funding for Indian corporates. On the other hand, for quite some time, the central bank, in its capacity as the banking regulator, has been expressing concern over the extent of unhedged exposures on the part of the corporate world, and to what extent these could impair the quality of their credit. In a paper published in September 2014 by the Bank for International Settlements (BIS), the researchers have made the same point, mentioning specifically "*energy and utilities firms in India*". Last year, the banking regulator also came out with guidelines for incremental provisioning and capital requirements for the banking system, against the likely loss arising from currency fluctuations.

On first principles, unhedged foreign currency liabilities by Indian corporates are nothing but "carry trades": borrowing (or shorting) a low interest currency and not borrowing (going long) high interest rupees. In many ways, foreign portfolio investors in India's bond market are engaged in a very similar carry trade, often on a leveraged basis. In another study by BIS I remember, according to its research, in the global currency markets carry trades are the second most popular trading/speculative strategy, after trend following or momentum trading.

In our case, to my mind, there are two major constraints in liability hedging by the corporate sector:

⇒ Empirical evidence over almost 2 ½ decades suggests that only in very few years has the rupee depreciated against the dollar, by more than the interest differential. In other words, the central bank's exchange rate policy has not kept the rupee reasonably stable in purchasing power parity (PPP) terms since, broadly speaking, interest differentials parallel inflation differentials. And, this makes carry trades attractive and profitable;

⇒ There is also a major imbalance between long and short positions of the corporate world, on both flow and stock side. As for the flow, there is a gap of something like $ 140 bn between imports and exports; and on the stock side, the aggregate long term foreign currency assets are far less than the foreign currency liabilities. In short, even if the corporate sector wants to hedge all short positions where will the supply come from?

One way of overcoming both the problems over a period, is to so manage the rupee's exchange rate as to, firstly, restore its parity in PPP terms, and, secondly, to depreciate it in future to compensate for inflation differentials with our trading partners.

As for the provisioning regulations, the BIS seems to rely on "*Sharpe ratio-type risk-adjusted return metrics (e.g. interest rate differentials adjusted for exchange rate volatility")* as a measure of the risk.

Capital deficit country?

In its Annual Report, the Reserve Bank has averred that *"India is likely to remain a capital deficit country in the near to medium term"* (Working and Operations, para V.19). The implication is that our domestic savings will remain short of domestic investments: in other words we would continue to incur deficits on the current account for the foreseeable future, given the macroeconomic identity. The question is whether one can quantify the savings investment imbalance *ex ante*? Are they a "given", independent of the inflation, interest and exchange rates? This may well be true to some extent as far as the investment side is concerned since projects take a few years for completion – but surely monetary conditions and growth environment would influence the start of new projects.

Arguably the savings side of the equation is influenced much more by the time and external values of the domestic currency. Focusing on the latter, overvalued exchange rates impact savings in various ways: they

⇒ help increase consumption, particularly of imported goods;

⇒ encourage foreign travel by residents, thus reducing personal savings;

⇒ the profitability and output of the tradeables sector comes under pressure reducing corporate savings;

⇒ the previous item also means lower direct and indirect taxes – and hence government savings; etc.

In short, it is difficult to form any reliable judgement about savings and investments, or "capital deficits", ex ante. The accepted wisdom for quite a long time was that poor countries' investment needs are higher than domestic savings and that they would therefore incur deficits on current account and need to import capital to finance them. The reality today is most Asian emerging economies have excess savings – and the rich, countries particularly US and UK, incur external deficits year after year after year.

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