What are sovereign bonds and what are their risks & rewards?

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"The current controversy relates to India's sovereign bonds that will be floated in foreign countries and will be denominated in foreign currencies. Both the initial loan amount and the final payment will be in either US dollars or some other comparable currency."

In her maiden Budget speech earlier in this month, Finance Minister Nirmala Sitharaman announced something that no previous FM had done. She said that the Indian "government would start raising a part of its gross borrowing programme in external markets in external currencies". According to most reports, this type of borrowing is likely to start by October with the initial amount of $10 billion. However, this idea has not gone down well with several top economists, such as former RBI Governor Raghuram Rajan, who have underscored the reasons why past governments have stayed away from raising loans overseas in foreign-denominated currencies.

The latest economist to caution the government is Rathin Roy, who is not only the director of the National Institute of Public Finance and Policy (a government think tank) but also a member of the Prime Minister's Economic Advisory Council. "I would pay very careful attention to what several Governors of the Reserve Bank are saying…", Roy said during a public event Monday.

What exactly are sovereign bonds?

A bond is like an IOU. The issuer of a bond promises to pay back a fixed amount of money every year until the expiry of the term, at which point the issuer returns the principal amount to the buyer. When a government issues such a bond it is called a sovereign bond.

Typically, the more financially strong a country, the more well respected is its sovereign bond. Some of the best known sovereign bonds are the Treasuries (of the United States), the Gilts (of Britain), the OATS (of France), the Bundesanleihen or Bunds (of Germany) and the JGBs (of Japan).

And what is the controversial part?

The current controversy relates to India's sovereign bonds that will be floated in foreign countries and will be denominated in foreign currencies. In other words, both the initial loan amount and the final payment will be in either US dollars or some other comparable currency. This would differentiate these proposed bonds from either government securities (or G-secs, wherein the Indian government raises loans within India and in Indian rupee) or Masala bonds (wherein Indian entities — not the government — raise money overseas in rupee terms).

The difference between issuing a bond denominated in rupees and issuing it in a foreign currency (say US dollar) is the incidence of exchange rate risk. If the loan is in terms of dollars, and the rupee weakens against the dollar during the bond's tenure, the government would have to return more rupees to pay back the same amount of dollars. If, however, the initial loan is denominated in rupee terms, then the negative fallout would be on the foreign investor.

For example, imagine two 10-year sovereign bond issues by India: one for $100 in the US, and the other for Rs 7,000 in India. For the sake of simplicity, suppose the exchange rate is Rs 70 to a dollar. As such, at the time of issue, both values are the same. Now suppose the exchange rate worsens for India and falls to Rs 80 a dollar at the end of the tenure. In the first case, the Indian government would have to pay Rs 8,000 (instead of Rs 7,000 that it got initially) to meet its dollar-denominated obligation. In the second case, it would pay Rs 7,000 and the lender would be short-changed as these Rs 7,000 will be equal to just $87.5 at the end of tenure. That is why, if the exchange rate is expected to worsen, sovereign bonds denominated in domestic currency are preferable.

There are many reasons why. Possibly the biggest of these is that the Indian government's domestic borrowing is crowding out private investment and preventing the interest rates from falling even when inflation has cooled off and the RBI is cutting policy rates. If the government was to borrow some of its loans from outside India, there will be investable money left for private companies to borrow; not to mention that interest rates could start coming down. In fact, the significant decline in 10-year G-sec yields in the recent past is partially a result of this announcement.

Moreover, at less than 5%, India's sovereign external debt to GDP is among the lowest globally. In other words, there is scope for the Indian government to raise funds this way without worrying too much about the possible negative effects.

Thirdly, a sovereign bond issue will provide a yield curve — a benchmark — for Indian corporates who wish to raise loans in foreign markets. This will help Indian businesses that have increasingly looked towards foreign economies to borrow money.

Lastly, the timing is great. Globally, and especially in the advanced economies where the government is likely to go to borrow, the interest rates are low and, thanks to the easy monetary policies of foreign central banks, there are a lot of surplus funds waiting for a product that pays more.

In an ideal scenario, it could be win-win for all: Indian government raises loans at interest rates much cheaper than domestic interest rates, while foreign investors get a much higher return than is available in their own markets. Then why are so many cautioning against this move?

The biggest potential fly in the ointment is the element of risk that comes into the picture when a government borrows in foreign markets and in foreign currency. As N R Bhanumurthy and Kanika Gupta (both of NIPFP) have shown recently, the volatility in India's exchange rate is far more than the volatility in the yields of India's G-secs (the yields are the interest rate that the government pays when it borrows domestically). This means that although the government would be borrowing at "cheaper" rates than domestically, the eventual rates (after incorporating the possible weakening of rupee against the dollar) might make the deal costlier.

Rajan has also questioned the assumption that borrowing outside would necessarily reduce the number of government bonds the domestic market will have to absorb. That's because if fresh foreign currency comes into the economy, the RBI would have to "neutralise" it by sucking the exact amount out of the money supply. This, in turn, will require selling more bonds. If the RBI doesn't do it then the excess money supply will create inflation and push up the interest rates, thus disincentivising private investments.

Lastly, based on the unpleasant experience of other emerging economies, many argue that a small initial borrowing is the thin end of the wedge. It is quite likely that the government will be tempted to dip into the foreign markets for more loans every time it runs out of money. At some point, especially if India does not take care of its fiscal health, the foreign investors will pull the plug on fresh investments, creating dire consequences for India.

Sovereign bond

Why in the discussion?

- More recently, Finance Minister Nirmala Sitaraman mentioned the sovereign bond during the 2019-20 budget speech.
- Through this bond, it has been estimated the government is trying to get a share of its gross borrowings from overseas markets.
- The term sovereign bond is used for government bonds.

What is it?

- Bond is a means of giving a fixed return by which companies or governments raise debt. The one who buys bonds is lending to the government or company in a way and it is promised to give a certain return in return with the principal at a given time.
- Thus, by releasing sovereign bonds abroad, there is a plan to raise the money of the government and put that money in development. Later on this money will be reimbursed with interest on maturity.
- In other words, it is the securities issued by the government through which the government manages the fiscal deficit and the temporary cash mismatch. It can also be issued in rupees or in foreign currency (dollar, etc.).
- So far in India, the government has released only Sovereign Bonds in the domestic market (Rupee-based) in the local currency. However, the foreign sovereign bonds may now be issued by the Indian government in foreign exchange (dollar) too.

What is the goal of the government?

- Officials of the finance ministry said that the government can raise about 10-15 per cent of the proposed Rs 7.1 lakh crore borrowedings through Sovereign Bonds in this financial year. The maker of the proposed bond was former Finance Secretary Subhash Chandra Garg.

Why is there opposition

- Many economists believe that taking a government loan in foreign currency is a misconception, and the international experience in this regard is quite bad.
- They are so trapped in the trap of foreign debt that they are now taking more loans to avoid sovereign defaults.
- Indonesia, Brazil, Argentina, Turkey and Mexico are examples of this. Foreign debt of these countries has reached 53.8 percent of GDP.
- Dollar based sovereign bonds are more sensitive to global interest rates. In such a situation, it can negatively influence the Indian economy.
- At present, the participation of foreign investors in Indian debt is low, it is only 3.6% of government securities, while in Indonesia it is 38% and in Malaysia it is 24%.
- In this context, efforts are being made by the Reserve Bank of India so that the investment situation can be made easier for foreign investors.

Expected Questions (Prelims Exams)

1. In the context of sovereign bond, consider the following statements-

1. Bond issuer promises to pay a certain amount by the end of term each year, at the point issuer returns buyer the principal amount. When a government issues such bond is called sovereign bond.
2. The best known sovereign bonds of the world are the Treasuries, the Gilts, the OATS, the Bundesanleihen or Bunds and the JGBs.

Which of the above statements is/are correct?

(a) Only 1 (b) Only 2

(c) Both 1 and 2 (d) All of the above

Expected Questions (Mains Exams)

Q. What are sovereign bonds? Indian government has recently taken a decision to issue these to raise foreign currencies from foreign markets. Discuss its affect on the Indian economy.

(250 Words)

Note: Answer of Prelims Expected Question given on 25 July. is 1(d).