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How to Become a Global Player

Kavaljit Singh

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 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. 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.

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 on 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 runds 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.

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 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.

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. 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. □□□