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Managing India's Foreign Exchange Reserve: A preliminary exploration of issues and options¹

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Abstract

Since mid-nineties, India's foreign exchange reserves (FER) – both nominal and real adjusted for price level – started growing considerably and reached a new peak of US\$ 251985 million in 2008-09. The fact that such unprecedented accumulation of FER build-up has materialized despite India's balance of payment on its current account being mostly negative, has raised debates on the major potential challenges for Indian Sovereign Wealth Fund (SWF), in case they come to existence. Using the two measures of reserve adequacy - the ratio of reserves to short-term external debt and ratio of reserves to broad money – the study indicates “too much” of reserves build-up for the Indian economy particularly since 2002, suggesting thereby that India has substantial amount of surplus reserves. Given the fact that India's current account balance is worsening for the last couple of years, it could be noted that the increase in India's FER has been caused by speculative capital inflows on the capital account. In other words, the reserve is very much exposed to potential sudden outflows by foreign investors and any decision should be taken keeping this perspective into account.

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¹ The Views expressed by the authors are personal.

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1. Introduction

Despite increasing inclination towards market liberalization and privatization observed over the last decade,⁵ the role of the States has in this period of time arguably grown in importance on some particular aspects of investment. Notably investments from emerging economies increased, a large proportion of which was executed by State-owned enterprises (SOEs) and sovereign wealth funds (SWFs). Both forms of investments originate from State ownership and State activity, and are thus regularly referred to as investments by “state-controlled entities” (SCEs).

Investments through SWF route is not a recent phenomenon, but is in operation for around five decades. The purpose of SWFs is to invest surplus State reserves in foreign currency to yield profits. The funds improve the liquidity of the financial markets, create long term growth and jobs and ensure stability for the companies they invest in. These responsible and reliable investors have pursued a long-term, stable policy that has certainly stood the test during the recent turmoil in the financial markets.

SOEs are particularly important in emerging and transition economies such as China, India, Vietnam, Singapore, Malaysia, Czech Republic and Russia. Many SOEs are listed among the Fortune Global 500 list. Chinese SOEs figure most frequently in this listing, making up for 24 firms. Due to the significance of FDI by Chinese SOEs, their characteristics have been received particular attention (Gugler and Boie, 2009). Indeed, by far the largest outward investments by Chinese MNEs are made by SOEs, and all investment projects follow a scheme that ensures that they are strictly in line with government policies. The motivations of Chinese firms to internationalize and the government interest in this effort are to large extent aligned and institutionally intertwined.

The current paper attempts to analyse the trends in SWF investment and the main obstacles they face with. In particular, the analysis focus on the major potential challenges for Indian SWF, in case they come to existence. The analysis is arranged along the following lines. First the global SWF experience is reviewed, followed by the possibility of creating an Indian SWFs. The subsequent analysis intends to identify the main regulations in the EU and the US market that Indian SWFs might face. These regulations might function as potential obstacles in

⁵ The recent economic crisis is however underlining the role to be played by the national Governments in no uncertain terms.

the sense that they incorporate conditions for any investment to enter their domestic markets. The analysis will then focus on the multilateral (IMF) guidelines on SWFs⁶, which apparently again might be perceived as an obstacle. However complying with these multilateral rules could be advantageous for Indian SWFs, if these regulations help them to avoid the EU and US obstacles to investment. On the basis of the analyses with respect to legal perspective, the policy conclusions on Indian investment strategies are drawn.

2. Trends in Sovereign Investments in the world

SWFs can be defined as pools of investment capital (whatever may be the legal form of the SWF: private or public) controlled by a government or central bank and invested in economic activities in other countries. The source of this capital is foreign exchange reserves, which all governments keep (typically in widely traded currencies such as the dollar, euro, or yen). When there is a surplus current account balance those reserves can be put into an investment fund and used to increase national wealth or diversify sources of revenue.

Sovereign wealth funds have come into the spotlight, especially since 2007 when China declared its intention to invest USD 3 billion of its fund reserves in private holding companies. The SWFs have raised concerns about: financial stability, corporate governance, and political interference and protectionism⁷. Interestingly, it is observed that the funds for many Merger and Acquisition (M & A) transactions originate from potential geopolitical rivals. Currently SWFs and central banks with a large SWF function manage an estimated USD 3.2 trillion of assets.

It is however important to put SWFs into perspective with other existing investment options. In 2006, by comparison, global stock market capitalisation was USD 42 trillion, while the market value of private debt securities was USD 23 billion. The importance of SWFs in global capital markets is expected to grow, mainly because of high oil prices, the relative weakness of the US dollar and persistent current account surpluses in China and certain other Asian countries (Blundell-Wignall et al, 2008: p. 6-7). The idea here is that a country can establish its SWF only

⁶ The IMF principles detailed below are not regulations in the strict sense of the term but rather they offer guidelines covering governance, accountability, transparency, and conduct of investments for SWFs.

⁷ It should be borne in mind that SWFs usually lack structures that are transparent and management processes that are domestically and internationally accountable. They work in an opaque way. SWFs do not publish statistics on their composition and size or their investments and strategies. Another concern is that management of SWFs may be motivated by “nationalistic considerations” and not only made in search of investment opportunities that yield optimal risk-adjusted rates of return as suggested by classical economic theories (Chaisse and Gugler, 2010).

if it is having surplus foreign currency. Looking at the data on SWFs from Sovereign Wealth Fund Institute website, it is observed that the surplus is generated through two channels⁸. On one hand, UAE, Saudi Arabia, Kuwait, Norway, Russia etc. set up SWFs from their oil revenue. On the other hand, the SWFs of China, Singapore, Australia, New Zealand etc. depend on their non-commodity export earnings.

Morgan Stanley (2007) predicted that SWFs may manage USD 12 trillion by 2015 (Jen, 2007). *Global Insight* announced in 2008 that SWFs have been growing by 24 per cent annually for the past three years.⁹ Projecting from this annual growth rate, Global Insight forecasted that SWFs will surpass the entire current economic output of the United States by 2015, and that of the European Union by 2016. In 2010, *Prequin Special Report on Sovereign Wealth Funds* gave an updated assessment of SWF growth. The start of a global economic recovery has helped the aggregate assets under management of all SWFs to reach \$3.59 trillion, which represents a 11% increase from last year. The picture is striking: despite the global economic and financial crisis, SWFs have retained their influence (Prequin, 2010: p. 190).

Because of the financial crisis, the US market remains an attractive option for the emerging economy SWFs (especially China), which is a matter of concern there, the most prominent being the fear of foreign government investment for the wrong reasons (threatening national security). The concerns expressed in the US are known and shared by the EU. Owing to the geographic proximity, however, Europeans are perhaps more concerned about Russia. This explains to some extent the different perceptions on the two sides of the Atlantic and the differences in terms of regulatory approach.

Four issues are generally important in relation with SWFs. First, the role of investing governments is often called into question. Second, the lack of transparency of SWFs is another area of concern. Third, the alleged political motivations behind SWF operations constitute a major debate. Finally from a political economic standpoint, there is certainly a difficulty in developed countries in accepting a shift in the balance of power in the world economy to new emerging market giants (Lyons, 2008).

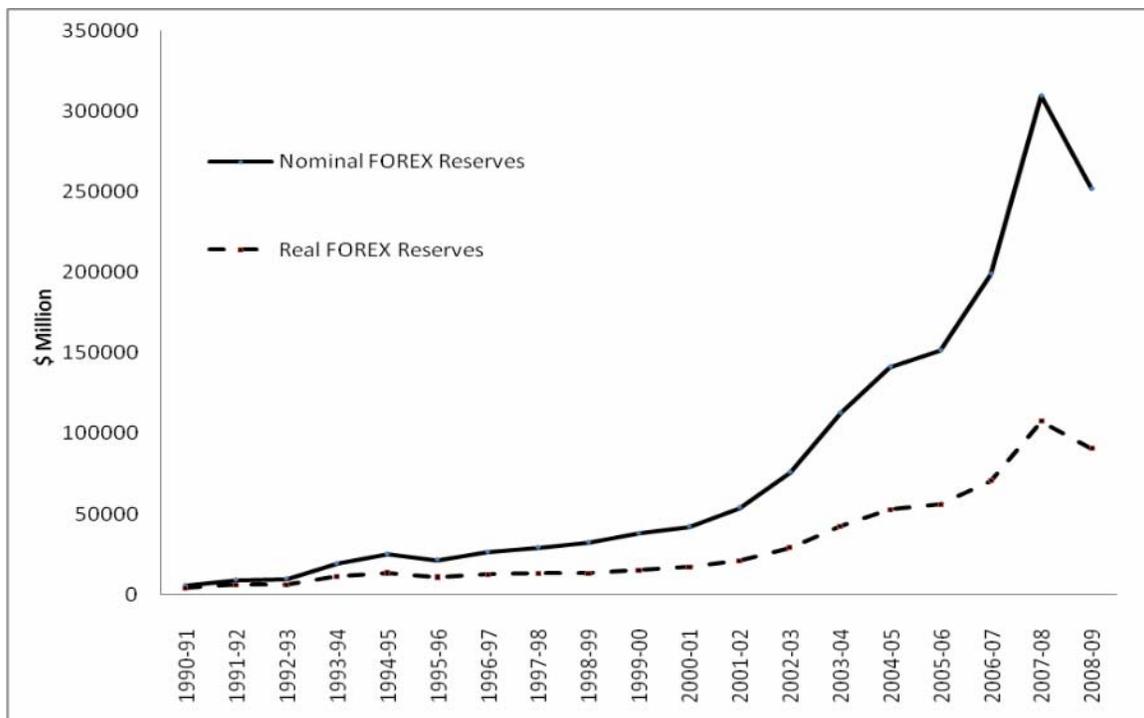
⁸ The data is obtained from Sovereign Wealth Fund Institute, available at <http://www.swfinstitute.org/funds.php> (last accessed on August 16, 2009).

⁹ The details can be obtained from <http://www.globalinsight.com/> (last accessed on March 8, 2009).

3. TOWARDS AN INDIAN SWF ?

The idea of an Indian SWF was not conceivable in the eighties or the nineties, owing to the relatively low level of overall foreign exchange reserve (FER) of the country and the consistent adverse current account balance during that period. The overall level of FER was quite low and fluctuating in the eighties. Owing to this reason, investment outflow was never actively encouraged. The situation reached a particular low in 1989-90 with an FER of USD 3962 Million. FER scenario improved to some extent with increase in gold reserves next year, but the foreign currency asset holding declined, which offset the effect partially. The transition towards an outward-oriented economic policy was adopted subsequently, resulting to increase in FERs, but with a simultaneous decline in India's Special Drawing Rights (SDRs) reserves since then. India's FER scenario is shown below with the help of Figure 1.

Figure 1. India's Nominal and Real Foreign Exchange Reserves from 1990-91 to 2008-09



Source : Drawn with data obtained from RBI (2009 -10)

Since mid-nineties as exhibited in Figure 1, India's FER – both nominal and real adjusted for price level – started growing considerably, which reached a new peak in 2006-07 at USD 199179 Million. India's foreign currency reserves are currently ranked World's fourth-largest. Besides, the level of exports increased considerably during late nineties and as a result during 2001-02 to 2003-04, the country's current account balance was in a surplus. Though in the

following period, India's current account balance turned negative again, the capital account balance was always surplus in the new millennium, which helped the overall balance of payments to remain emphatically positive.

It is worthwhile to note that during 2007-08 rupee has appreciated vis-à-vis the dollar by more than 10%. This increased the return earned in foreign exchange, when rupee assets are sold and the revenue converted into dollars. The investments turn even more attractive triggering an investment spiral. This availability of investible funds in the economy paved the way for outward investment opportunities and the government encouragement to the same should be interpreted in this background.

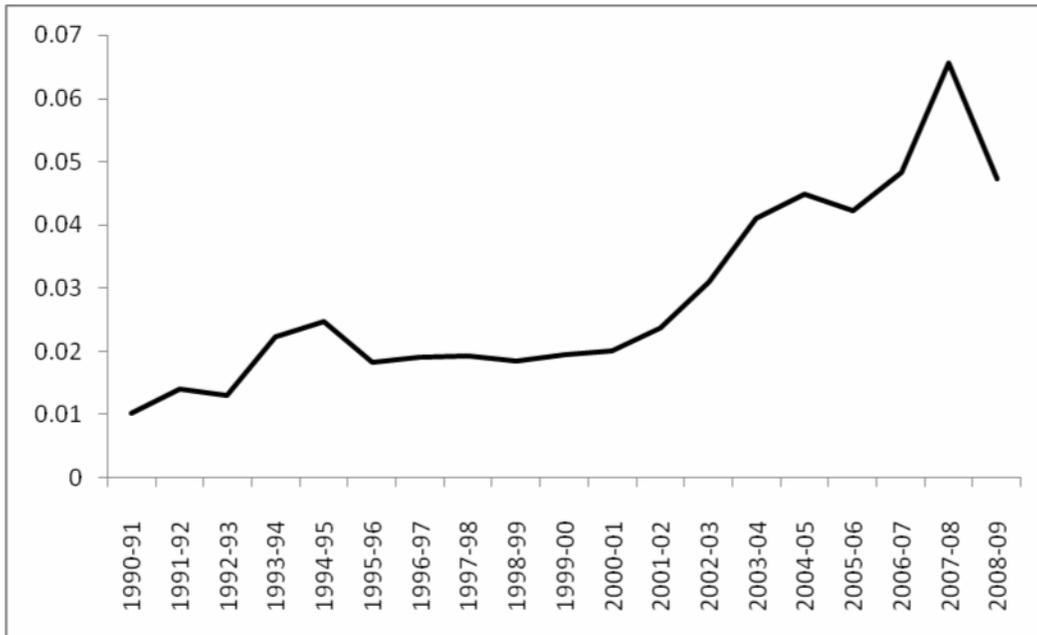
Thus the overall picture is one of secular growth since 1990, interposed by a noticeable acceleration of Reserves buildup since 2002. However, following the collapse of Lehman Brothers in September 2008 and the ensuing global financial crisis, there has been a significant amount of capital outflows¹⁰, resulting in a sharp decline in India's FER, both real and nominal.

Figure 2 in the following shows the ratio of FER relative to the GDP. The reserves-GDP ratio shows a similar pattern as the absolute amount of reserves: a continual increase, which partly echoes India's economic growth over time. However, unmistakably, the ratio declines in the aftermath of the recent global financial crisis.

In the new millennium, the Reserve Bank of India (RBI) undertook a number of steps for increasing the flow of private outward investments in order to maintain macroeconomic stability, which helped the Indian corporate houses significantly (WIR, 2007).

¹⁰ Although the recent global financial crisis started with the busting of housing bubble in US, US financial markets continue to be of crucial importance to the rest of the world: More than \$4 trillion of reserves are held in US currency. With global financial crisis, there is a 'flight to safety' and investors all over the world are buying US treasury bills even at near zero interest rates. Economists argue that a lack of financial development at home makes foreigners keener to invest in America. What attracts them is the size, liquidity, efficiency and transparency of its financial markets compared with what is on offer in their domestic markets.

Figure 2: Ratio of Foreign Exchange Reserves to GDP



Source : Drawn with data obtained from RBI (2009 -10)

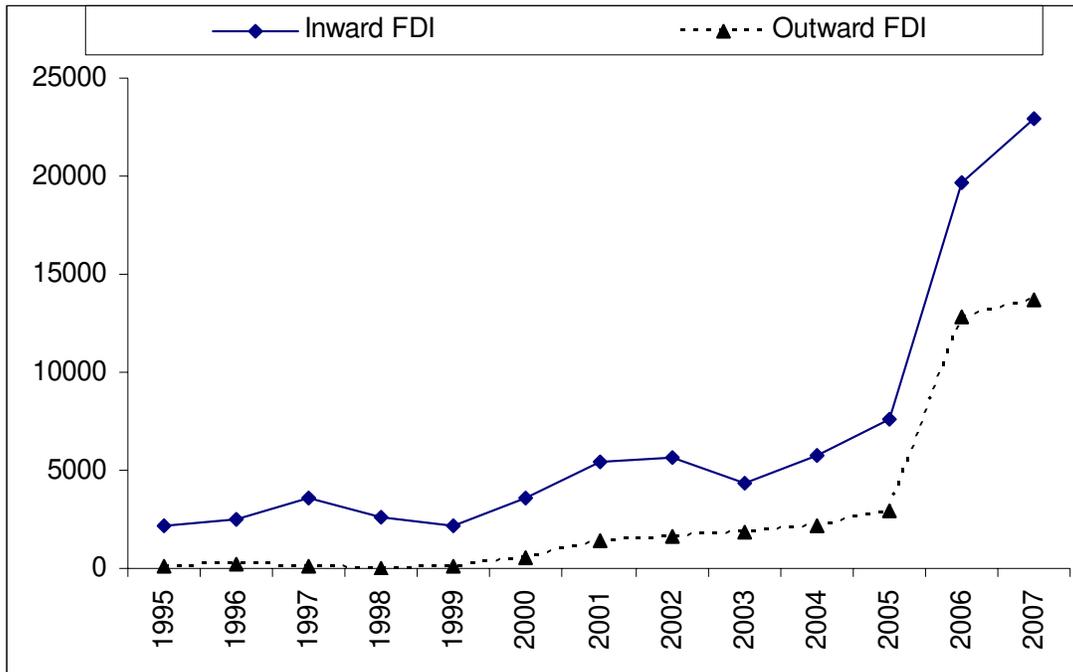
For instance, the 2003-04 budget of the Government smoothed overseas investment norms for corporate houses by allowing prepayment of External Commercial Borrowings (ECB) over US\$100 million.¹¹ In the subsequent period, the limit to overseas investment under the automatic route was increased from 100 percent of the net worth of the Indian entity to 200 percent in April 2005 (RBI, 2006a). In June 2007, the limit of overseas investment was further increased to 300 per cent of net worth and further to 400 per cent of net worth in September 2007 (Singh and Jain, 2009). Soon thereafter the RBI further relaxed the overseas investment norms for mutual funds and amended the remittance opportunities through various policies (RBI, 2006b). Subsequently, RBI has increased the overseas investment limit for the mutual funds to US\$ 5 billion from the earlier level of US\$ 4 billion (RBI, 2009). Moreover, the limit on overseas portfolio investment by Indian companies was increased by RBI from 35 percent of their net worth to 50 percent of their net worth in September 2007 (RBI, 2007). The Export Import Bank of India also supported more than 200 outward investment ventures by 164 Indian companies in over 50 countries (World bank, 2008).

As a result of the reforms undertaken at home, the volume of outward investment flows has increased considerably over the years, which can be observed from Figure 3. It is learnt from

¹¹ The Budget Speech of the Minister of Finance (2003-04), Government of India, available at <http://indiabudget.nic.in/ub2003-04/bs/speecha.htm> (last accessed on March 17, 2009).

the RBI documents that India's total investments in joint ventures and wholly owned subsidiaries (WOS) abroad reached US\$ 23.07 billion (with 2261 proposals) in 2008 as compared to the corresponding figure of US\$ 15.06 billion (with 1817 proposals) in 2007 (IBEF, 2008).

Figure 3 : Comparing FDI Inflow and Outflow Figures for India (US \$ Million)



Source : Calculated from the data provided in Singh and Jain (2009)

Looking at the investment flows of the Indian private sector, it is observed that the investment flows has been directed towards energy sources, metal (e.g. - steel, aluminium), pharmaceuticals, IT, banking, industrial products etc., and spanned over various continents. Energy sector has been the major receiver of Indian investment till date. For instance, Essar Exploration & Production (EEPL) has recently bought two offshore petroleum exploration blocks in Australia, first time such initiative being shown by an Indian oil company (AGOCC, 2009).. In September 2007, Reliance Industries had bought a majority stake of East African oil retailer Gulf Africa Petroleum Corp (GAPCO), which owned and operated large storage facilities and a retail distribution network in several East African countries (IBR, 2007). In Latin America, Venezuela's State-owned oil company PDVSA has recently entered into an agreement with an Indian oil company (Duarte, 2006). Moves to acquire stakes in the retail businesses of BP, Europe's largest oil company in Malaysia and Singapore has also been considered (Rai, 2004).

Apart from the private sector, the State-supported public sector has also played a key role in ensuring investment in energy sector. The Indian Oil-Oil India combine recently procured three onshore oil blocks in Libya, in addition to the two blocks they already were operating in (ET, 2007). Oil and Natural Gas Commission (ONGC) Videsh Ltd (OVL) has won an oil block in Colombia through auction as part of a consortium (Pandey, 2008). The presence of Indian firms in Africa is also to be noted, as ONGC (24 percent stake) with Malaysian state oil firm Petronas (68 percent stake) got a \$400 million agreement to develop Thar Jath oil fields in Sudan for to an initial capacity of 80,000 barrels per day (FE, 2005).

One interesting feature has been the initial competition between China and India on oil exploration in Africa and Central Asia. China National Petroleum Corp. (CNPC) at one point purchased oilfields in Kazakhstan, Ecuador and Nigeria, where ONGC was also interested in getting into (CD, 2006). However cooperation between the two sides was noticed subsequently as in December 2005 companies from the two countries successfully bought the Al-Furat oilfields in Syria. Later the two countries attempted to finalize modalities of future cooperation between OVL and the CNPC, which may pave the way for joint biddings in future (Varadarajan, 2006). The presence of SWFs may come beneficial in that scenario.

4. Pros and cons

India over the last few years have witnessed a stable macroeconomic regime until the recent global economic downturn and its growth scenario has been comparable only with China over this period. It is observed from the Economic Survey (2007-08) that while the annual GDP growth rate in 2002-03 was 3.8 percent, the same has consistently been over 7 percent for the last five years before the global meltdown. In particular the GDP growth rate during 2005-06 and 2006-07 has been 9.4 and 9.6 percent respectively, the service sector being the largest contributor to this growth. This unprecedented growth scenario has fuelled both gross domestic savings and gross domestic capital formation (investment) significantly. While the gross capital formation expressed as a ratio of GDP has increased from 22.8 percent in 2001-02 to 35.9 percent in 2006-07, gross domestic savings has increased from 23.5 percent of the GDP to 34.8 percent over the same period. The inflation fluctuated over this period, and increased considerably at times, but as a whole remained within controllable limits. The export growth rate however suffered to some extent in recent period, owing to the appreciation of Indian Rupee vis-à-vis the American dollar. This favourable macroeconomic scenario resulting the unprecedented level of FER perhaps prompted the Indian Government to think of a hitherto unexplored investment strategy for boosting growth rate further.

In spite of strong macroeconomic fundamentals, India's balance of payment on its current account has mostly been negative. However, following liberalization in the 1990s (precipitated by a balance of payment crisis), India's exports increased for some time, covering 80.3 percent of its imports in 2002–03, up from 66.2 percent in 1990–91. However as of 2008-09, the ratio stand at 61.40 percent.¹² At the same time substantial inflows of foreign capital in the form of FPI and FDI explains India's unprecedented accumulation of FER buildup to the tune of USD 251985 million in 2008-09. According to economists, there are usually two main motives behind such buildup: the precautionary motive and the mercantilist motive. According to the first explanation, like many Asian economies, following the East Asian currency crisis of 1997-98, Indian Government followed a protectionist approach to safeguard against a sudden shortages of international liquidity by accumulating a large volume of FER. The second explanation – the mercantilist motive – argue that India's soaring reserves are an indicator of the country's overdependence on trade and capital inflows as engines of growth (Park and Estrada, 2009).

Following Park and Estrada (2009) one may use two measures of reserve adequacy to examine whether India has “too much” reserve buildup and hence ‘surplus’ reserves. One of the measure of India's susceptibility to currency crisis is the ratio of reserves to short-term external debt. According to the so-called Greenspan-Guidotti rule¹³, the critical value of this ratio is one, with a value below one signaling danger. The rationale is that countries should have enough reserves to overcome a massive withdrawal of short term foreign capital.

The second indicator of reserve adequacy is the ratio of reserves to M3 or broad money. This ratio is especially relevant for countries like India that are a haven for ‘hot money’ investment by large foreign institutional investors and hence are subject to a major risk of capital flight. The higher the ratio, the greater is the confidence of the general public in the value of the local currency and hence the lower the risk of capital flight from the country. Park and Estrada (2009) suggested a critical value in the range of 5 to 20 percent as a measure of reserve adequacy.

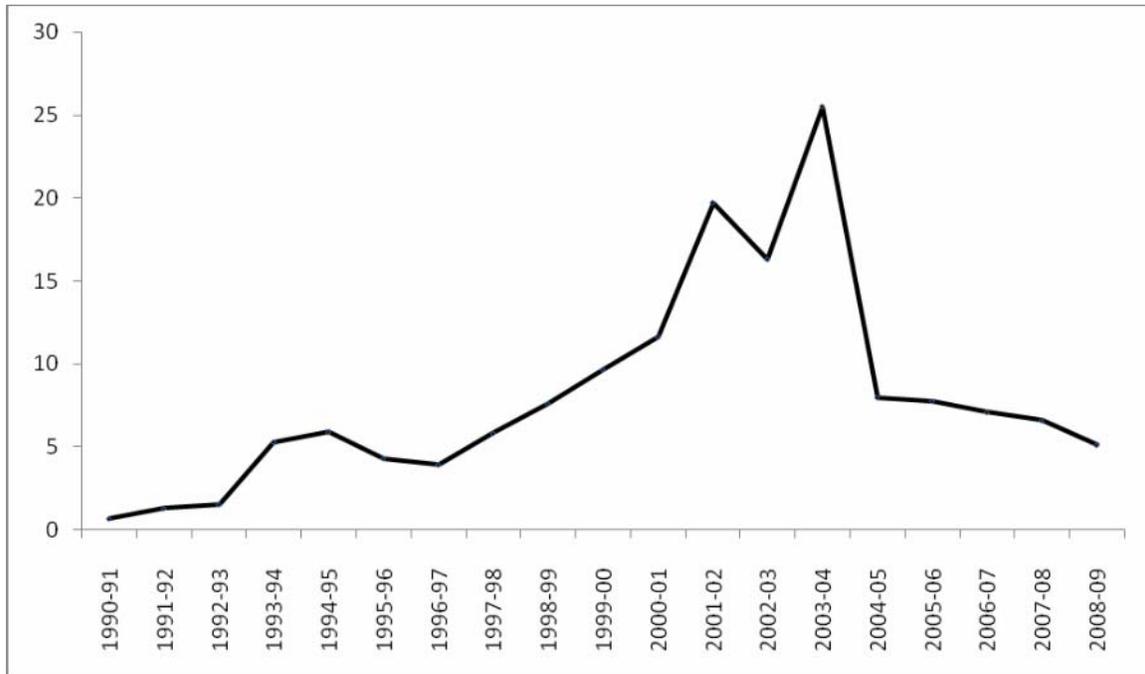
Figure 4 in the following presents diagrammatic representation of inthe time-series value of the two ratios from 1990-91 till 2008-09. The diagram shows that India comfortably passes the

¹² Calculated from India's trade data.

¹³ The rule is named after Pablo Guidotti – Argentine former deputy minister of finance – and Alan Greenspan – former chairman of the Federal Reserve Board of the United States. Guidotti first stated the rule in a G-33 seminar in 1999, while Greenspan widely publicized it in a speech at the World Bank. Guzman Calafell and Padilla del Bosque found that the ratio of reserves to external debt is a relevant predictor of an external crisis, available at http://en.wikipedia.org/wiki/Guidotti-Greenspan_rule (last accessed on May 20, 2010).

Greenspan-Guidotti test of reserve adequacy as the ratio of reserves to short-term external debt exceeding one in all the years since 1991-92.

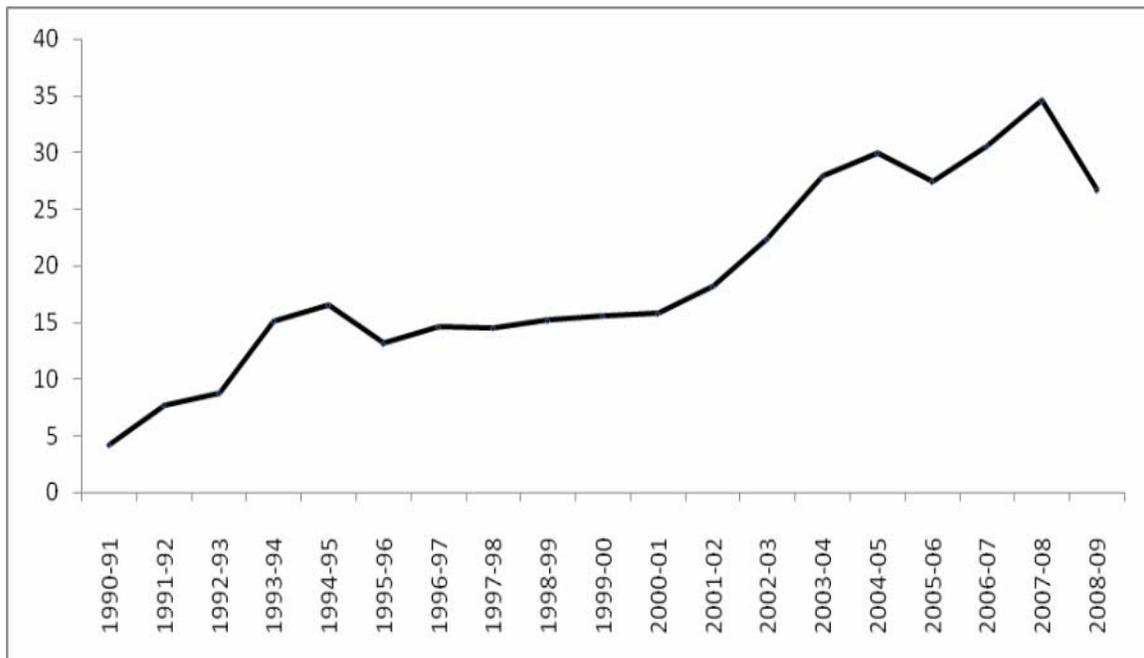
Figure 4: Ratio of reserves to short-term external debt



Source : Ratios Calculated with data obtained from RBI (2009 -10)

Figure 5 exhibits that the ratio of reserves to M3 or broad money is above 20 percent for all the years since 2002-03. Thus a look at both these ratios indicate “too much” of reserves buildup for the Indian economy particularly since 2002, suggesting thereby that India has substantial amount of surplus reserves.

Figure 5: Ratio of reserves to M3 or broad money



Source : Ratios Calculated with data obtained from RBI (2009 -10)

Since 2008 the possibility of creation of an Indian SWF has been floated at times, although the same is yet to be constituted. The idea of strategic investments in overseas debt and equity markets has been supported on the ground that it will enable Indian firms in their acquisition drive on one hand and enable higher return on accumulated foreign exchange reserves on the other. The Prime Minister's Advisory Council on Trade and Industry has recently recommended creation of a SWF with an initial corpus of \$5 billion (Choudhury, 2008). It has been argued that creation of such a fund would boost domestic economic growth (SWF Institute, 2008). While the huge volume of FER has prompted the Council to come out with such a recommendation, the fiscal deficit (3.4 percent of GDP in 2006-07) and a widening current account deficit (1.58 percent of GDP in 2006-07) has perhaps prompted the Indian Government to move cautiously in this regard.

Because of the democracy in India, the Government would be accountable for the fund's performance and would face constant pressure of managing dynamic risks involved with a SWF (EL, 2008). The transparency and accountability that go with a democracy are not a convincing argument against having a SWF. Many democracies have very successful, accountable, and transparent SWFs starting with Norway, Australia, Canada, and the United States (Alaska).

The increasing inclination of India towards SWFs in recent period is becoming evident through the perspectives from the policymakers in different forums. Carl Linaburg, Co-founder and Vice President of the Sovereign Wealth Fund Institute, noted that the Governor of the RBI has recently mentioned during a speech in Washington that India is indeed interested in creating a variant of SWF in coming future. It is expected that the SWF would function as a reserve investment corporation, and try to earn higher returns through diversifying into equity investments rather than lower risk investments such as treasury bonds (Linaburg, 2008).

However, the justification of India's recent inclination towards SWFs has been questioned by a section of professionals and economists. One major cost of reserve accumulation is that it is inflationary. When the RBI 'issues' domestic currency to purchase foreign currency, it increases the monetary base, which in turn leads to inflation. Although RBI use sterilization mechanism to neutralize such inflationary effect through open market sale of bonds, it puts pressure on interest rate and hence on Government's fiscal prudence.

It is argued that India's achievements in terms of infrastructure, education, basic health care etc. are still innocuous as compared to China and other economies currently having SWFs. Moreover, the country possess a limited natural resource endowment and the current account deficit is quite high. In these circumstances, returns on well-picked domestic investments should match the same earned by corresponding SWF returns. It is also argued that the SWFs take time to mature in terms of investment decisions (IKW, 2008), and in the learning stage they are susceptible to mistakes just like the financial companies.

India has however made its choice clear in recent period, when it decided to create room for investing the FER in infrastructure projects abroad. For this purpose, India Infrastructure Finance Company Limited has been set up as a wholly owned subsidiary in London in 2008. The subsidiary will borrow up to US \$ 5 billion from RBI by issuing US-dollar denominated bonds and lend the resources to Indian infrastructure companies for meeting their capital expenditures outside India (Economic Survey, 2009-10).

Another major criticism against the possible establishment of a SWF by India highlights the potential volatility of the FER and the global capital markets, especially in the face of the economic downturn. The investments in the global market in general are risky, and hence so would be the SWF investments. Moreover, the idea of floating SWF has been guided by massive FER in recent years. While the average annual FER growth rate was 9.66 percent over 1995-96 to 2000-01, the same has increased to 30.15 percent from 2001-02 to 2006-07. Over 2001-02 to

2006-07, the FER has increased by more than 145 billion. Now if the global economic downturn continues and the FER stock depletes, the future of the SWF venture may not be very bright.

ADB (2008) has noted that in the traditional SWFs, countries like Norway and the Gulf states have mostly invested their oil export revenues through the fund. On the other hand, the newly created SWFs in Asia (e.g. - China and Singapore) are mostly relying on conventional current account surpluses derived from non-resource exports for investment (Park, 2008). Given the fact that India's current account balance is worsening for the last couple of years, it could be noted that Indian SWF would not belong to either group. On the other hand, the increase in India's FER has been caused by speculative capital inflows on the capital account. Hence, it is argued that the amount needs to be considered as 'liabilities' created by sound domestic macro conditions and global liquidity boom and not a 'sovereign wealth'. In other words, the reserve is very much exposed to potential sudden outflows by foreign investors and any decision should be taken keeping this perspective into account (Bykere, 2008).

Apart from the economic criticisms, the possibility of the existence of SWF should also be understood in terms of the political scenario in India. The experience of Capital Account Convertibility (CAC) should be taken as a parallel here. The Tarapore Committee report on CAC in 1997 recommended introduction of CAC in India. However, the Southeast Asian crisis delayed the same. A decade after the debate on introduction of CAC was initiated by the Prime Minister of India, but the required policy change was not witnessed (Hindu, 2006). It is to be noted that the previously elected coalition Government was then receiving support from conservative Left parties. After completion of the recently concluded general election in 2009, the new government is not dependent on the left parties for support, and is in a better position to negotiate new financial policies. Hence, the idea of creating an Indian SWF may eventually materialize in coming days.

5. Possible characteristics of the Indian SWF

Given the fact that the policymakers have expressed their willingness to realize an Indian SWF in recent years, three issues need to be taken into account to understand the coverage and depth of a potential SWF in the future. The first issue would be the potential size of such an SWF; second, the investment strategies to be adopted by the SWF; and finally, the management pattern of the newly created SWF.

The first and foremost question in this subject is to determine the size of the proposed Indian SWF. It is revealed from the reactions of the policymakers at various points of time that

the Government is considering creation of a SWF with an initial corpus of US \$ 5 billion. However any final decision on that front is yet to be arrived at (SIB, 2008). Given the fact that currently India's FER is about to touch 200 billion, the figure may look meagre in that comparison in isolation. However, it needs to be borne in mind that barely a decade back, India's FER was around US \$ 26 billion and in 2002-03, the same was around 75 billion. The spectacular growth in the FER has been witnessed only in the recent period fuelled by capital inflow. In that perspective, India should perhaps start with a modest initial SWF operation of US \$ 5 billion and contemplate over the optimal size of it's SWF a few years after the same is operational, based on practical experience (i.e., risk uncertainty and the size of returns).

It is generally argued that SWFs intend to manage non-commodity based assets to increase returns on reserves. However, their investment decisions should be based on commercial considerations and not on geo-strategic reasons. Looking at India's current outward investment trends, it could be ascertained that its SWF investment strategies might keep two considerations in mind: one, increased returns on reserves and two, ensuring energy security. Given the oil price trends in recent period, perhaps the two may not be completely uncorrelated from an Indian perspective. Hence, a proportion of the newly created SWF may definitely be utilized in India's energy security quest. The other target areas might include iron and steel sector and other fields where the possibility of return looks higher.

The management of SWF in the turbulent era of global slowdown has received wider focus in recent period. Linaburg (2008) has however argued that India is not a new player as far as SWF type operation is concerned. The country has earlier created the India Infrastructure Finance Company Limited (IIFC) in 2004, which provides long-term debt for financing public private partnership infrastructure development projects in India. The IIFC has the experience of raising money through equity finance, currency debt raised on the open market, debt from multilateral and bilateral institutions, foreign currency debt through external commercial borrowings etc. All these experiences makes IIFC an ideal body for managing the Indian SWF, once the same is established.

It is to be noted that the RBI has welcomed the idea of setting up of a SWF but is not keen to manage it. The argument is that the existing RBI mandate to perform as a Central Bank might refrain it from successfully managing the SWF type operation. It has recently suggested to the Parliamentary Standing Committee on Finance that a dedicated and independent entity set up by an act of Parliament instead would be the best forum to do so (Choudhury, 2008).

Given these circumstances, perhaps the best way of managing Indian SWF would be to follow the RBI recommendation, and the independent entity created for this purpose should be benefited from the experience of both IIFC and RBI. There should be executives from both IIFC and RBI present in the managerial board of the Indian SWF. The newly created entity should also have representatives from the Ministry of Finance and industry associations.

6. Conclusions

SWFs constitute an important element in the policy dimension of many countries that decided to set up such a fund. For instance in China, they are a key example of the interference of the Chinese government in business transactions and the private sector, which may not be present in the Indian case. However, as the earlier analysis suggests, there may exist a commonality of interest between the public and the private sector in India in terms of outward investment (e.g. – energy). In addition, it is to be noted that acquisition attempts in strategic sectors like steel by Indian private players have already been criticised in Europe (e.g. – Arcelor-Mittal takeover in 2006) and any SWF operation in that area might also be viewed in that light. The analysis with Indian macroeconomic scenario indicates that creating an SWF and successfully managing the same may not be impossible for the country in the current settings.

India however needs to keep in mind the management policies of SWF and the international norms. In October 2007, the G7 Finance Ministers invited major multilateral organisations, such as the IMF and the OECD, to launch a reflection on the role of SWFs and on the mechanisms to address the challenges they pose. Since the G7 summit, the activities in the IMF and OECD have been running in parallel but they are not dealing with exactly the same themes. They are however generally described as complementary. OECD has finished its work in 2009, and the playing field has not been changed. The IMF agreed on a set of 24 voluntary principles for the funds to follow and to ensure their competitiveness in global financial markets. These Generally Accepted Principles and Practices (GAPP) or “Santiago Principles” were released on 11 October 2008 and appeared in Annex 1.

Complying officially with IMF guidelines should not require a lot of concessions from the Indian side. Since the Santiago principles remain quite vague and minimal, a good strategy would be to respect them and use these standards as a tool to ensure that Western countries will not create obstacles that run against the philosophy of this core of multilateral principles.

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Annex 1: A summary of the 24 Generally Accepted Principles and Practices (GAPP)

- **GAPP 1. Principle**

The legal framework for the SWF should be sound and support its effective operation and the achievement of its stated objective(s).
- GAPP 1.1 Subprinciple *The legal framework for the SWF should ensure the legal soundness of the SWF and its transactions.*
- GAPP 1.2 Subprinciple *The key features of the SWF's legal basis and structure, as well as the legal relationship between the SWF and the other state bodies, should be publicly disclosed.*
- **GAPP 2. Principle**

The policy purpose of the SWF should be clearly defined and publicly disclosed.
- **GAPP 3. Principle**

Where the SWF's activities have significant direct domestic macroeconomic implications, those activities should be closely coordinated with the domestic fiscal and monetary authorities, so as to ensure consistency with the overall macroeconomic policies.
- **GAPP 4. Principle** *There should be clear and publicly disclosed policies, rules, procedures, or arrangements in relation to the SWF's general approach to funding, withdrawal, and spending operations.*
- GAPP 4.1 Subprinciple *The source of SWF funding should be publicly disclosed.*
- GAPP 4.2 Subprinciple *The general approach to withdrawals from the SWF and spending on behalf of the government should be publicly disclosed.*
- **GAPP 5. Principle**

The relevant statistical data pertaining to the SWF should be reported on a timely basis to the owner, or as otherwise required, for inclusion where appropriate in macroeconomic data sets.
- **GAPP 6. Principle**

The governance framework for the SWF should be sound and establish a clear and effective division of roles and responsibilities in order to facilitate accountability and operational independence in the management of the SWF to pursue its objectives.
- **GAPP 7. Principle**

The owner should set the objectives of the SWF, appoint the members of its governing body(ies) in accordance with clearly defined procedures, and exercise oversight over the SWF's operations.
- **GAPP 8. Principle**

The governing body(ies) should act in the best interests of the SWF, and have a clear mandate and adequate authority and competency to carry out its functions.

- **GAPP 9. Principle**
The operational management of the SWF should implement the SWF's strategies in an independent manner and in accordance with clearly defined responsibilities.
- **GAPP 10. Principle**
The accountability framework for the SWF's operations should be clearly defined in the relevant legislation, charter, other constitutive documents, or management agreement.
- **GAPP 11. Principle**
An annual report and accompanying financial statements on the SWF's operations and performance should be prepared in a timely fashion and in accordance with recognized international or national accounting standards in a consistent manner.
- **GAPP 12. Principle**
The SWF's operations and financial statements should be audited annually in accordance with recognized international or national auditing standards in a consistent manner.
- **GAPP 13. Principle**
Professional and ethical standards should be clearly defined and made known to the members of the SWF's governing body(ies), management, and staff.
- **GAPP 14. Principle**
Dealing with third parties for the purpose of the SWF's operational management should be based on economic and financial grounds, and follow clear rules and procedures.
- **GAPP 15. Principle**
SWF operations and activities in host countries should be conducted in compliance with all applicable regulatory and disclosure requirements of the countries in which they operate.
- **GAPP 16. Principle**
The governance framework and objectives, as well as the manner in which the SWF's management is operationally independent from the owner, should be publicly disclosed.
- **GAPP 17. Principle**
Relevant financial information regarding the SWF should be publicly disclosed to demonstrate its economic and financial orientation, so as to contribute to stability in international financial markets and enhance trust in recipient countries.
- **GAPP 18. Principle**
The SWF's investment policy should be clear and consistent with its defined objectives, risk tolerance, and investment strategy, as set by the owner or the governing body(ies), and be based on sound portfolio management principles.
 - *GAPP 18.1 Subprinciple The investment policy should guide the SWF's financial risk exposures and the possible use of leverage.*
 - *GAPP 18.2 Subprinciple The investment policy should address the extent to which internal and/or external investment managers are used, the range of their activities and authority, and the process by which they are selected and their performance monitored.*

- *GAPP 18.3 Subprinciple A description of the investment policy of the SWF should be publicly disclosed.*
- **GAPP 19. Principle**
The SWF's investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds.
- *GAPP 19.1 Subprinciple If investment decisions are subject to other than economic and financial considerations, these should be clearly set out in the investment policy and be publicly disclosed.*
- *GAPP 19.2 Subprinciple The management of an SWF's assets should be consistent with what is generally accepted as sound asset management principles.*
- **GAPP 20. Principle**
The SWF should not seek or take advantage of privileged information or inappropriate influence by the broader government in competing with private entities.
- **GAPP 21. Principle**
SWFs view shareholder ownership rights as a fundamental element of their equity investments' value. If an SWF chooses to exercise its ownership rights, it should do so in a manner that is consistent with its investment policy and protects the financial value of its investments. The SWF should publicly disclose its general approach to voting securities of listed entities, including the key factors guiding its exercise of ownership rights.
- **GAPP 22. Principle**
The SWF should have a framework that identifies, assesses, and manages the risks of its operations.
- *GAPP 22.1 Subprinciple The risk management framework should include reliable information and timely reporting systems, which should enable the adequate monitoring and management of relevant risks within acceptable parameters and levels, control and incentive mechanisms, codes of conduct, business continuity planning, and an independent audit function.*
- *GAPP 22.2 Subprinciple The general approach to the SWF's risk management framework should be publicly disclosed.*
- **GAPP 23. Principle**
The assets and investment performance (absolute and relative to benchmarks, if any) of the SWF should be measured and reported to the owner according to clearly defined principles or standards.
- **GAPP 24. Principle**
A process of regular review of the implementation of the GAPP should be engaged in by or on behalf of the SWF.