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Business

ECB curbs to impact Indian M&As, at least in the interim

D.Murali

Chennai, Aug. 11: Why should firms with good credit standing that are attempting to expand domestically using low cost funds raised overseas be penalised in comparison to export oriented ones, asks Mr Ramkishen S. Rajan, Associate Professor, School of Public Policy, George Mason University, US.

This is a fundamental issue, though there may be sound short-term rationale for the imposition of the ECB (external commercial borrowing) curbs, both from a monetary management and prudential perspectives, he says, in a recent interaction with *Business Line*.

"Indian exporters need to increase domestic productivity so that they can manage currency appreciations going forward and the RBI (Reserve Bank of India) is able therefore to allow greater rupee flexibility without having to worry about the fiscal costs of sterilisation or without having to impose selective and ad hoc controls," insists Mr Rajan.

Excerpts from an interview.

On the need for and timing of controls.

The unending capital inflows is putting upward pressure on the rupee and export growth has been slowing down. Moderating the appreciation of the rupee without impacting domestic liquidity, on the one hand, and the higher fiscal costs of monetary sterilisation, on the other, has left the RBI with limited ammunition but to revert to selective capital controls. While they have been liberalising capital outflows selectively, the new limits on ECB are a step to reduce capital inflows.

On the context.

In some sense, insofar as the BOP (balance of payments) data reveals that the bulk of the capital inflows into India have been of the debt variety in recent times as opposed to equity (net equity flows have been stable as there have been both gross inflows and outflows), selective ECB controls are understandable.

To be more specific, according to RBI data, between April-December 2005 and April-December 2006, India's current account deficit remained constant at around \$11.8 billion. Equity inflows remained stable at around \$11 billion. Yet during this period Indian forex reserves have skyrocketed, as has the Indian rupee. The reason has largely been because of ECBs -- ECB inflows were around \$10 billion in April-December 2006, compared with -\$1.2 billion in the same period in 2005.

On precedents.

Indian policy makers have clearly learnt lessons from Thailand and other countries, which tried to impose blanket capital controls on inflows leading to significant equity market turmoil. The ECB controls have been imposed by other countries such as Korea (which has faced many of the problems that India has been facing).

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Chile (1991–98), Malaysia (1994), and Thailand (1995–97) are also examples of countries that have used capital controls to limit short-term capital inflows. The Thai experience pre 1997 is especially instructive in that it shared many similarities to India today -- fast growth (darling of the investment world), current account deficit but larger capital inflows leading to upward pressure on the currency, large-scale capital inflows of the short-term debt variety. Interestingly the Thai controls of capital inflows didn't prevent capital infusion and subsequent capital outflows and economic collapse.

On additional rationale for ECB controls.

There is basis for the ECB controls beyond monetary management. Anecdotal evidence suggests that many Indian corporates have been using the ECB channel largely due to the expectation of continued appreciation of the rupee and lower costs. More concerning is that the borrowings are not hedged in many cases.

In the chance event of sharp negative shock in India and depreciation of the rupee (it could happen -- think Thailand 1997), the unhedged borrowing could have severe negative balance sheet effects on corporates in India. While India will be able to withstand such a shock much better than Thailand or Indonesia did in 1997-98 in view of the stronger financial system and prudential regulations, the impact on the economy can still be potentially severe.

On the effectiveness of the controls.

Clearly one will need to wait and see. However, there are two issues of import. On the one hand, for those corporates that are using the ECB channel primarily to purchase imported capital goods, the impact will be limited as they can still borrow reasonably freely (except that the funds will have to be parked overseas).

Paradoxically, the ECB will have little net impact on the Indian rupee because if the funds were going to be used to purchase imports in the first instance, the net impact of the overseas borrowings on the rupee would have been negated in any case.

The ECB will also not impact corporations that are using funds to undertake overseas M&As (mergers and acquisitions). It will, however, have an impact on Indian corporates attempting to raise money overseas to purchase a stake in another Indian firm. Thus, the extent of domestic M&As may be impacted, at least in the interim. Many Indian global corporates can avoid these curbs via borrowing through offshore subsidiaries.

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