Poverty and Social Inequality: Should India Set Up a Sovereign Wealth Fund?

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New Delhi's proposal to establish a $10-billion sovereign wealth fund should be treated with caution. The necessary preconditions for setting up a SWF are squarely lacking in India. Besides, the purported objectives of the fund to pursue strategic investment opportunities abroad are highly debatable.

It appears that New Delhi is blindly following a "me-too" approach rather than understanding the rationale behind setting up such funds. What are sovereign wealth funds? In simple terms, SWF is a large pool of assets and investments owned and managed (directly or indirectly) by a national or state government.

Rationale behind the fund

The main policy rationale behind setting up a SWF is not to acquire strategic assets and secure supply of natural resources, as proposed 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 its SWF, China Investment Corporation, with a $200 billion corpus to manage its excessive forex reserves, which reached 2.4 trillion by end-June 2010.

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.

At present, there are more than 50 SWFs in the world, managing assets worth around $3 trillion. Of the top 20 SWFs, 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 Stabilisation 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.

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 $29.8 billion in fiscal 2009 as against $15.7 billion in fiscal 2007. 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 despite steady growth in software services exports and a rise in workers' remittances from overseas Indians.

Its persistent current account deficits have been financed by large capital inflows in the form of portfolio investments and other volatile capital flows that are subject to capital flight. Given the overriding presence of volatile capital flows in India's forex reserves, coupled with vulnerability to external shocks, it would be erroneous to consider its foreign exchange reserves ($280 billion) as a position of strength.

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. Besides, India also runs a perennial fiscal deficit which means that raising substantial money for sovereign fund from budgetary allocation would be extremely difficult.

Santiago Principles

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. 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. Not long ago, the Western world had characterised SWFs as "villains" and introduced new policy measures, popularly known as Santiago Principles, to regulate the investments of SWFs globally. Thus, acquisition of strategic cross-border assets (including natural resources) will not be a cakewalk. Also $10 billion is not enough to acquire strategic assets abroad — unless they become very cheap.

Furthermore, there is no guarantee that investments made by the 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.

Paradoxical as it may sound, extreme poverty and hunger still pervades India. For New Delhi, the first priority should be to free the nation from hunger, malnutrition and illiteracy rather than financing the acquisition of strategic assets or rivals abroad.

In this regard, a portion of the country's forex reserves could be prudently used in the improvement of physical infrastructure, education, health and financial services, particularly in rural India.

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