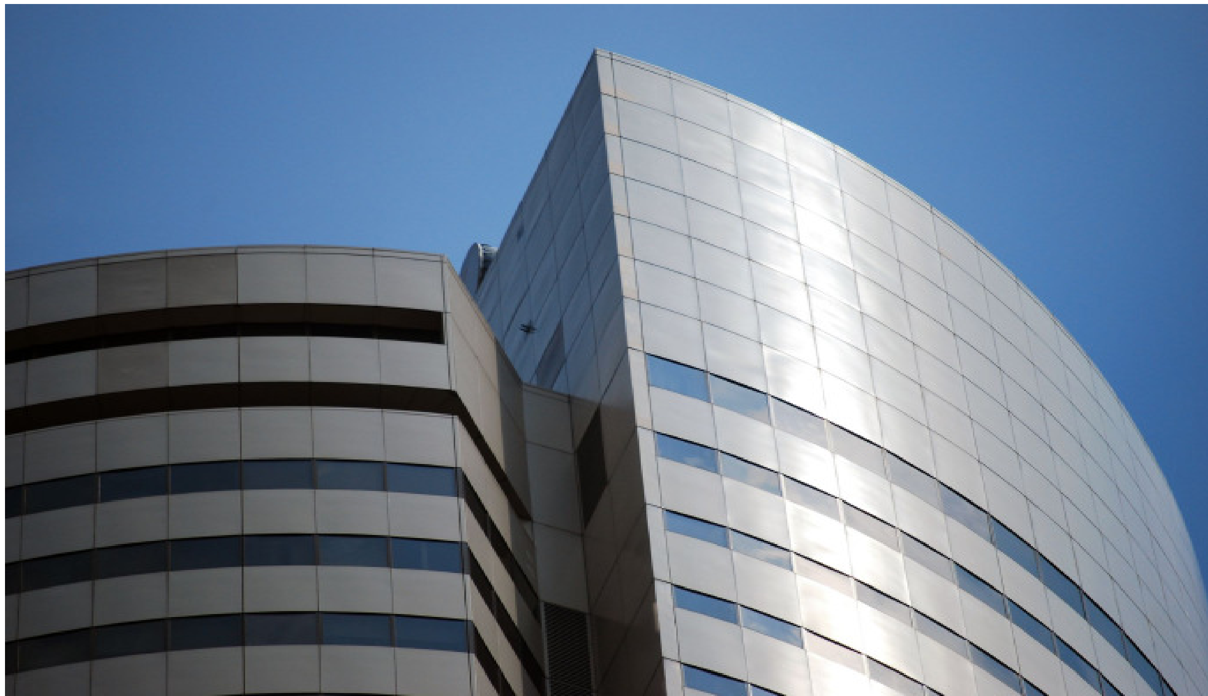

• BRIEFING PAPER •

Should India Establish a Sovereign Wealth Fund?

New Delhi will soon take a final call on the issue of setting up of a sovereign wealth fund (SWF). The idea of setting up an Indian SWF has been going around since 2007 when China established its major sovereign wealth fund, China Investment Corporation (CIC), with an initial capital fund of $200 billion. However, this time the proposal has received strong support from India's corporate leaders who recently suggested the establishment of a state-owned SWF primarily to secure access to natural resources and pursue strategic investment opportunities overseas.

With the strong backing of corporate leaders, a SWF may soon be a reality and India will join other BRIC nations having such a fund. Although the initial capital of the proposed fund is still under discussion, it is unlikely to exceed $10 billion. Despite the excitement in official circles, the necessary preconditions for establishing a sovereign fund are missing in India. It appears that New Delhi is blindly following a "me-too" approach rather than understanding the rationale behind setting up such funds.

The main policy rationale behind setting up a SWF is not to secure access to natural resources or acquire strategic assets abroad, as perceived by New Delhi. Such funds are established to manage excessive foreign exchange reserves, commodity exports, the proceeds of privatisations and fiscal surpluses. For

What is a SWF?

The term "sovereign wealth fund" was first used in 2005 by Andrew Rozanov to describe funds created out of foreign exchange (forex) reserves to meet specific purposes.

In simple terms, a sovereign wealth fund is a large pool of assets and investments owned and managed (directly or indirectly) by a national or state government. It may be funded by forex reserves, commodity exports, the proceeds of privatisations or fiscal surpluses.

To a large extent, SWFs have been set up to diversify and improve the return on a country's foreign exchange reserves or commodity revenues, and to protect the domestic economy from fluctuations in international commodity prices. Typically, a sovereign wealth fund, besides being state-owned and managed separately from official foreign exchange reserves, has:

- a high foreign currency exposure;

- no explicit individual liabilities (unlike pension funds);

- a high-risk tolerance; and

- a long-term investment horizon.

It would be a mistake, however, to consider SWFs as a homogeneous group because their key characteristics – sources of funds, governance structures, operations, investment patterns, objectives, and legal and institutional structures – are hugely divergent. Many SWFs are not legally separate from their respective governments or central banks (such as Norway's Government Pension Fund) although some do operate under a separate legal entity (such as the Korea Investment Corporation), while Temasek Holdings of Singapore has been established as a private corporation governed by the country's company law.

Like central banks, SWFs deploy surplus forex reserves; but since SWFs are set up to diversify investment, they undertake long-term investments in illiquid and risky assets, whereas central banks typically undertake short-term investments in low-yielding liquid assets, such as government securities and money market instruments.

Are SWFs a New Phenomenon?

Some claim that the first sovereign wealth fund was the Caisse des Dépots et Consignations, created by France in 1816 to restore trust in public finances after the 1803-1815 Napoleonic wars.

It was in the early 1950s after the Second World War that the first wave of more recently established SWFs arose. The British colonial administration took the lead in setting up SWFs in its colonies. For instance, it set up the Kuwait Investment Board (which later became the Kuwait Investment Authority) in 1953 to invest the country's oil profits for future generations. The British colonial administration of the Gilbert Islands in the Pacific Ocean established the Kiribati Revenue Equalization Reserve Fund in 1956 to manage revenues from the export of phosphate deposits.

The second wave of SWFs came in the 1970s and 1980s when a number of oil-producing countries established stabilization funds to accumulate current account and budget surpluses during the oil boom. The Abu Dhabi Investment Authority, now the largest SWF in the world, was formed in 1976, the Brunei Investment Agency in 1983, and the Norwegian Government Pension Fund–Global was set up in 1990.

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Singapore was the first country in East Asia to establish a sovereign wealth fund. Its two large funds, Temasek Holdings and the Government Investment Corporation (GIC), were set up in 1974 and 1981 respectively. Other non-oil producers from East Asia have also established funds, largely in response to the 1997 Asian financial crisis.

Since 2005, more than 12 new SWFs have been established as a result of record commodity prices leading to rapid accumulation of foreign reserves. South Korea launched its SWF in 2005 with $20 billion in assets; Australia's Future Fund was established in 2006; China Investment Corporation (CIC) in 2007; and Russia's National Wealth Fund in 2008. In December 2008, Brazil announced the launch of its sovereign wealth fund with $6 billion raised from budget surplus. Also in December 2008, the Malaysian state of Terrengganu announced its plan to set up a $3 billion sovereign wealth fund based on the state's oil and gas revenue surplus.

Of late, Bolivia, Japan and Thailand have also expressed interest in setting up a SWF in the near future.

What are the Main Sources of Funds of SWFs?

Of the world's top 20 sovereign wealth funds, 14 are funded from commodity revenues, predominantly from oil and gas exports but some from metals and minerals (such as Russia's Reserve Fund or Chile's Social and Economic Stabilization Fund). The revenues are generated in a variety of ways, including profits made by state-owned companies, commodity taxes and export duties.

Non-commodity SWFs are largely funded by transferring assets from official foreign exchange reserves, although some are based on fiscal surpluses, proceeds from the sale of state-owned enterprises to the private sector, and direct transfers from the state budgetary resources. SWFs are one of many investment vehicles used to deploy surplus foreign exchange reserves earned from all these sources.

What are the Main Types of SWFs?

Although SWFs are a heterogeneous group, they can be broadly divided into three main types based on their purposes:

Stabilisation Funds (e.g., The Reserve Fund of Russia) are set up by countries rich in natural resources to provide budgetary support and to insulate (or stabilise) the national economy from volatile international commodity prices. These funds are usually set up during boom times and then drawn upon when commodity prices are lower or there is a shortage of reserves.

Savings Funds (Alaska Permanent Fund of the US) are set up by governments to create wealth over the longer term so as to meet future needs. Revenues from commodities or fiscal surpluses provide their initial basis. For commodity exporting countries, savings funds help to convert non-renewable assets (such as oil) into financial assets for the benefit of present and future generations. There are few withdrawals on these funds, which invest over a longer-term compared to stabilization funds.

Pension Reserve Funds (e.g., Norway's Government Pension Fund-Global) are set up with a specific mandate to finance future public pensions. Owned directly by the government, a pension reserve fund is often treated as a SWF. Pension Reserve Funds usually invest abroad in a wide range of assets. Some PRFs are not allowed to make any payouts for several decades.

instance, China established CIC to manage its excessive forex reserves, which reached $3.2 trillion by August 2011.

SWFs help in diversifying and improving the return on a country's foreign exchange reserves or commodity revenues (Aizenman and Glick 2008). Like central banks, SWFs deploy surplus forex reserves; but since SWFs are set up to diversify investment, they undertake long-term investments in illiquid and risky assets, whereas central banks typically undertake short-term investments in low-yielding liquid assets, such as government securities and money market instruments (Singh 2008a).

SWFs are typically patient investors with long-term investment horizons. Since they have no explicit liabilities, they can remain committed to their investments in the hope of booking higher returns in the future. Also their funding sources tend to be fairly stable, which makes them less sensitive to market volatility. Unlike hedge funds and private equity funds, SWFs are not prone to withdrawals by investors that could force them to liquidate their market positions quickly.

Unlike China and other East Asian countries, which have established such funds on sustained current account surpluses, India has been running persistent current account deficits. Its current account deficit touched $44 billion in fiscal 2011 as against $38 billion in fiscal 2010.

Unlike West Asia, India does not have any dominant exportable commodity (such as oil or gas) so as to generate significant surpluses. It continues to be a huge net importer of oil and gas. The country's current account deficit is widening due to higher trade deficit in spite of steady growth in software services exports and a rise in workers' remittances from overseas Indians.

India's external debt has been rising steadily for the past few years on account of higher borrowings by the Indian companies and short-term credit. In March 2011, external debt stock stood at $305 billion as against $261 billion a year ago. Besides, India also runs a perennial fiscal deficit which implies that raising substantial money for sovereign fund from budgetary allocation would be extremely difficult.

As far as the proposed fund's objectives to invest directly in strategic cross-border assets are concerned, the Indian policy-makers need to recognise that the overwhelming majority of sovereign funds are passive investors.

Often people tend to confuse high-profile investment proposals in Western companies (such as Unocal by CNOOC and P&O by Dubai Ports World) with investment by SWFs. None of these proposed investments had involved sovereign wealth funds, although they have included state-owned corporations that have completely different motives. Unlike SWFs, state-owned companies acquire foreign companies in order to manage them actively and integrate them into their global business operations, much like a privately-owned company.

In the rare cases where SWFs have made direct investments, they have not sought controlling interests or active roles in the management of invested companies, as private investors do. Even the large-scale direct investments made by SWFs in US and European banks during 2007-08 were minor in terms of bank ownership and did not come with any special rights or board representation (Singh 2008b). Any direct investment in strategic assets by a sovereign fund will invite severe criticism for its alleged political and non-commercial objectives. Already there are strong fears that the sovereign funds are

pursuing strategic foreign and security policy objectives rather than commercial ones. These fears have have sparked a heated debate in the US and Europe about the extent to which SWFs from other countries should be allowed to invest in national markets. Not long ago, the Western world had pushed new policy measures, popularly known as Santiago Principles, to regulate the investments of SWFs globally. The Santiago Principles are meant to align the investment behavior of SWFs with recipient country norms (Monk 2008).

Several countries including US, Canada, Australia and Germany have introduced substantial legislative changes in order to screen and restrict investments by SWFs and other state-owned entities (Singh 2008c). A growing protectionist backlash against SWFs cannot be denied. Against the backdrop of rising economic nationalism, acquisition of strategic cross-border assets (including natural resources) will not be a cakewalk, as perceived by policy makers.

Furthermore, there is no guarantee that investments made by the proposed Indian fund will be profitable. As witnessed during the global financial crisis, SWFs from West Asia, China, Singapore and Norway suffered huge losses for their investments in Western banks and private equity funds. Therefore, the Indian authorities should reconsider the proposal for establishing a SWF.

Given the widespread poverty coupled with lack of adequate investments in physical and social infrastructure, New Delhi should innovatively use a portion of the country's forex reserves to meet these development challenges, rather than financing the acquisition of projects and companies linked to natural resources or strategic assets abroad.

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