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Should India create a Sovereign Wealth Fund?

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As India's forex reserves balloon, so do their costs. It may be time for India to reconsider its exchange management practices and increase its risk-taking appetite.

India's reserves have been skyrocketing, reaching $ 260 billion as of end October 2007. This makes India the fifth largest holder of reserves in the world. Without the sustained appreciation of the rupee, the buildup of reserves would have been even larger.

However, by any objective measure of adequacy (that is, reserves as a share of imports, short term debt, broad money, and so on), India's reserves are clearly "excessive"�-- as are those of most of its Asian neighbours. And, while the benefits of more reserves at the margin are falling, the costs of managing the liquidity costs of the reserve accumulation are escalating. The obvious solution to this would be to reduce the rate of reserve accretion. There are at least two ways of doing this.

First, the RBI could allow a faster pace of currency appreciation which should help reduce the size of the current account balance. While such a policy is clearly something that should be pursued more vigorously by countries with large current account surpluses such as China and oil-exporting countries (most notably Russia), India is running a current account deficit and there are growing concerns of loss of export competitiveness with the appreciation of the rupee as noted above.

The appreciation of the rupee relative to the Chinese currency in particular but also vis-�-vis some other emerging Asian currencies, especially against the background of major infrastructure deficiencies in India, clearly places labour-intensive firms in India at a significant competitive disadvantage in the near term.

Second, the RBI and related authorities could attempt to reduce the size of the capital account surplus by promoting capital outflows and/or curbing capital inflows. However, such selective manipulations of the capital account quickly run into diminishing returns and become counter-productive at some stage.

Of course, a more direct and sustainable way of reining in cross-border capital flows without creating a financial market turbulence would be to make it less attractive to invest in India by lowering the domestic interest rates. However, on its own, this would fuel domestic economic activity even further and re-ignite inflationary pressures. Of course, a looser interest rate policy could be combated with a much tighter fiscal policy stance but this is unlikely to happen in India in the near term, given political compulsions (recent fiscal improvements have been due to growth-induced revenues and not consolidation of expenditure).

Rather than attempting to reduce reserve buildup, many countries like China, Russia and other commodity-rich economies have been focusing instead on ways to increase the rate of return on reserves by diversifying reserve holdings. Some of this has been ongoing in a gradual but rather ad hoc manner via a shift from the depreciating US dollar to Euros and other higher-yielding currencies. However, many capital exporting developing countries have begun to look for more systematic ways of raising returns on a longer-term basis by creating Sovereign Wealth Funds (SWFs).

SWFs broadly refer to designated pools of assets owned and managed by governments and predominantly deployed worldwide to attain higher returns. SWFs are not something new. Kuwait created the Kuwait Investment Authority (KIA) in 1953. The UAE, Oman, Singapore and Brunei also created investment agencies to recycle their reserves holdings in the 1970s and 1980s. Norway and Malaysia did so in the 1990s. Russia followed suit more recently by creating a Stabilisation Fund in 2003, as did some other countries like Chile and Veneuzuela.

Oil-producing countries (OPEC and Russia) have constituted over half of SWF funds (that is, commodity-based funds) in terms of assets under management as well as numbers. The UAE's Abu Dhabi Investment Authority Fund (ADIA), which was established in 1976, is the world's largest SWF currently, with $625 billion under management.

Among the better known non-commodity-based SWFs in� Asia are Singapore's Government of Investment Corporation (GIC) and Temasek Holdings. In fact, Singapore is the only country which has two separate agencies among the top ten SWFs. This said, strictly speaking though, since some of the sources of funding for the agencies also include pension contributions from Singapore residents, these entities are really a combination of SWFs and Sovereign Provident Funds (SPFs).

GIC was established in 1981. It has around $215 billion under management and tends� predominantly to make financial and real estate investments. Temasek was established in 1974. It has around $100 billion under management and is a more active investor in international companies regionally and globally, including in India.

Temasek's investments overseas have given rise to concerns about whether they have been driven purely by commercial considerations or whether they have been undertaken to fulfill broader strategic objectives, particularly when it comes to investments in their immediate neighbourhood of Southeast Asia. However, the same could be said for many other SWFs as well, leading Standard Chartered to refer to SWFs as "State Capitalism" in their recent report (October 15, 2007).

SWFs have taken on increased prominence with their phenomenal growth in recent times, and especially with the creation of the China Investment Corporation (CIC) earlier this year. The CIC, which is said to be motivated by Singapore's GIC in both concept and design, began operations in 2007. The Chinese government transferred $200 billion of its $1,300 billion of its reserves to the agency to kick-start operations, making it the world's fifth largest SWF. The new fund's first major investment was a $3 billion investment in the US-based private equity group, the Blackstone Group.

Estimates suggest there are about 25 to 30 active SWFs with assets under management in the ballpark of $2.5 trillion. These assets exceed those held by hedge funds which have hitherto received a great deal of press for their relative opaqness in operation and the propensity to take on highly-leveraged positions in the market. SWFs are clearly flush with liquidity and are looking to aggressively invest abroad with a view to raising the rate of return on their country's reserve holdings. Morgan Stanley expects the total assets held by the SWFs to rise by five to six times in the next few years, making SWFs a major force in international financial markets in terms of scope and scale.

Some argue that the problem in India is the sustainability of reserves given they are driven by capital account surpluses rather than the current account. Thus there may be a need to maintain reserves in relatively more liquid and lower-yielding assets. However, what this really suggests is that, from a prudence perspective, India should maintain a relatively greater share of reserves in the form that can be liquidated easily, but not all of its reserves. And, no one is suggesting all of India's reserves be deployed in the SWF. Even China has only transferred about 15 per cent of its reserves to the CIC.

The RBI has been rightly praised by the IMF for its sound reserve management in the conventional sense. However, 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. In other words, attention should be paid to liquidity management as well as wealth management in deciding asset allocation.

There are clearly a number of prickly issues surrounding the creation and operation of SWFs in India, including the degree of independence of the agency and its investment managers from the RBI and finance ministry (that is, governance), organisational structure, investment objectives and policies (for example, commercial versus strategic; diversified portfolio or concentrated bets), and the degree of transparency in the agency's holdings and policies.

These issues are admittedly much harder to resolve in a democratic and open society like India, but that is no reason to shy away from debating the issue seriously. India should at least actively participate in the ongoing�-- though nascent�-- international dialogue of establishing a code of best practices/ behavioural guidelines for the creation, management and operation of SWFs.

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