THROUGH THE LOOKING GLASS

POLICY TOOLS FOR THE MANAGEMENT OF FOREIGN EXCHANGE RESERVES NEED TO BE DEVELOPED IN PEACE TIMES LIKE NOW (WHEN THE RUPEE IS STABLE) SO THAT IT CAN BE DEPLOYED EFFECTIVELY

Hedging INR for the long-term

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THE RECENTLY CONCLUDED Virtual Global Investor Conference saw large global investors recommitting to their interest in investing in India for the long-term. For investors, the return they seek is dependent on the performance of underlying investment and the exchange rate of the Indian rupee. Foreign investors with long-term commitments to Indian infrastructure need the ability to hedge their currency exposure in India. The exposure can typically last for multiple decades, especially in the context of infrastructure.

While, over the long-run, the Indian rupee has depreciated in small single-digit percentages (2.3% pa over the last two decades), there are years when the exchange rate has moved significantly causing a large variability in returns. Many large moves of the rupee are caused by factors exogenous to India—a taper tantrum or a large dollop of inflows before the Great Financial Crisis (GFC). The average, hence, hides the variability.

Indian foreign exchange currency hedging market is (a) limited to a few currencies like the US dollar, euro, etc, even as investors from across the globe are now investing here, (b) it is illiquid beyond the 12-months horizon or a few spots like 3-year and 5-year horizons, and (3) beset with regulatory requirements of underlying exposure and largely plain-vanilla hedges.

Economic rationale for the issue

India's balance of payments is more liberal and open on the current account with a combined transaction value of $1 trillion, which has a reasonably equal matching on the incoming and outgoing. India has trade import and exports of $850 bn a year (~$500 bn imports and ~$350 bn exports) and another $250 bn of invisible flows (~$200 bn of services and ~$70 bn of remittances inwards). These flows are settled over a short period of say, one to twelve months—such a large market has meant that the Indian currency has natural buyers and sellers, thereby, creating an efficient hedging market. Since global trade is denominated largely in US dollar, the currency pair that is most actively traded is the INR-USD pair.

On the capital account, however, India has imbalances between inflows and outflows, with inflows being meaningfully higher. Inflows take place via the foreign direct investment (FDI) and foreign portfolio investment (FPI) route. Outflows take place largely only via the Liberalized Remittance Scheme (LRS). In the pre-GFC era, Indian companies had, for a few short years, embarked on large global acquisitions—this trend has practically stopped over the last decade. In any year, hence, inflows of foreign exchange significantly exceed outflows in India. This has led to the building up of large foreign exchange reserves for India, which have now crossed half-a-trillion dollars. This also means that there are no natural counterparties who are available to hedge rupee over the long-term. If India had a thriving two-way market for long-term investments (both into and out of the country), a natural hedging market would have evolved.

> **The Indian govt can consider borrowing in US dollar (or in some other currencies) with long-term paper (5-year, 10-year, 20-year and 30-year)**

As a natural consequence of the current account being more active than the capital account, extant rules with respect to the foreign exchange markets have been conceptualised and written accordingly. The idea of underlying exposures, the certainty of transactions, need to have only plain vanilla hedges all draw from the idealised buy-sell transaction of an importer and exporter. The needs and requirements of a long-term investor, like a sovereign wealth fund (SWF) or a pension fund, are very different. The different nature of this set of investors requires a deeper think on the regulations, types of instruments, and nature of market participants allowed.

Possible solutions

Expanded market access: With a large foreign exchange reserve, which now covers more than 16 months of imports, India can now afford to progressively relax regulatory requirements for underlying exposures and allow more than plain vanilla derivatives. This will bring in market-makers who can offer liquidity to the market. Unfortunately, when the word 'speculator' is used for such market participants, it carries a negative tone in the policymaking circles. In any case, such a market exists outside India: the Non-Deliverable Forward (NDF) market.

Liberalised outflows: Outflows on the capital account could be liberalised further for both individuals and corporate. This will create a natural market as Indians (retail or corporate) who invest outside India: they will seek hedges on their global holdings. With Indian companies now allowed to list outside the country, the Indian public could be allowed, via mutual funds and alternative investment funds (AIFs) to invest more liberally abroad. This will allow Indians to benefit from the India growth story while also making the foreign exchange market more balanced.

Benchmarks for better pricing: The Indian government can consider borrowing in US dollar (or in some other currencies) with long-term paper (5-year, 10-year, 20-year and 30-year). This will allow price discovery between the highly traded INR bonds and foreign currency Indian bonds. The price differentials will allow market participants to have a view on the long-tenor exchange rates. This move needs to be done in a prudential manner to ensure that the market is of a reasonable size relative to the overall debt.

Policy tools for the management of foreign exchange reserves need to be developed in peace times like now (when the rupee is stable) so that it can be deployed effectively if there are sudden, sharp movements. The central bankers have created cross-currency swaps inter se between themselves post the Great Financial Crisis—this tool was re-invoked easily during the pandemic.