



## India Is Right to Avoid Western Bank Fire Sale: Andy Mukherjee

Commentary by Andy Mukherjee

Jan. 17 (Bloomberg) -- State-owned investment vehicles in Asia and the Middle East have spent at least \$40 billion in the past couple of months to buy significant stakes in Citigroup Inc., Morgan Stanley, Merrill Lynch & Co. and UBS AG.

However, the Indian government has decided to sit out the great fire sale of Western banks and securities firms.

By not having a sovereign wealth fund in place -- and by showing no desire to set one up -- isn't India forgoing a rare chance to buy strategic assets on the cheap in the world's developed economies?

Libya has set aside \$100 billion for a fund; Saudi Arabia may join the bandwagon, the Financial Times reported last month.

Now, India isn't an oil exporter. But nor are China and South Korea, both of whom have established state-owned investment vehicles. China Investment Corp. last month invested \$5 billion in Morgan Stanley, while Merrill Lynch this week accepted a \$2 billion check from Korean Investment Corp.

India can easily afford to use part of its \$276 billion official foreign reserves -- slightly bigger than Korea's -- to chase risky assets. So why isn't it joining the game?

There are good reasons.

India's reserves may be unduly high but they are neither the result of windfall commodity-price gains that the government is free to spend nor an excess of the nation's savings over domestic investments.

In other words, India doesn't yet have sovereign wealth.

### Other People's Money

The foreign-currency accumulation that has taken place in India in the past few years has been on account of financial flows; the current account part of the balance sheet that captures trade, tourism and money sent home by Indians working overseas has been in deficit.

That makes India very different from other big, developing- country holders of reserves in the region. Most of them have built up their war chests via sustained current-account surpluses, Donghyun Park, a researcher at the Asian Development Bank in Manila, said in a recent study.

For India, the motivation for accumulating dollars may be to preserve export competitiveness, the same as China or Korea, but since the resultant foreign reserve comprises foreign -- rather than national -- savings, it doesn't represent either the government's or the people's wealth.

Most of this capital is free to leave the country tomorrow.

It isn't terribly risky to tie up a few dollars of this money in illiquid assets. But what if there's another investment proposal that's too good to refuse, and then another?

### Too Conservative?

``Consideration of a sovereign wealth fund for India may ideally await more comfortable current account and significantly improved fiscal situations," Reserve Bank of India Governor Yaga Venugopal Reddy said in a speech in Mumbai in October.

Not everyone agrees with such a conservative approach.

``As India's forex reserves continue to balloon, as do their costs, it may be time for India to reconsider its reserve management policies going forward and be more willing to increase its risk-taking appetite," Ramkishan

Rajan, an economist at the George Mason University in Arlington, Virginia, wrote recently on the Web site Rediff.com. India should have a serious debate about setting up a sovereign fund, he said.

Rajan has a point about costs. Following the subprime crisis, developed-country interest rates earned by the Indian central bank on its reserves are on a declining trend. The local borrowing costs paid by the Indian government to finance the acquisition of reserves are high and steady.

#### A Better Way

One way out of this money-losing proposition is for the central bank to slow down its reserve buildup. That may cause further appreciation in the Indian rupee, which has gained almost 13 percent against the U.S. dollar since the beginning of 2007. Exporters are unhappy, especially in categories where they have to compete with Chinese rivals.

Another approach may be to either curb foreign inflows or encourage outflows; both have been tried with limited success.

A better strategy might be to use the reserves to raise the productive capacity of the economy.

As Columbia University economist Arvind Panagariya notes in his forthcoming book on India, labor-intensive manufacturing for the world market is yet to begin in earnest in the country.

One reason for that is lack of infrastructure, especially power and port capacity. This is where India should pour some of its foreign reserves for maximum gain in welfare.

#### Financing Infrastructure

The government doesn't have to finance the entire cost of these projects. That will need \$475 billion, much more than what the central bank has in its reserves and what it can spare without causing the economy to overheat or weakening its foreign credit rating. State support is required merely as a catalyst to supplement commercial loans and only to the extent that foreign currency is needed to import machines and equipment.

That's precisely what the Indian government proposes to do.

A more creative use of reserves may be to deploy them to mitigate risks on private-sector investments, says Park of the Asian Development Bank. "Contingent liabilities in the form of guarantees would not result in debt and could boost national productivity," he says.

Modernizing its own economy is a bigger priority for India right now than chasing returns in U.S. and European banking stocks. Before India starts worrying about investing sovereign wealth, it must first create it.

(Andy Mukherjee is a Bloomberg News columnist. The opinions expressed are his own.)

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