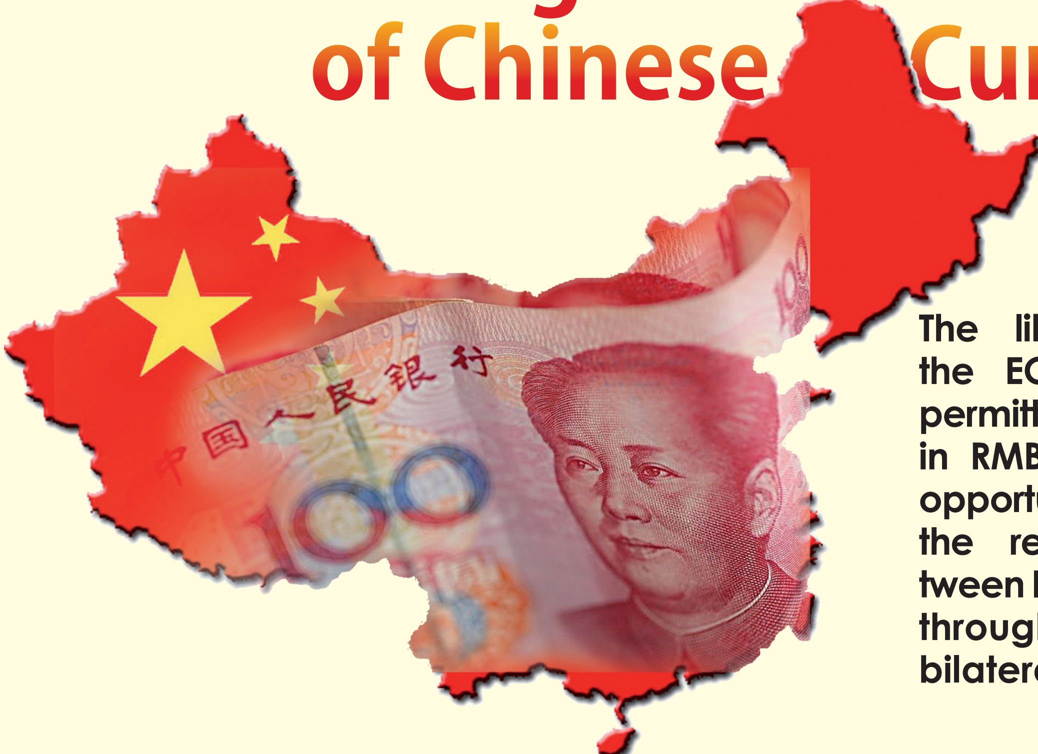
Let's Uphold

The Growing Clout of Chinese Currency



The liberalization of the ECB regime by permitting borrowing in RMB is a fantastic opportunity to foster the relationship between India and China through the means of bilateral trade.

India has set itself a GDP growth target of 9 percent in the 12th Five Year Plan (2012-2017). A highlight of this plan is the emphasis laid down on comprehensively addressing the persistent problem of infrastructural bottlenecks, seen as a major hindrance to India's economic ambitions. However, the figure of USD 1 trillion, which India has committed to spend on this sector during the Plan period, seems like a distant dream in the wake of the current global economic crisis.

Interest rates in India, while admittedly not at an all-time high, have been hiked twelve times over the last eighteen months as a measure to control the persistent inflation that has engulfed the domestic economy. In stark contrast, other countries have chosen to slash deposit rates in a bid to stimulate productive economic activity by ensuring adequate supply of cheap credit. This differential rate of interest could possibly spur Indian corporate houses to explore the option of meeting its financing requirements outside the country.

Among the alternatives available to them, besides traditional favourites like the USD and the Euro, loans denominated in Renminbi (RMB), the currency of the People's Republic of China, could potentially emerge as a dark horse vying for the attention of India Inc. While the Euro has been experiencing increasing volatility in the international currency market due to the European sovereign debt crisis; the supply of USD has also become relatively scarce, possibly attributable to the prevailing sentiment of risk aversion in the United States. Also there is a lot of chatter about the virtues of the RMB, especially its relative stability, with many tipping it to be the global reserve currency of the future.

More importantly, for corporate houses, RMB denominated loans are attractive as they are cheap and in abundant supply with the current lending rate in China being considerably lower than its Indian counterpart. But the importance of accessing such loans goes beyond exploiting interest rate arbitrage. China is a major manufacturing hub and India is increasingly looking eastwards to satiate its appetite for capital goods deployed in infrastructure projects such as power, roads, telecommunications, airports, mining, industrial parks and urban infrastructure. Instead of being compelled to borrow funds in a notified currency (such as the Great British Pound, Japanese Yen, Euro or USD) and converting it into RMB, inefficient due to costs incurred at every stage of conversion, money can now be directly paid to suppliers in Chinese currency.

Possibly influenced by the above factors, the High Level Co-ordination Committee on External Commercial Borrowings (ECBs) (comprising members of both the Ministry of Finance and Reserve Bank of India (RBI)) announced the relaxed norms on ECBs on September 15, 2011, notified by the RBI on September 27, 2011. The circular issued by RBI permits Indian infrastructure companies for the first time to raise, through the approval route, ECBs denominated in RMB up to an extent of USD 1 billion, subject to the existing overall ECB ceiling limit of USD 30 billion.

This can only have positive ramifications for the modern revival of the Silk Route – a historically important trade route linking India and China from antiquity – which seems to be well underway with some reports estimating Indo-China trade to be worth USD 60 billion for the financial year 2010-2011. With reserves of more than USD 3 trillion, China has always had the funds and the willingness to extend credit to Indian companies. With the recent notification streamlining the procedure involved, this commercially viable proposition is now achievable.

The Source of Funds

Post the notification, funds denominated in RMB can be availed by Indian companies principally in two ways. The first of these are loans for financing infrastructure construction and development. As such projects require large scale funding and have a long gestation period, borrowers will be looking to obtain funding with a similarly long tenor of maturity and low interest rates, which banks in China can offer at the moment. Reliance Communications is an instance of an Indian company which had, prior to the ECB notification, secured a loan of approximately USD 1.93 billion from the China Development Bank for a term of ten years so as to avail of the benefit of low interest payable in respect of such facility.

With the advent of the notification in respect of RMB denominated loans, such credit can also be secured to conveniently settle payments to Chinese equipment manufacturers for import of telecommunications equipment.

The second route through which funding through this channel can be attained is by issue of corporate bonds denominated in RMB and issued in the offshore RMB market located in Hong Kong. Colloquially known as 'dim sum bonds', these face less regulatory controls as compared to debt instruments in the Chinese mainland. For Indian companies, such as Infrastructure Leasing and Financial Services Limited which looks all set to be the first Indian company to issue such bonds, the main incentive is access to RMB at extremely low interest rates

Chinese investors for their part possess surplus quantities of investible savings which they would like to deploy so as to participate in the Indian growth story. Such an investment opportunity is doubly attractive to them as it adds diversity to their portfolio, which is currently overweight in American Treasury Bonds. Although the market for dim sum bonds is relatively new, their growth has been rapid and it would be unwise to discount the potential of this mechanism.

Sawant Singh
Partner

Davis Kanjamala
Associate

Phoenix Legal

The Slip Side

While liberalization of the ECB regime by permitting borrowing in RMB is unquestionably the need of the hour and a positive commercial move on the part of Indian authorities, there are potential downsides of such trade flows.

China, just like India, does not freely permit capital inflows and outflows from its borders. The RMB is not fully convertible – a persistent bone of contention with the United States – and its present low valuation is tightly reined by authorities more interested in preserving the price competiveness of Chinese exports, rather than fairly reflecting its true value. This is a significant issue for Indian infrastructure companies interested in availing long term borrowings as present trends indicate that, in all likelihood, the value of the RMB will appreciate in the future.

In such a situation, it might be possible that a loan in a freely convertible international currency, for example the USD, may eventually turn out to be less expensive in Indian Rupee (INR) terms than a seemingly cheaper loan denominated in RMB. The potential depreciation of the INR is therefore a variable which must be factored in by borrowers so as to calculate the true cost of obtaining a loan denominated in RMB.

Another cause of concern with the RMB is its limited ability to be traded outside China and the restricted scope of hedging currency risk – a vital element in any facility agreement involving foreign currency. This is not an issue in case of a freely tradable currency such as the Japanese Yen as volatility in exchange rates can be mitigated through swaps and derivatives. However, the RMB is not freely convertible in the international currency market, making the risk of exposure due to fluctuation of its value much more acute. So, whereas a free market exists for trade of the Yen and risk of its future appreciation can be hedged at any point, the RMB must be purchased at every instance of repayment of loan or interest component at the prevailing price unilaterally fixed by the Chinese authorities.

The fact remains that the RMB is widely touted as being in line to succeed the USD as the future global reserve currency by virtue of the sheer strength of China's underlying economy, the second largest in the world. While the erstwhile economic super powers have floundered or been stuck in financial doldrums of late, the steady growth of the Chinese economy while sitting on a declared current account surplus of more than USD 87 billion is yet another strong reminder of its credentials. The notification of the RMB by the RBI is therefore a fantastic opportunity to foster the relationship between India and China through the means of bilateral trade. It also provides a golden opportunity for India to lay the foundation for its ascent as an economic superpower by gifting itself world class infrastructure, albeit paid for in Chinese currency.

•