Sovereign Wealth Funds for India: Delineating Issues and Options from International Experience#

by

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Abstract

In recent years, foreign exchange reserves of some of the central banks are increasingly being switched into investments in riskier assets that have been perpetually meant for liquid and safe instruments. Those reserve funds are mainly derived from excess liquidity in the public sector stemming from government fiscal surpluses or from official reserves of central banks of emerging market economies constituting as Sovereign Wealth Funds (SWFs). The estimated assets currently managed by the SWFs exceed the combined pool of assets by hedge funds and private equity firms but smaller than the pension funds and mutual funds taken together. The rapid accumulation of low-risk foreign exchange reserve assets by many emerging market economies has generated debate on how such assets could be invested in order to improve the return without taking excessive risks. If SWFs grow as estimated by various agencies and their international diversification continues, liquidity inflows into a wide range of asset classes can be expected at higher order. A substitution away from central bank reserves invested in liquid sovereign paper to SWFs invested in higher yielding and dividend-bearing private securities is a likely situation in the coming years. In this pursuit, India is also vying for establishment of SWFs. At the same time, demand for asset management and investment banking services is also set to increase. Keeping in mind the advantages that the rise of SWFs may bring, there is also good reason to introspect implications for global financial market stability, corporate governance and national interest in the backdrop of current international financial turmoil.

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Section I
Taxonomy of Sovereign Wealth Funds

As such, there is no readymade definition of Sovereign Wealth Funds (SWFs) exists in economic literature that incorporates variety of funds available for operation in international financial markets. Basically, it is a government investment vehicle that manages foreign assets with a higher risk tolerance and higher expected returns than for central bank foreign currency reserves. The fuzzy logic behind this definition is: central bank reserves in some countries, which traditionally have been invested mainly in liquid and safe instruments, are increasingly being switched into riskier assets. Their funds are mainly derived from excess liquidity in the public sector stemming from government fiscal surpluses or from official reserves at central banks. It has been assessed that, investments by SWFs are typically one type of capital flow among countries so they have always been closely related to global imbalances in trade. When countries run surpluses on their current

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account, they generate equal and opposite net capital outflows of one sort or another and those capital flows produce an investment income (Gieve, 2008).

Traditionally, the pattern of investments was emanating mainly from the developed countries and was investing in developing ones, which had abundant land and natural resources but scarce capital signifying the higher returns. In the present day context, it is flowing in opposite direction. While earlier investors were mainly from the private sector and were seeking out the best returns on capital, now-a-days the investors are mainly from the emerging market economies central banks and governments and the build up of foreign assets reflects their policy choices.

Modern SWFs are basically originated from oil-producing countries, the first one being Kuwait Investment Fund set up in 1953. It makes sense for oil-producing countries to spread the benefits of this endowment across generations by investing part of current income in assets for future income generation. Abu Dhabi instituted the largest fund consisting USD 875 billion, whereas, Norway established a fund for its excess oil incomes of about USD 380 billion in 1990. Singapore has accumulated two large funds but unusually not based on oil income. More recently, China and Russia have instituted large SWFs of their own, and India has also carved a corpus of USD 5 billion for the purpose of creating SWFs. Furthermore, Brazil and Japan also have plans for such type of funds. The major SWFs in operation since 1953 are presented in Table 1.

Table 1: Major SWFs in Operation

Country	Name of Fund	Assets Managed (USD Billion)	Year of Inception	Sources of Fund
United Arab Emirates	Abu Dhabi Investment Authority	875	1976	Commodity wealth
Norway	Government Pension Fund- Global	380	1990	Commodity wealth
Singapore	Government Investment Corporation	330	1981	Other, including foreign exchange
Kuwait	Kuwait Investment Authority	250	1953	Commodity wealth
China	State Investment Corporation	200	2007	Foreign exchange
Hong Kong	HKMA Investment Portfolio	163	1998	Foreign exchange
Singapore	Temasek Holdings	159	1974	Other
Russia	Oil Stabilisation Fund	125	2004	Commodity wealth
Australia	Australian Future Fund	61	2006	Other
Qatar	Qatar Investment Authority	60	2000	Commodity wealth
Libya	Libyan Arab Foreign Investment Company	50	1981	Commodity wealth
Algeria	Revenue Regulation Fund	43	2000	Commodity wealth
Alaska, USA	Permanent Reserve Fund	40	1976	Commodity wealth
Russia	National Welfare Fund	32	2008	Commodity wealth
Brunei	Brunei Investment Agency	30	1983	Commodity wealth
Korea	Korea Investment Corporation	30	2005	Foreign exchange
Total		**3,200 approx.**		

Source: Sovereign Wealth Fund Institute (as on March 2008).

In general, foreign exchange reserves are intended to make transactions available for imports and for management of the exchange rate. This requires reserves to be invested in liquid, low-return foreign assets such as sovereign debt, deposits with the Bank for International Settlements and other central banks and commercial banks with higher ratings. With SWFs, governments set higher return objectives and this opens up possibilities for investment in a range of riskier assets – corporate debt, private equity, hedge funds, etc. Whereas, the time horizon for investment of forex reserves is relatively short, it is comparatively longer for SWFs. In this context, the paper discusses types of funds and their genesis in Section II; Section III covers delineated issues for discussion; Section IV deals with risks and opportunities of SWFs; issues and arguments of SWFs for India are dealt in Section V; Section VI draws implications followed by the concluding observations.

Section II
Type of Funds and their Genesis

The rapid accumulation of low-risk foreign exchange reserve assets by many emerging market economies has focused attention on how such assets could be invested so as to improve their return without taking excessive risk. This has led many countries, like Singapore, to establish national foreign asset funds other than official reserves. These funds could be classified according to several criteria, including motives for establishment and sources of funding. The classification based on motives for establishment usually distinguishes between stabilisation funds, savings funds and 'pure' sovereign wealth funds. Stabilisation funds are mechanism designed to reduce the impact of volatile foreign exchange inflows on the economy. Such funds have been established in many oil-exporting countries (including Algeria, Norway, Russia, and several central Asian and Gulf countries) and in some non-oil commodity producers (e.g., Botswana and Chile).

Savings funds are based on the principle of inter-generational equity: non-renewable resource revenue should be managed in a manner that will leave future generations at least as well off as the current one. Once a fund has reached a certain size, the main issue becomes how to preserve accumulated wealth and manage the fund's assets prudently while realising a reasonable rate of return[1]. Such entities could be termed as 'pure' sovereign wealth funds.

As mentioned in Table 1, SWFs generally categorised into two broad groups based on the source of the foreign exchange assets:

(1) Commodity based funds are established through commodity exports - either owned or taxed by the sovereign government. They serve different purposes like stabilisation of fiscal revenues, inter-generational saving and sterilised assets of the central banks. As a result of recent rise in commodity and fuel prices, many funds initially established for fiscal stabilisation or for sterilisation purposes have evolved into savings funds.

(2) Non-commodity based funds are typically established through transfers of assets from official foreign exchange reserves. Large current as well as capital account surpluses have enabled non-commodity exporters (particularly, in South East Asia) transfer 'excess' foreign exchange reserves to stand-alone funds. Non-commodity SWFs assets often derived from at least partially sterilised intervention and may therefore, be thought of more as 'borrowed funds'. Since commodity SWFs assets often derive from foreign currency accruing directly to the government, the foreign currency is not converted to domestic currency, does not enter the domestic economy, and therefore does not need to be sterilised through the issuance of domestic debt to avoid unwanted inflationary pressures (Box 1).

Some SWFs have operated for several decades as institutional investors managing government foreign asset portfolios (e.g., in Kuwait, Singapore and the United Arab Emirates). Others were carved out recently from foreign exchange reserves, after these were deemed to have exceeded most common benchmarks for reserve adequacy. The demarcation lines between these categories are in practice often blurred, as the fund's purpose evolves over time and with the size of the fund. The most recent example is Russia's oil stabilisation fund, which splits into a reserve fund and a fund for future generations being started in February 2008. Funds may also perform different functions at the same time. Norway's Government Pension Fund-Global currently performs stabilisation, budget financing, intergenerational saving and wealth management functions (Table 2).

As reported in a Deutsche Bank study of 12 economies, including 5 with a natural resource fund and 7 without, the IMF draws five conclusions on the effectiveness of such funds viz., (1) For countries with resource funds, the establishment of the fund did not have an identifiable moderating impact on government spending; (2) In terms of causality, findings suggest that countries with more prudent expenditure policies tended to establish

1/ In Norway, for instance, the amount of savings accumulated for future generations was seen as sufficient when they reached 100 per cent of GDP.

Box 1
How SWFs differs from Official Reserves?

As per the Balance of Payments Manual (1993) by IMF, reserve assets are ‘those external assets that are readily available to and controlled by the monetary authorities for direct financing of payment imbalances, for indirectly regulating the magnitude of such imbalances through intervention in exchange markets to affect the currency exchange rate, and for other purposes’. Key issues in determining whether SWF assets can be considered as official reserve assets include their liquidity and marketability as well as whether there is some legal or administrative guidance that would preclude the assets from being readily available to the monetary authorities to meet BoP need. Whether a given foreign exchange asset can be classified as a reserve asset has to be assessed on a case-by-case basis: In some cases, SWF assets may be invested in liquid and marketable instruments and the monetary authorities retain a clear legal right to call upon those assets to meet a balance of payments need. These SWF assets are likely to be classified as official reserves. In many other cases, however, SWF assets may be invested in less liquid instruments and/or the monetary authorities may not have a clear legal right to call upon them. These SWF assets would not be classified as official reserves. As SWF assets fall out of reserves, even if perfectly appropriate from a statistical perspective, they also carry risks falling out of the mechanisms that the international financial system has for reserves transparency. The two principal such mechanisms (both voluntary) are the IMF’s aggregate quarterly Currency Composition of Official Foreign Exchange Reserves (COFER) database and the Data Template on International Reserves and Foreign Currency Liquidity (Reserves Template), part of the IMF’s Special Data Dissemination Standard (SDDS). At present, there are 119 countries participating in COFER and 64 countries subscribe to the SDDS.

Table 2: Asset Management of Selected Funds

Country	Fund name	Foreign/domestic asset Split	Operational management
Alaska	Permanent Reserve Fund	Non-Alaskan and foreign	Alaska Permanent Fund Corporation (special private corporation)
Alberta	Alberta Heritage Trust Fund	Mainly domestic	Treasury’s Investment Management Division
Kuwait	General Reserve Fund	Domestic and foreign	Kuwait Investment Authority (KIA), autonomous government body
Kuwait	Future Generation Fund	Mainly foreign	KIA
Norway	Government Pension Fund –Global	Only foreign (heldas NOK account)	Central bank, including private investment managers
Oman	State General Reserve Fund	Almost entirely foreign	Autonomous government agency

Source: IMF; SWF Institute.

resource funds, rather than the fund itself leading to increased expenditure restraint; (3) The establishment of resource funds may have helped in the relevant cases to maintain cautious policies in the context of ongoing revenue variability; (4) The coordination of fund operations with overall national fiscal policy - to the extent that this is defined as a policy objective – has proven difficult; and (5) Evidence suggests that funds have been most difficult to operate when the extent of reliance on resource revenues has been largest.

The classification based on sources of funding distinguishes between ‘real wealth’ or ‘own wealth’ and ‘borrowed wealth’ funds. The former include entities funded by natural resource rents and taxes, fiscal surpluses and government asset sales (e.g., land sales or privatization revenue). These funds may not have clearly defined liabilities and are thus similar to private endowments. This feature also gives fund managers more freedom in selecting asset classes in which they could invest. By contrast, funds carved out of foreign exchange reserves are typically 'borrowed wealth' funds, in that they derive at least partly from sterilised foreign exchange intervention and therefore have clearly defined liabilities.

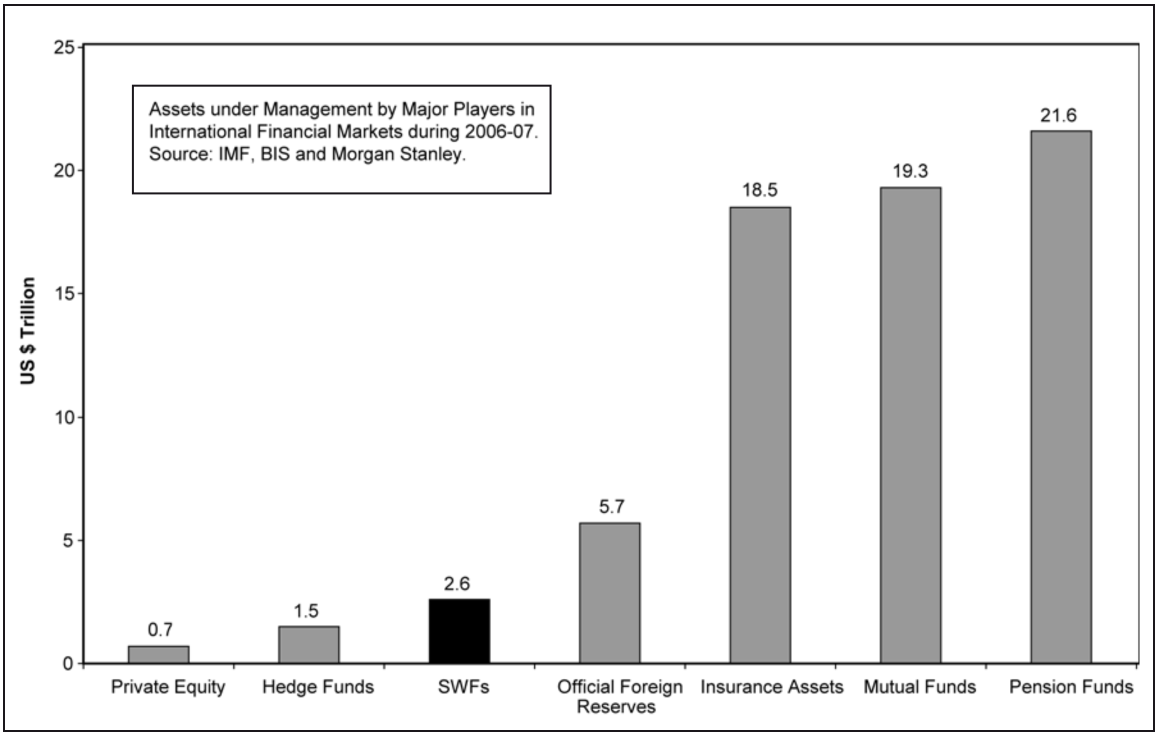
According to some rudimentary estimate by economists in Morgan Stanley, SWFs will grow to USD 12 trillion by 2015, an amount that roughly corresponds to the size of the entire US economy (Jen, 2007a). The recent activities relating to SWFs that are worthy of mention: Dubai's purchase of an undisclosed amount of Sony shares, Abu Dhabi's acquisition of USD 7.5 billion worth of Citigroup, China's USD 3 billion stake in private equity firm Blackstone, etc. According to an estimate by Morgan Stanley, SWFs have poured about USD 37 billion into financial institutions as rescue operations during 2007. Table 3 provides recent activities of SWFs in international financial markets. SWFs have shot into the limelight in the wake of the sub-prime crisis because of the recent high-profile investments made by some SWFs from the developing world. SWFs from China, West Asia and Singapore have emerged as saviours of some of the best known names in the industrial and financial sectors. Among the beneficiaries of SWF investments in recent months are the leading private equity company.

Table 3: SWF Capital Injections in Financial Institutions since November 2007

Date of Announcement	Sovereign Wealth Fund	Financial Institution	Amount (US USD Billion)
November 26, 2007	Abu Dhabi Investment Authority	Citigroup	7.5
December 10, 2007	GIC – Singapore	UBS	9.8
December 19, 2007	China Investment Corporation	Morgan Stanley	5.0
December 24, 2007	Temasek - Singapore	Merrill Lynch	4.4
January 15, 2008	GIC – Singapore	Citigroup	6.9
January 15, 2008	Kuwait Investment Authority	Citigroup	3.0
January 15, 2008	Korea Investment Corporation	Merrill Lynch	2.0
January 15, 2008	Kuwait Investment Authority	Merrill Lynch	2.0
		Total	**40.6**

Source: Gieve, 2008.

Chart 1: Relative Size of SWFs



The estimated assets currently managed by SWFs exceed the combined pool of assets by ‘hedge funds and private equity firms’ but smaller than the ‘pension funds and mutual funds’ taken together (Chart 1). This phenomenon, in general, attributable to the global macroeconomic imbalances exists since mid-1990s having large chunk of capital flows to the emerging market economies including India benefiting mostly from trade. According to the WTO statistics, the world economy at present is increasing at the rate of 3.5 per cent during last three years, i.e., 2005-07 which is considered strongest since last thirty years. During the same period, the average merchandise trade also increased by 6.8 per cent getting benefited out of integration among the world’s main trading regions – Europe, Asia and the US – along with the expansion of global financial markets.

Whether these SWFs are considered large or small depends on the metric used. Two points, however, are inescapable regardless of the metric. The first is that SWFs are already large enough to be systemically significant. The second is that they are likely to grow larger over time, in both absolute and relative terms that calls for a discussion of the issues emanated from the international financial system.

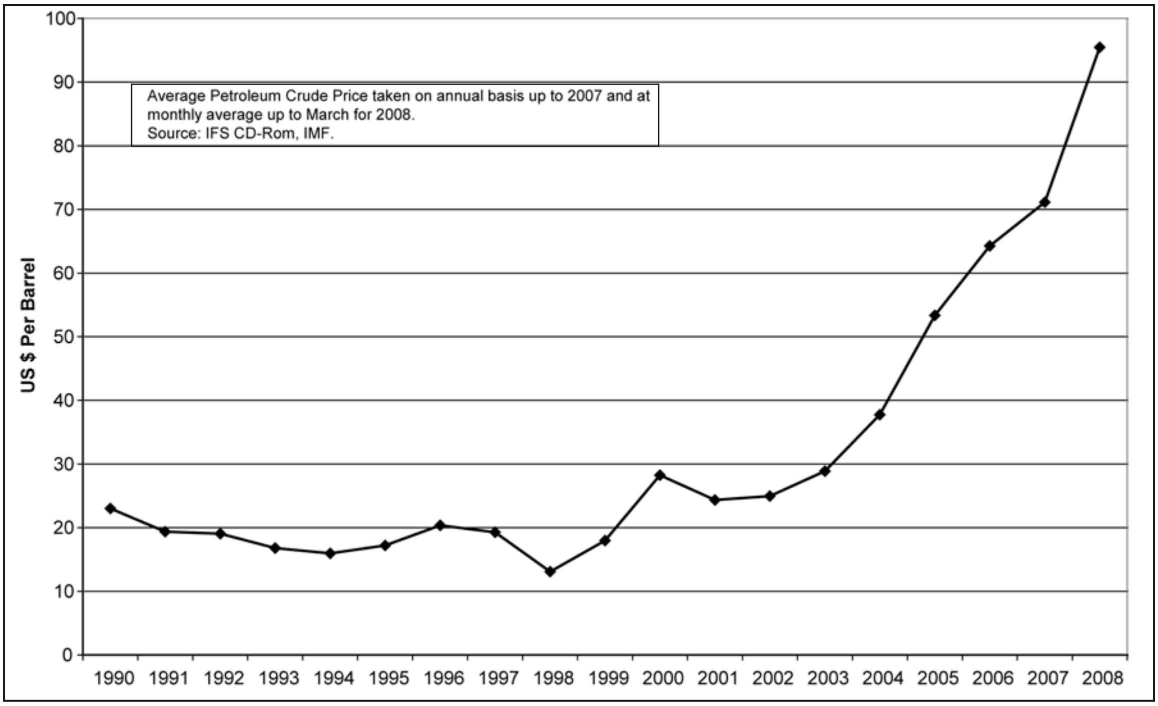
The other key feature of the current economic expansion is that it has been happening in a low-inflation environment quite for some time but current position is different. A number of factors including trade helped to explain why recent high oil prices have not fed through to consumer prices. Along with central banks’ improved use of monetary policy tools and management of inflationary expectations, cheaper goods from emerging market economies relied heavily on cheap supply of labour have flooded global markets thereby curbing inflationary pressures coming from the energy and commodity side. If trade is the main driver of global economic activities, it is also one of the drivers of capital flows and the resulting imbalances between countries with a surplus in their trade balance and countries with a deficit. This has led to large expansion of capital flows to the emerging economies and huge build-ups of foreign exchange reserves to match trade surpluses. Most of these capital flows are directed towards the US market. Reserves accumulation, in particular, has been the main feature of the Asian economies after the financial crisis of 1997. It provides a means to stabilize the exchange rate, to keep it at a level consistent with export growth and to provide enough liquidity in case of a BoP crisis, as all these countries are softly pegged to the dollar and therefore, potentially prey to speculative attacks.[2]

The South East Asian economies have witnessed an increase in savings and a fall in investment in the wake of the Asian financial crisis with the exception of China (Genberg, et al., 2005). Since then, these countries have generally continued to pursue a macroeconomic policy mix in support of an export-led growth strategy which sustains the saving-investment patterns. Meanwhile, in the oil exporting countries, export revenues have been boosted by the increase in the price of oil since 2000 (Chart 2).

Since domestic investments in these countries have not increased at the same pace, the result has been a rise in net savings in the oil exporting countries. The foreign assets are accumulated almost entirely by the official sector. Higher oil revenues in oil exporting countries translate into higher government budget surpluses. In South East Asia, where the currencies shadow the dollar, foreign assets are accumulated primarily by the central banks in the form of official foreign exchange reserve accumulation (Hildebrand, 2007). It is also observed that in some countries, the reserve accumulation has been further magnified by private capital inflows.

2/The International Monetary Fund defines official reserves as ‘external assets that are readily available to and controlled by monetary authorities for direct financing of payments imbalances, for indirectly regulating the magnitudes of such imbalances through intervention in exchange markets to affect the currency exchange rate, and/or for other purposes’. Total reserves comprise gold, foreign currency assets, reserve positions in the IMF and Special Drawing Rights (IMF, 1993).

Chart 2: Crude Oil Price



Section III
Delineated Issues for Discussion

This section delineates following three issues for discussion in general and Indian scenario in particular.

1. To what degree should central banks play a role in the formation and running of sovereign wealth funds?
2. What are the main operational issues that central banks face in (a) managing sovereign assets; and (b) pursuing normal central bank functions in the presence of a sovereign wealth fund managed outside the central bank.
3. What challenges could arise for financial markets and corporate control from a substantial increase in sovereign cross-border asset holdings in the medium term?

By applying a simple rule to identify which countries potentially hold excess reserves, we can readily identify the countries that are obvious candidates for future SWF. A list of countries that meet the following two conditions: they have no SWF at present and judging by the Greenspan-Guidotti rule, they hold excess reserves of at least USD 10 billion (Table 4).

Table 4: Countries with Excess Foreign Exchange Reserves (end of 2007)

(USD Billion)

Country	Excess Reserves according tothe Greenspan-Guidotti Rule
Japan	582
Taiwan (Province of China)	121
India	80
Brazil	37
Thailand	35
Nigeria	24
Morocco	13
Poland	11

Table excludes countries which already have established SWFs and countries for which data on reserves are not available or reliable.

Source: Hildebrand, 2007.

One of the basic premises of open global capital markets is the idea that capital flows freely among the economies in search of investment opportunities that yield optimal risk-adjusted rates of return. The fact that large and government-controlled investment companies make substantial investments in privately owned companies in other countries raises concerns about the validity of the hypothesis that capital seeks optimal risk-adjusted rates of returns. Governments of recipient countries may have doubts about the motivation behind such investments.

These doubts are like this: Are SWFs in pursuit of a variant of the traditional motive to maximise returns? Or could a particular government be tempted to use its SWF as a financial instrument in pursuit of a particular political objective? The mere fact that such questions arise could serve as a trigger for protectionist policies in recipient countries, thus again undermining the proper functioning of free markets. The real or perceived activities of SWFs play a role in challenging these deeply held assumptions about the world economy. The most important challenges associated with the rise of SWFs are therefore to ensure that the policy reactions in the recipient countries of potential and actual SWF investments do not degenerate into what ultimately amounts to financial protectionism.

Section IV
Risks and opportunities of SWF

As the troubled conditions prevailed in international financial markets arising out of sub-prime crisis, many people worry about the implications of the growing clout of SWFs from the developing world. The worry is on three counts viz., financial, political and ideological (Box 2). It has been alleged that, many SWFs lack transparency in their operations - neither their investment objectives nor their size nor their asset allocations are known. This raises supervisory and other concerns for economies in which SWFs have made investments. It is contended that, SWFs could pose a threat to financial stability. The members of the International Working Group of Sovereign Wealth Funds (IWG), which met in the beginning of September 2008 in Santiago, Chile, has reached a preliminary agreement on a draft set of principles and practices for recommendation to their respective governments.

Box 2: Outlook on SWF growth – calculative uncertainties

A simple calculation by Deutsche Bank Research sheds some light on the potential weight of state-funded investment entities in the medium to long term provided that the favourable economic conditions observed over the past decade, especially in emerging economies, persist. Such projections, however, are subject to a number of substantial economic and political uncertainties, most importantly, the general level of growth, especially in the emerging markets, the development of individual balances of payment, and commodity prices, especially oil. In addition, the calculation entails some specific imponderabilities – on the downside as well as the upside:

- The actual growth of SWF assets may be substantially weaker than these figures suggest if asset inflows into state funds are reduced by e.g. cyclical downturns in general, a weakening of competitiveness in exporting economies, or a slowing of oil price rises in the case of oil exporting countries.
- Additional transfers from official reserves into SWFs are far from unlikely, given the current level of excess reserves in the emerging markets. Even by conservative measures, excess reserves have been calculated to amount to more than USD 1.5 trillion in the emerging markets.
- The above results may be taken as conservative projections, taking into account that they start off from the current estimates of existing state funds and do not discount that countries which have not established SWFs so far may decide to rededicate available funds into SWF-type entities in future.
- More optimistic assumptions on general economic and commodity market conditions yield considerably higher forecasts.

Source: Deutsche Bank Research, September 10, 2007.

The Generally Accepted Principles and Practices for Sovereign Wealth Funds (GAPP) is a voluntary framework that would guide the appropriate governance and accountability arrangements, as well as the conduct of appropriate investment practices by SWFs. In response to the call from the International Monetary Fund's policy-guiding International Monetary and Financial Committee (IMFC), the IWG expects to present the GAPP to the IMFC at its October 11, 2008 meeting in Washington DC. The IWG intends to publish the GAPP thereafter. The IWG members[3] also decided to explore the establishment of a standing group of SWFs. This is in recognition of the need to carry forward the work relating to the GAPP, as necessary, and to facilitate dialogue with official institutions and recipient countries on developments that impact SWF operations.

The political concern is that SWFs will be used by foreign governments to advance strategic objectives. One scare scenario, for instance, is that a foreign government may acquire a controlling interest in a particular manufacturing company, then use its control to simply dismantle the facilities in that country and relocate these to the foreign country or elsewhere. Thus, financial control will be used to weaken manufacturing capability. Assuming, however, that foreign governments might entertain such objectives, the code of conduct may be formulated to address the underlying concern. Fair enough, but these concerns are best addressed by having a limited negative list for SWF investment or indeed for foreign direct investment (FDI) in general. There remain concerns of an ideological variety. Given that the financial and political concerns can be addressed without great difficulty, it is the ideological concern that is at the root of much of the hostility towards SWFs.

It is worth mentioning this type of concern at some length in Indian scenario - the case of Unit Trust of India (UTI). A few years ago, when UTI ran into problems, many were quick to argue that government ownership was not consistent with performance in mutual funds. But UTI has successfully reinvented itself and remained a formidable player in the mutual fund business. A recent case is a pointer to the rescue operation by the US Government taking control of the troubled mortgage finance giants 'Fannie Mae' and 'Freddie Mac'. The regulator of the two companies, the Federal Housing Finance Agency proposed to manage these two companies, though on a temporary basis for the time being.

The debate about the risks and opportunities of sovereign wealth funds is similar to the ongoing debate in the US and the EU about hedge funds. One of the problems about hedge funds is that their operations are opaque and they are not regulated by any single authority. The same could apply, with some modification, to sovereign wealth funds, except that Singapore publishes its balance-sheet and details of assets under management periodically. One may also ask whether a Sovereign who owns the funds can be meaningfully regulated by any authority other than a multilateral organisation. It is clear that SWFs also operate through hedge funds, and in one or two cases, through private equity companies. They invest their resources in these high-return entities. They also leverage their resources by raising debt against their contribution. If this leverage - borrowed funds against the SWF's assets is taken into consideration, the impact of sovereign wealth funds can be considerably higher than the USD 3 trillion as mentioned earlier in this paper.

On the above background, the order of magnitudes of resources managed through SWFs also becomes more serious in its implications. The economies receiving SWF investment should follow four basic principles. First, avoid protectionism at any cost. Countries should not erect counterproductive barriers to investment, regardless of whether the investor holds a controlling interest in national firms. Second, uphold fair and transparent investment frameworks. Investment policies and processes, especially those involving national security considerations, should be public, clearly articulated, predictable, and non-discriminatory. Third, within those frameworks, respect investors' decision. Having laid out the ground rules, recipient countries should not tell SWFs how to invest their money. Decisions on how to allocate investments across countries and asset classes are for the fund managers alone, particularly given the potential for losses as well as gains. Finally, treat investors equally. Tax and regulatory policies should not discriminate between foreign and domestic entities.

3/ The IWG member countries are: Australia, Azerbaijan, Bahrain, Botswana, Canada, Chile, China, Equatorial Guinea, Iran, Ireland, South Korea, Kuwait, Libya, Mexico, New Zealand, Norway, Qatar, Russia, Singapore, Timor-Leste, Trinidad & Tobago, the United Arab Emirates, and the United States. Oman, Saudi Arabia, Vietnam, the OECD, and the World Bank, participate as permanent observers. The IMF helped to facilitate and coordinate the work of the IWG by providing a secretariat for the IWG.

On the other hand, SWFs should follow five policy principles of their own. First, invest commercially, not politically. SWF investment decisions should be based solely on economic grounds, rather than political or foreign policy considerations. SWFs should make this statement a formal part of their basic investment management policies. Second, convey world-class institutional integrity. SWFs should be transparent about their investment policies and have strong risk-management systems, governance structures, and internal controls. Although not highly leveraged and, in principle, long-term investors, SWFs can represent large, concentrated, and opaque positions and thus may cause worries of systemic risk. Third, compete fairly with the private sector, too. SWFs should be careful not to be seen as having an unfair advantage in competing with the private sector for transactions, including by financing acquisitions at below-market rates. Fourth, promote international financial stability. As public-sector entities seeking to benefit from healthy global markets, SWFs have a strong stake in and responsibility for international financial stability. During times of market stress, SWFs should be committed to communicating effectively with the official sector to address financial-market issues. Finally, respect host-country rules. SWFs should comply with and be subject to all applicable regulatory and disclosure requirements of the countries in which they invest.

These principles are all predicated on the fact that SWFs asset accumulation is appropriate in the first place. Still, the underlying macroeconomic policies creating the resources for SWFs should be under constant review to see that they, too, remain appropriate - both for the countries with SWFs and the international financial system. Public disclosure is therefore appropriate for SWFs to mitigate systemic risk. The wide variety of experience and investment strategies among SWFs, combined with the wide diversity of regimes for regulating inward investment, underscores the need for broadly discussed and accepted best practices.

Section V
Sovereign Wealth Fund for India

Given the large accumulated reserves of about USD 300 billion as at end-August 2008 and sub-optimal investment strategy adopted, there are suggestions from various walks of life to create a sovereign wealth fund for India. Forex reserves from India are still being invested in low-risk OECD government securities and bank deposits yielding less than 5 per cent. As this pool of capital has increased, so has the cost of an overly risk-averse investment strategy. When one compares that Temasek of Singapore has earned 18 per cent on its USD 100 billion portfolio, the scale of lost on earnings is going to be an alarming proportion in case of India.

In fact, India is one of the largest holders of forex reserves. While the idea of investing reserves has many supporters in India, there remains strong opposition from the policy makers. According to Dr. Y. V. Reddy, former Governor, RBI, "the rationale for an SWF does not exist in India as yet. We do not have volatile commodity exports that need to be smoothed out through a stabilisation fund. We have not had consistent current account surpluses – for the most part, the current account has been in deficit." Further, he was having opinion that management of the foreign exchange reserves in India is subject to international best practices and disclosure standards and traditionally vests with the central banks or monetary authorities of the country. In some cases, central banks advise the government in the design and establishment of Stabilisation Funds or SWFs. In some other cases, they also operate as fund managers, but subject to formal principal-agent agreements. In a few cases, the central bank creates a separate unit within itself to manage a fund. In view of the expertise and credibility, involvement of a central bank in such funds to a significant extent appears logical (Reddy, 2007). India's foreign exchange reserves are managed according to the law; the Reserve Bank adheres to the internationally best practices of measuring the reserves and data dissemination standards; and the Reserve Bank follows appropriate prudential norms in the management of the foreign exchange reserves.

One might add that, India don't have a fiscal surplus either, which would warrant excessive savings being parked abroad. Given the shortages in infrastructure for which India need foreign inflows, the argument would be to the contrary. Instead of building up forex reserves out of which India could carve out SWFs, she must create conditions for absorption of inflows into infrastructure so that forex reserves decline (Rammohan, 2008).

As mentioned in Table 4, India has excess reserves of USD 80 billion according to Greenspan-Guidotti rule - the amount of reserves that is earning a low rate of return and could be put to better use through the creation of an SWF. The difficulty is with the computation of 'excess' reserves. It cannot be presumed that all inflows on the capital account are stable and irreversible. Elements of capital inflows that have contributed to the increase in forex reserves in India in recent years are indeed of the volatile in nature. As regards the Indian debate on Participatory Notes, the doubts of the regulator are centered on the anonymity of contributors to funds, which end up in Participatory Notes. It may well be the case that Sovereign Wealth Funds are themselves among the sources of funds for hedge funds. This adds yet another piquant element to the question of what funds Participatory Notes (Rammohan, 2008).

In this context, it is necessary to view the concept of 'excess reserves' from several angles, including from the perspective of possible real sector shocks to the current account and the nature of capital flows. India is vulnerable to shocks on account of oil price and fluctuations in food grains production, which is still largely dependent on monsoon conditions. Additionally, a large part of the capital flows are portfolio flows and a significant component of FDI is in the nature of private equity or for acquisition of existing firms and not in Greenfield projects. India has been seeking comfort in respect of the nature of investment associated with capital inflows through hedge funds channels and participatory notes. Similar issues could also be relevant in respect of private equity flows. While it is essential to recognize the public sector nature of the Stabilisation Funds and SWFs that may be investing in India, it is also useful to study the evolving global practices of investee countries' approaches to these funds (Reddy, 2007). Dr. Reddy was not altogether against the formation of SWFs in India. He added, "if and when such a consideration is given, it would be essential to put in place sound governance, transparency and accountability standards that would provide necessary comfort to the domestic, fiscal and monetary authorities and, additionally, to the investee countries."

There are three major arguments on flip side slightly in favour of creating an Indian SWF.

(1) India's reserves are built from capital account inflows and are hence encumbered assets that are subject to capital flight. The fact that India has a merchandise trade deficit of about USD 90 billion during 2007-08 and a current account deficit of USD 17 billion does make it different from other large reserve holders whose reserves have been built up from huge trade surpluses. However, the current account deficit as a percentage of GDP is manageable if we add software and services income. As a result, India's balance of payments and trade position appear stable given the size of the economy. Clearly, Forex reserve at around USD 300 billion, India has far exceeded the cushion needed for any capital flight and to cover the current account deficit.

(2) Although, RBI has recently made easier for Indians to invest abroad through the Joint Ventures and Wholly Owned Subsidiaries. Hence over the long term, India should continue to see capital move from developed countries to high-growth developing countries. Opening the capital account for outward investment may slow down net capital inflows but is unlikely to reverse the process.

(3) It has been argued that, an Indian SWF will be subject to corruption and mismanagement and could be misused to promote domestic, political or foreign policy objectives. A very valid concern, given governance in India and the scale of funds involved, however, one that can be mitigated through designing the fund correctly and limiting the amount of funds available. Norway has already set up a good template for its fund that has now in effect become the standard for other SWFs.

The following five best practices that can be delineated from the experiences of other countries: (1) Ensure accountability through a board of directors that includes the Prime Minister, so there is a political cost of mismanagement (for example, Singapore and Malaysia). (2) Use third-party fund managers, so professionals can invest and conflicts are reduced (for example, UAE and Norway). (3) Determine asset allocation (public versus private and equity versus debt) and return expectations. (4) Follow high standards of transparency and disclosure (for example, Norway). (5) Adopt socially responsible investment practices (again, Norway). There is much that India can learn from other countries' experiences with SWFs.

Section VI
Concluding Observations

From the above analysis, it can be assessed that SWFs have great potential to grow in near future given the international financial capital flow framework. This is reflective of the rising foreign exchange reserves in the emerging markets of Asia (more specifically oil-exporting countries). If SWFs grow as estimated by various agencies, and their international diversification continues, liquidity inflows into a wide range of asset classes can be expected at higher order. Similarly, a substitution away from central-bank reserves invested in liquid sovereign paper to SWFs invested in higher-yielding and dividend-bearing private securities is likely to occur. At the same time, demand for asset management and investment banking services is set to increase in international financial markets. Keeping in mind the many advantages that the rise of SWFs may bring, there is also good reason to expect implications for global financial market stability, corporate governance and national interests.

As a corollary to this development, various actions may emerge with respect to the transparency of SWFs which could help to promote financial stability. The national security concerns can be a cause for government intervention, but it should be limited to exceptional cases. As a general rule, however, SWFs like other investment vehicles should be able to benefit from free markets on a reciprocal basis. In the recent period the debate reflects a broad variety of views over the potential impact of SWFs (Annex). A more appreciative approach to the potential benefits of SWF investment in companies in search of capital, as well as a sober assessment of the potential risks involved is needed.

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Annex:

Policy initiatives – SWFs growth and national and international responses

Factually, the policy debate on SWFs issues has only just started in the majority of countries concerned. At this relatively early stage, widely diverging views and approaches can be observed – both at the national level as well as in an international comparison. This may not least reflect that there is widespread disagreement not only over the means by which a regulation of the activities of SWFs could be regulated, but on the potential policy implications of their growth and activities in the first place.

- United States: In the US, Treasury officials have underlined the country's commitment to an open investment climate, welcoming SWFs in principle. In addition, it has been suggested that the IMF and the World Bank should provide a set of best practice rules for SWFs with a view to providing guidance and incentives to ensure appropriate institutional arrangements, governance, operational and risk management, accountability, as well as transparency of rules, operations, asset management guidelines and performance.
- United Kingdom: The government maintains the UK's traditional liberal position and has rejected notions of discouraging foreign state investment funds from pursuing investments in the country, and also the negotiations of common rules at international level similar to WTO-type deliberations. However, the Chancellor has emphasised that reciprocity in market access is considered a vital precondition in the long run.
- France: France already has a stringent legal framework that allows the protection of key industries against foreign ownership. Although no concrete policy measures have been announced, the current government has indicated that it is pursing an industrial policy that takes a broadly defined national interest into consideration.
- Italy: The Italian government has taken a liberal stance on the SWF issue and announced its support for liberal market access and indifference regarding the nationality of potential investors. The concept of golden shares has been met with reservations.
- Germany: The government has announced that it will suggest – in the context of its presidency – that the G8 develop a set of transparency rules for the operation and asset management of SWFs. It also intends to make equivalent proposals in the context of the IMF. The US and French governments are understood to support these initiatives.
- European Union: The EU has reiterated its commitment to open markets, emphasising that it would be disconcerting if the EU were not open and attractive to SWF investments and the latter were to invest anywhere but in the Internal Market. However, the Commission acknowledges the potential need to protect sensitive industries, especially where buying countries protect these domestically. It has emphasised the importance of reciprocal market openness. As a potential mitigant, the Commission is considering the introduction of a regime of European golden shares. Reviewing the implications of SWF growth and possible policy responses, the Commission has announced that it will present a report in mid-September 2007.
- Russia: Operating a large SWF itself, the Russian government takes a protectionist stance on foreign investments. Following recent legislation, the Russian national intelligence agency Federal Security Service, FSB, is actively involved in decisions regarding foreign ownership of 39 key industries, such as nuclear energy, aerospace, natural resources and the arms industry. Recently, Senior Russian politicians have backed plans to create a government agency to enable its sovereign wealth fund to pursue a riskier investment strategy. Furthermore, the assets of the country's National Wealth Fund are now managed by the country's central bank. However, Russian law restricts the central bank from investing in riskier products, meaning that the fund's assets have been invested in safer instruments, which garner a lower return.