is external debt a cause for worry?

What is external debt?

External debt is the money that borrowers in a country owe to foreign lenders. India's external debt was $513.4 billion at the end of December 2017, an increase of 8.8% since March 2017. Most of it was owed by private businesses which borrowed at attractive rates from foreign lenders.

To be precise, 78.8% of the total external debt ($404.5 billion) was owed by non-governmental entities like private companies. The size of external commercial borrowings and foreign currency convertible bonds, which represents Indian companies' foreign borrowings, has risen from Rs. 99,490 crore at the end of December 2015 to Rs. 1,72,872 crore at the end of December 2017. While external debt may be denominated in either the rupee or a foreign currency like the U.S. dollar, most of India's external debt is linked to the dollar. This means Indian borrowers will have to pay back their lenders by first converting their rupees into dollars. As of December 2017, about 48% of India's total external debt was denominated in dollars and 37.3% in rupees.

What are the risks?

There are two major risks involved in foreign borrowings. One is that, like in the case of domestic borrowings, there could be unexpected changes in the interest rates charged on these loans. This can, for instance, cause widespread default when rates rise as borrowers may not be able to make higher interest payments, thus raising the risks of a systemic crisis.

The raising of interest rates by the U.S. Federal Reserve has already caused borrowing rates to rise in various countries, including in India where bond yields have shot up sharply. The yield on the 10-year government bond, for instance, has risen to about 8% from around 6.5% at the end of June last year. Another major risk is unexpected changes in the exchange rates of currencies.

An unexpected fall in the value of the rupee, for instance, can cause severe difficulties for Indian companies that need to pay back dollar-denominated loans as they will now have to shell out more rupees than they had previously estimated to buy the necessary dollars. Lenders generally take possible fluctuations in the value of currencies into account when determining their lending rates.

But such forecasts are not always perfect. Unexpected changes in exchange rates could still impose surprise gains or losses on them. Various emerging market currencies have seen a sharp fall in value this year against the dollar. The rupee, in particular, has fallen about 7% since the beginning of the year. The fall in the value of the emerging market currencies is due to increasing demand for dollars from investors, who wish to sell their assets in the emerging markets and invest them in the U.S. where yields have been rising quite rapidly.

What happens next?

The U.S. central bank, which has already raised its benchmark interest rate twice this year, is expected to raise rates two more times in the rest of 2018. Further interest rate hikes could cause more outflow of capital from the emerging markets, thus causing unexpected changes in borrowing rates and the value of the rupee.

Both government and non-government borrowers in India, who are exposed to foreign debt, could be in trouble in such a scenario. The foreign exchange reserves, held by the Reserve Bank of India (RBI), were around $425 billion as on March 2018. This is the firepower that the RBI can use to support the rupee and bail out borrowers who get into trouble. The RBI, which raised its

benchmark interest rate for the first time in more than four years this month, may also decide to raise domestic interest rates further. While such a step could help to stem the capital outflow from the country and support the rupee, it could lead to further uncertainty about borrowing rates in the domestic economy.

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