Exporters can benefit from foreign currency loans

Exports encompass a critical foreign exchange generator in today's inter-connected and open economies, and are vital to maintain a comfortable balance of trade. Governments, therefore, encourage exports by providing various sops and incentives such as export subsidies and duty drawbacks that render exports competitive in the international market.

However, for a country like India, the costs of financing exports are high, given the high borrowing costs in the domestic currency. Exporters can, therefore, consider borrowing in low-cost foreign currencies which are benchmarked to international reference interest rates such as the LIBOR (London Inter-Bank Offered Rate).

However, LIBOR, the reference rate for determining the interest rate at which banks offer foreign currency loans, will be phased out by the end of 2021. And the same will be replaced by Alternative Reference Rates (ARRs) such as the SOFR (Secured Overnight Financing Rate), which is used for issuing dollar-denominated loans.

Considering that ARRs such as SOFR eliminate credit risk, unlike the LIBOR, the spread between these two rates has to be minimized for a smooth transition to the new reference rates. At the same time, banks need to cease entering into new financial contracts that reference LIBOR as a benchmark.

Challenge associated with LIBOR transition

LIBOR is a forward-looking interest rate, and therefore, factors in the credit and liquidity risks needed to determine term rates. However, the informality in the process of determining LIBOR term rates led to manipulation by the participating banks in the international interbank market for short-term loans, during the global financial crisis of 2008.

This severely hampered the credibility of LIBOR as a benchmark reference rate, and the Intercontinental Exchange (ICE), which administers LIBOR, will stop publishing the one-week and two-month term rates of USD LIBOR after December 31, 2021 and the remaining USD LIBOR term rates on June 30, 2023.

However, since the ARRs that will replace LIBOR and the associated IBORs (Inter-Bank Offered Rates), are risk-free benchmark interest rates, these are backward-looking rates based on the average interest rates that banks and financial institutions pay for overnight transactions.

While financial regulators across the world are devising new ARR term rates that will replace IBOR term rates, these will also require liquid derivative markets for setting forward interest rates.

Impact on Export Financing

In India, the Financial Benchmark India Pvt Ltd (FBIL), an independent benchmark administrator for interest rates and foreign exchange, has started publishing the Modified MIFOR (Mumbai Inter-Bank Forward Offer Rate) and Adjusted MIFOR as replacements for MIFOR, which is a mix of LIBOR and a forward premium derived from Indian forex markets, for setting prices on forward-rate agreements and derivatives; and few Authorized Dealer Banks have started executing SOFR-linked term loans.

Union Minister for Commerce and Industry, Shri Piyush Goyal, has recently advised exporters to borrow more in foreign currency. Considering that export revenues are generated in foreign currencies, exporters can consider borrowing in these currencies, thereby lowering their financing costs. In order to enhance India's share in international trade, we need robust financial instruments and dynamic forex trading markets, that can help in bringing down the costs of exporting.

Notifications

PIB

PLI scheme for the Pharmaceutical Sector

https://pib.gov.in/PressReleasePage.aspx?PRID=1775321

Exchange Rate Notification

https://pib.gov.in/PressReleasePage.aspx?PRID=1775111

Cabinet approves continuation of National Apprenticeship Training Scheme

https://pib.gov.in/PressReleasePage.aspx?PRID=1774577

India, ADB sign $300 million loan to improve primary health care in India

https://pib.gov.in/PressReleasePage.aspx?PRID=1774514