

EXTERNAL COMMERCIAL BORROWING



vEcoSys

Understanding External Commercial Borrowing



EXTERNAL COMMERCIAL BORROWING



Let's assume you suddenly have a guest at home and you are running short of milk to prepare tea.

In such a scenario you will have no option but to borrow some from your neighbors, which you can replace later.



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Likewise, **external** means non-Indian / foreign source, **commercial** would mean engaged in commerce and **borrowing** means acquire temporarily with a promise to return along with interest.

The concept of this strange sounding term is just as simple.



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ECB has become a major source for raising money by large Indian companies in recent years. In comparison with India, interest rates are a lot lower abroad. Therefore, this is the single biggest incentive for companies raising money from overseas.



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For example, even if a company borrows in the international market at 4% for one year; the cost of borrowing for a similar tenor may be close to 10% in the domestic market.

Companies in India are allowed to borrow from overseas, under certain conditions, through different instruments, with a minimum average maturity of 3 years.



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The main objective is to provide companies with an option of low-cost capital.



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However, it is not that ECB is always beneficial to a company and the country and does not carry any risk. There is a definite risk involved and those reading newspapers these days should be able to guess easily.



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The depreciation of the rupee is the biggest hurdle to this kind of borrowing.

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Let's assume, I have borrowed \$100 at 4% and converted it into rupees at Rs. 50 per dollar.

Now effectively I have borrowed Rs. 5,000 at 4%. Under normal circumstances, I will have to pay \$104 after a year.



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So, if the currency were to remain stable, I would have added the interest amount (4% of Rs. 5,000 which is Rs. 200) to the principal to make it Rs. 5,200 and buy US dollars at the rate of Rs. 50 per dollar. This would fetch me $\text{Rs. } 5,200 / \text{Rs. } 50 = \104 .

So far this makes complete business sense. Isn't it?



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But what if the rupee depreciates to Rs. 60?

As far as the overseas party is concerned the liability of the Indian company is clearly **\$104.**

At \$1 = Rs. 60, Rs. 5,200 would only fetch me Rs. 5,200/

Rs. 60 = **\$86.67. There is thus a shortfall of **\$17.33** (\$104 - \$86.67).**



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Now, the cost of buying additional \$17.33 at Rs. 60 per dollar turns out to $(\$17.33 \times \text{Rs.}60) = \text{Rs. } 1,040$. Thus, the interest which was planned as Rs. 200 turns out to be $(\text{Rs. } 200 + \text{Rs. } 1,040) \text{ Rs. } 1,240$.



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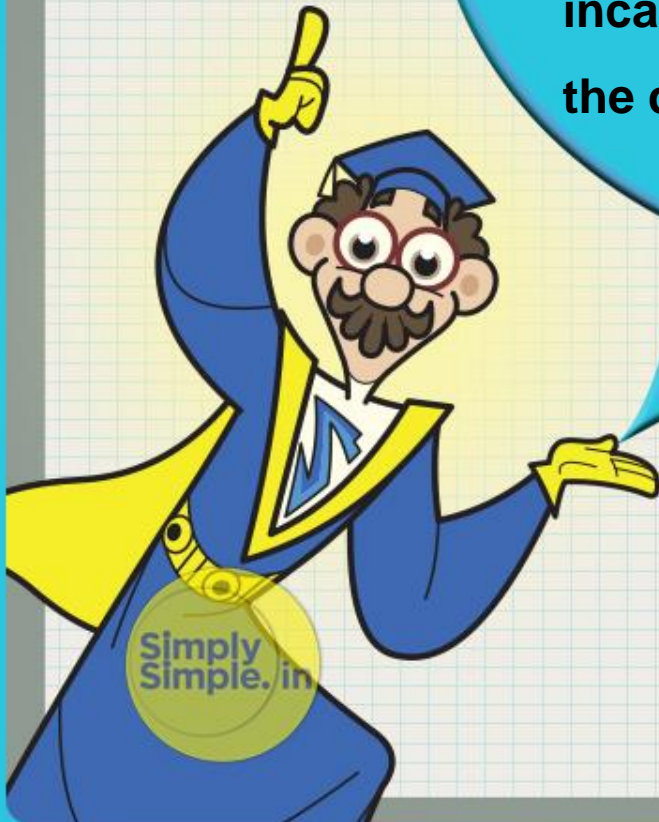
Now if you were to calculate the rate of interest the business enterprise in India lands up paying turns out to be $(Rs. 1,240 / Rs.5,000) \times 100\%$ which works out as **24.80%** which is much more than the 10% interest rates prevailing in the local market.



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Thus, in this case the borrower would surely feel short changed.

The opposite will be the scenario incase rupee appreciates against the dollar.



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Hope you have understood the concept of External Commercial Borrowing.



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