Managing India's Foreign Exchange Reserve: An Exploration of the SWF Temptation

Julien Chaisse, Debashis Chakraborty and Jaydeep Mukherjee[1]

Abstract

Despite increasing inclination towards market liberalization and privatization observed over the last decade,[2] the role of States has, in this period of time arguably grown in importance in some particular aspects of investment. Notably, investments from emerging economies have increased, and 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).

Investment through the SWF route is not a recent phenomenon, but has been 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 transitioning economies such as China, India, Vietnam, Singapore, Malaysia, Czech Republic and Russia. Many SOEs are listed on the Fortune Global 500 list. Chinese SOEs figure most frequently in this listing, and count for 24 spots on the same. Due to the significance of foreign direct investment by Chinese SOEs, their characteristics have received particular attention.[3] By far the largest outward investments by

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

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 a large extent aligned and institutionally intertwined.

This paper attempts to analyse the trends in SWF investment and the main obstacles they face. In particular, the analysis focuses on the major potential challenges for Indian SWFs, in case they come into existence. The analysis is arranged along the following lines. First the global SWF experience is reviewed, followed by the possibility of creating Indian SWFs. The subsequent analysis intends to identify the main regulations in the EU and the US markets that Indian SWFs might face. These regulations might function as potential obstacles in 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 SWFs,[4] which might, as well 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.

CONTENTS

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[3] P. Gugler and B. Boie, *The Rise of Chinese Multinational Enterprises*, EXPANSION OF TRADE AND FDI IN ASIA: STRATEGIC AND POLICY CHALLENGES 25-57 (J. Chaisse *et* al. eds., 2009).

[4] 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.

I. 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 protectionism.[5] 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 the persistent current account surpluses in China and certain other Asian countries.[6] The idea here is that a country can establish its SWF only if

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5 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. *See* J. Chaise and P. Gugler, *Investment Regulation: Is Fragmentation further Increasing in the Light of Emerging Investment Issues?* THE FRAGMENTATION OF INTERNATIONAL TRADE REGULATION – 12 ESSAYS ON ACHIEVING COHERENCE (T. Cottier *et al.* eds., 2010).

6 A. Blundell-Wignall, Y. Hu, and J. Yermo, *Sovereign Wealth and Pension Fund Issues* 14 OECD WORKING PAPERS ON INSURANCE AND PRIVATE PENSIONS. 6-7 (2008).

it has surplus foreign currency. Looking at the data on SWFs it is observed that the surplus is generated through two channels[7] 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.

In 2007, Morgan Stanley predicted that SWFs may manage USD 12 trillion by 2015.[8] *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, *Preqin 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.[10]

As a result of the financial crisis, the US market remains an attractive option for the emerging economy SWFs (especially China). This has become a matter of concern there, the most prominent being the fear of foreign government investment for the wrong reasons like 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 represent a major clash. Finally, from a political economic standpoint, there is certainly a difficulty for developed countries in accepting a shift in the balance of power in the world economy to new emerging market giants.[11]

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7 The data is obtained from Sovereign Wealth Fund Institute, http://www.swfinstitute.org/funds.php.

8 S. Jen, *How big could Sovereign Wealth Funds be by 2015?* MORGAN STANLEY (May 4, 2007).

9 The details can be obtained from http://www.globalinsight.com/.

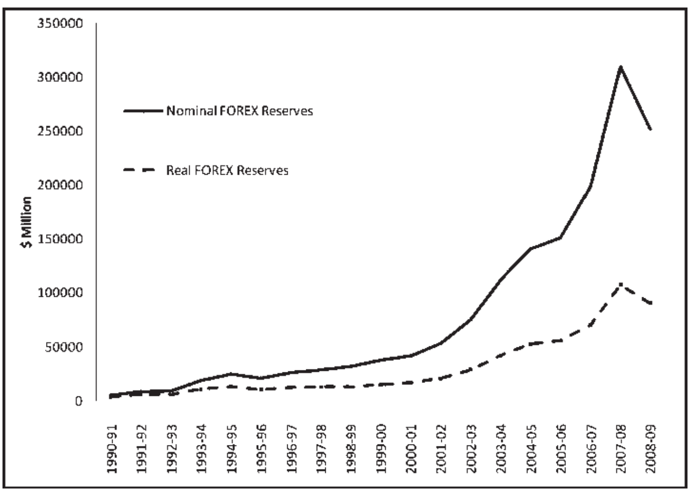
10 *See* Preqin, *Special Report on Sovereign Wealth Funds* 190 (2010).

11 G. Lyons, *State Capitalism: The rise of sovereign wealth funds* LAW AND BUSINESS REVIEW OF THE AMERICAS 14 ((2008).

A. 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 an all time low in 1989-90 with an FER of USD 3962 Million. The FER scenario improved to some extent with increase in gold reserves in the 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, which resulted in an increase in FERs, but has been followed by a simultaneous decline in India's Special Drawing Rights (SDRs) reserves since then. India's FER scenario is graphically represented below in 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, and reached a new peak in 2006-07 at USD 199179 Million. India's foreign currency reserves are currently ranked the 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 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 in remaining emphatically positive.

It is worthwhile to note that during 2007-08 the Rupee had appreciated vis-à-vis the Dollar by more than 10%. This increased the return earned in foreign exchange, when rupee assets were sold and the revenue converted into dollars. The investments turned even more attractive and it triggered 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 has been 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 significant amount of capital outflow,[12] resulting in a sharp decline in India's FER, both real and nominal.

Figure 2 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.

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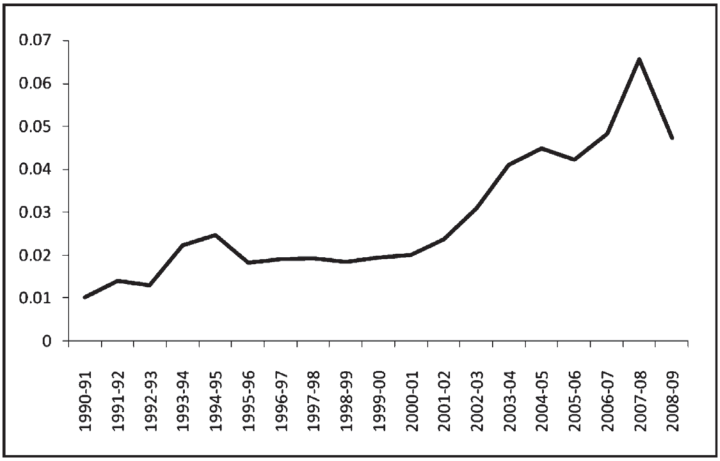
12 Although the recent global financial crisis started with the busting of housing bubble in US, US financial markets continue to be of crucial importance to the rest of the world: more than $4 trillion of reserves are held in US currency. With global financial crisis, there is a 'flight to safety' and 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)

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.[13] For instance, the 2003-04 budget of the Government smoothened overseas investment norms for corporate houses by allowing prepayment of External Commercial Borrowings (ECB) of over US$100 million.[14] In the subsequent period, April, 2005, 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.[15] 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.[16] Soon thereafter, the RBI further relaxed the overseas investment norms for mutual funds and amended the remittance opportunities through various policies.[17]

13 *World Investment Report 2007* UNCTAD (Geneva, 2007).

14 The Budget Speech of the Minister of Finance, Government of India (2003-2004), http://indiabudget.nic.in/ub2003-04/bs/speecha.htm.

15 *Chronology of Major Policy Announcements: April 2005 – July 2006* ANNEX IV IN 'RBI ANNUAL REPORT' OF THE RESERVE BANK OF INDIA 250-266 (2006).

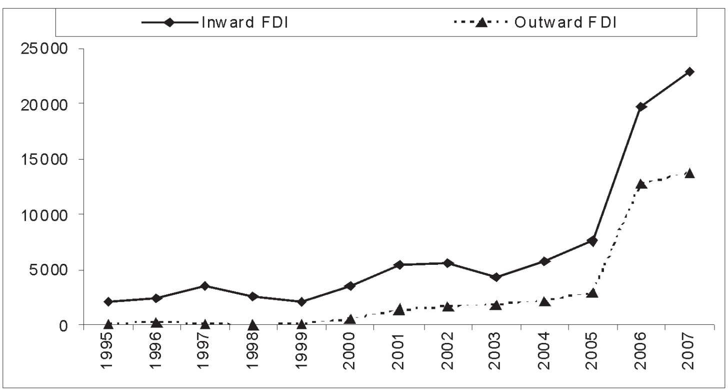
16 Lakhwinder Singh and Varinder Jain, *Emerging Pattern of India's Outward Foreign Direct Investment Under the Influence of State Policy: A Macro View* MUNICH PERSONAL REPEC ARCHIVE (2009), http://mpra.ub.uni-muenchen.de/13458/1/MPRA_paper_13458.pdf.

17 *Investment by Mutual Funds in Overseas Securities - Liberalisation of* RESERVE BANK OF INDIA RBI/2006-07/88, A.P. (DIR Series) Circular No. 3 (July 26, 2006); *Liberalised Remittance Scheme of USD 50,000 for Resident Individuals* RESERVE BANK OF INDIA RBI/2006-2007/216, A.P. (DIR Series) Circular No. 24, (December 20, 2006).

Subsequently, RBI has increased the overseas investment limit for the mutual funds to US$ 5 billion from the earlier level of US$ 4 billion.[18] 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.[19] The Export Import Bank of India also supported more than 200 outward investment ventures by 164 Indian companies in over 50 countries.[20]

As a result of the reforms undertaken in India, the volume of outward investment flows has increased considerably over the years, as can be observed from Figure 3. It is learnt from 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.[21]

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



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

18 *Indian Investment Abroad in Joint Ventures and Wholly Owned Subsidiaries* RESERVE BANK OF INDIA, http://www.rbi.org.in/scripts/BS_ViewBulletin.aspx?Id=10364 .

19 *Overseas Direct Investment- Liberalisation*, RESERVE BANK OF INDIA RBI/2007-08/148, A. P. (DIR Series) Circular No.11 (September 26, 2007).

20 *Developing Countries: Globalisation through Overseas Investment* WORLD BANK (2008), http://www.fdi.net/documents/WorldBank/databases/india/EXIM07.pdf .

21 *Indian Investments Abroad* INDIA BROAD EQUITY FOUNDATION (2008), http://www.ibef.org/economy/indianinvestmentsabroad.aspx.

Looking at the investment flows in 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. The energy sector has been the maximum receiver of Indian investment, till date. For instance, Essar Exploration & Production (EEPL) has recently bought two offshore petroleum exploration blocks in Australia, and this is first time such initiative being shown by an Indian oil company.[22] In September 2007, Reliance Industries had bought a majority stake of East African oil retailer Gulf Africa Petroleum Corporation (GAPCO), which owned and operated large storage facilities and a retail distribution network in several East African countries.[23] In Latin America, Venezuela's State-owned oil company PDVSA has recently entered into an agreement with an Indian oil company.[24] Moves to acquire stakes in the retail businesses of BP, Europe's largest oil company in Malaysia and Singapore have also been considered.[25]

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.[26] Oil and Natural Gas Commission (ONGC) and Videsh Ltd (OVL) have won an oil block in Colombia through auction as part of a consortium.[27] 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) enteres into a $400 million agreement

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22 *Essar Exploration buys two oil blocks in Australia* 14(1) ALEXANDER'S GAS AND OIL CONNECTIONS COMPANY NEWS (January 29, 2009), http://www.gasandoil.com/goc/company/cns90490.htm.

23 *Reliance Industries buys out GAPCO Group in East Africa* INDIA BUSINESS REVIEW (September 5, 2007), http://www.indiabusinessview.com/2007/09/reliance-industries-buys-out-gapco.html

24 Joe Duarte, *Peak Oil - Venezuela: Slowly Turning Off the Tap Toward the US* FINANCIAL SENSE EDITORIALS, (April 22, 2006), http://www.financialsense.com/editorials/duarte/2006/0422.html.

25 Saritha Rai, *Asia: India: Oil Bid Planned*, (February 3, 2004), THE NEW YORK TIMES, http://query.nytimes.com/gst/fullpage.html?res=9C00E7DC143BF930A35751C0A9629C8B63.

26 *Indian Oil-Oil India win 3 onshore oil blocks in Libya* THE ECONOMIC TIMES (December 14, 2007), http://economictimes.indiatimes.com/Oil__Gas/Indian_Oil-Oil_India_win_3_onshore_oil_blocks_in_Libya/articleshow/2623110.cms .

27 Piyush Pandey, *OVL consortium bags Colombia oil block*, THE ECONOMIC TIMES, (November 13, 2008), http://economictimes.indiatimes.com/News/News_By_Industry/Energy/Oil__Gas/OVL_consortium_bags_Colombia_oil_block/articleshow/3706744.cms .

to develop Thar Jath oil fields in Sudan for to an initial capacity of 80,000 barrels per day.[28]

One interesting feature has been the initial competition between China and India in oil exploration in Africa and Central Asia. China National Petroleum Corportation (CNPC) at one point purchased oilfields in Kazakhstan, Ecuador and Nigeria, which ONGC was also interested in getting into at the time.[29] 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.[30] The presence of SWFs may come beneficial in that scenario.

B. Pros and Cons

India over the last few years has 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

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28 *Sudan inks oil field deal with ONGC consortium* FINANCIAL EXPRESS *(March 29, 2005),* http://www.financialexpress.com/news/Sudan-inks-oil-field-deal—with-ONGC-consortium/130731/ .

29 *China, India for joint Kazakh oil bid*, CHINA DAILY (June 11, 2006), http://www.chinadaily.com.cn/china/2006-06/11/content_613810_2.htm .

30 Siddharth Varadarajan, *India, China, and The Asian Axis Of Oil*, THE HINDU (January 26, 2006), http://www.countercurrents.org/po-varadarajan260106.htm.

remained within controllable limits. The export growth rate has however suffered to some extent in recent periods, owing to the appreciation of the Indian Rupee vis-à-vis the American dollar. This favourable macroeconomic scenario resulting in 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 stood at 61.40 percent.[31] At the same time substantial inflows of foreign capital in the form of FPI and FDI explain 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 sudden shortage of international liquidity, by accumulating a large volume of FER. The second explanation says 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).[32]

Following Park and Estrada (2009)[33] one may use two measures of reserve adequacy to examine whether India has too much reserve buildup and hence 'surplus' reserves. One of the measures of India's susceptibility to currency crisis is the ratio of reserves to short-term external debt. According to the so-called Greenspan-Guidotti rule,[34] the critical value of this ratio is one, with a

31 Calculated from India's trade data.

32 D. Park, and G. Estrada, *Developing Asia's Sovereign Wealth Funds and Outward Foreign Direct Investment*, 26(2) ASIAN DEVELOPMENT REVIEW 57–85 (2009).

33 *Id.*

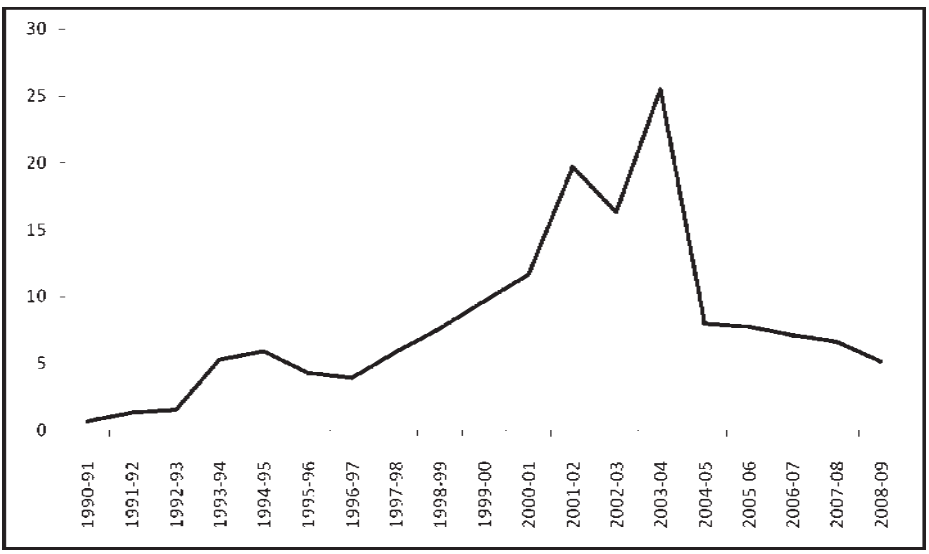
34 The rule is named after Pablo Guidotti – Argentine former Deputy Minister of Finance – and Alan Greenspan – former chairman of the Federal Reserve Board of the United States. Guidotti first stated the rule in a G-33 seminar in 1999, while Greenspan widely publicized it in a speech at the World Bank. Guzman Calafell and Padilla del Bosque found that the ratio of reserves to external debt is a relevant predictor of an external crisis, http://en.wikipedia.org/wiki/Guidotti–Greenspan_rule.

value below that 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' investments 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 presents a diagrammatic representation of in the time-series value of the two ratios from 1990-91 till 2008-09. Column 2 shows that India comfortably passes the 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.

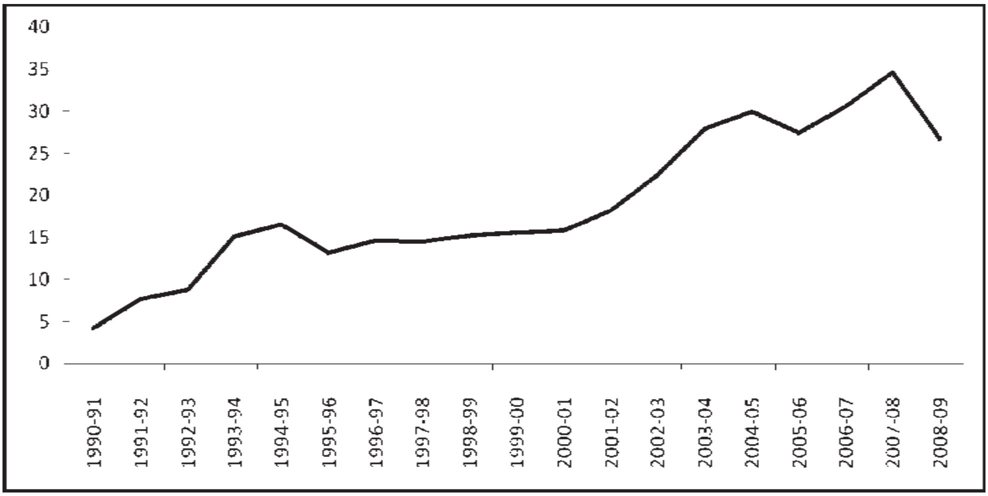
Figure 4: Ratio of reserves to short-term external debt



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

Column 3 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 investment 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 the creation of a SWF with an initial corpus of $5 billion.[35] It has been argued that the creation of such a fund would boost domestic economic growth.[36] While the huge volume of FER has prompted

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35 Gaurav Choudhury, *RBI not keen on managing sovereign wealth fund* HINDUSTAN TIME (August 18, 2008).

36 *Finance Ministry May Approve $5 Billion Fund for India* SWF INSTITUTE (February 21, 2008) http://www.swfinstitute.org/fund/india.php .

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.[37] 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 including Norway, Australia, Canada, and the United States (Alaska).

The increasing inclination of India towards SWFs in the recent period is becoming evident through the perspectives of 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 the 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.[38]

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 the RBI uses a sterilization mechanism to neutralize such inflationary effect and 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 sectors such as infrastructure, education basic health care are still innocuous as compared to China and

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37 *India not in a good position to start SWF* EXCESS LIQUIDITY (February 12, 2008), http://sovereignwealthfunds.wordpress.com/category/sovereign-wealth-funds/ .

38 Carl Linaburg, *India might create reserve investment corporation* (2008), http://www.swfinstitute.org/news/apreight.php .

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,[39] and that 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 will 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 a consequence even the SWF investments would be such. Moreover, the idea of floating SWFs 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.

The Asian Development Bank in 2008 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.[40] Given

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39 *Should India Set up a Sovereign Wealth Fund? It's a Bad Idea* INDIA KNOWLEDGE@WHARTON (March 27, 2008), http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4272.

40 Donghyun Park, *Developing Asia's New Sovereign Wealth Funds and Global Financial Stability* 1 ADB BRIEFS (2008), http://www.adb.org/Documents/Briefs/ADB-Briefs-001-Sovereign-Wealth-Funds.pdf .

the fact that India's current account balance has worsened in 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 the global liquidity boom but not as '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.[41]

Apart form 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. Even a decade after the debate on introduction of CAC was initiated by the Prime Minister of India the required policy change was not witnessed.[42] It is to be noted that the previously elected coalition Government was then receiving support from conservative Left parties. After completion of the general election in 2009, the new government was not dependent on the Left parties for support, and was in a better position to negotiate new financial policies. Hence, the idea of creating an Indian SWF may eventually materialize in coming days.

C. 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 needs 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.

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41 Arpitha Bykere, *Cost of India's Burgeoning Foreign Exchange Reserves: What to Do With So Many Reserves?,* (March 6, 2008), http://www.rgemonitor.com/economonitor-monitor/248231/cost_of_indias_burgeoning_foreign_exchange_reserves_what_to_do_with_so_many_reserves .

42 *Prepare road map for full rupee float: Manmohan* THE HINDU (March 19, 2006), http://www.blonnet.com/2006/03/19/stories/2006031902920100.htm.

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.[43] 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 times, 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 has however argued that India is not a new player as far as SWF type operation is concerned.[44] The country has earlier created the India Infrastructure Finance Company Limited (IIFC) in 2004, which provides long-term debt for financing public private

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43 *Sovereign Wealth Fund*, THEME 197 SOUTH INDIAN BANK, (2008), http://www.southindianbank.com/UserFiles/Theme_197.pdf.

44 *Supra* note 38.

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.[45]

Given these circumstances, perhaps the best way of managing an 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 the IIFC and RBI. There should be executives from both these bodies 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.

II. The Regulatory Obstacles an Indian SWF Would Face

There are few, if any, examples of SWFs that have caused damage to MNEs or the international financial system. Nevertheless, the newly established SWFs such as CIC from China have led to considerable concern among experts in international economics and finance. These concerns are mostly based on a fear of political interference by the Chinese Government in economic exchange and business activities rather than actual incidence of it.

The prime goal for China in establishing an SWF seems to be to make profitable use of the foreign exchange it has accumulated as the result of

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[45] *Supra* note 35.

trade imbalances or foreign exchange intervention. Yet, other reasons may also play an important role. Essentially, China is saving today to consume even more in the future when China will be richer. This poses a puzzling behaviour. China is, after all, a relatively poor but rapidly growing country, and would possibly be better off with a higher consumption rate today. The ultimate outcome is that the Chinese government exchanges its own bonds for foreign assets. But this mechanical explanation fails to answer the question why China accumulates foreign assets, rather than consuming more or even investing more in domestic physical assets? It follows from such argumentation that the activities of the Chinese SWF must be assumed to also be being used for other, strategic goals: Chinese economists have argued that the available savings could support the economic development of China best if used to as means to acquire international technologies, brands, and resources, and to smoothen access to international markets.[46]

From a macro-economic perspective, major shifts in SWF investments could potentially disrupt global financial markets. On a national level, politically driven investments in a country could raise national security concerns. Furthermore, there is a possibility that China could use the CIC as a mechanism to pursue geopolitical objectives. For example, a strategic investment in natural resources with means that exceed those of Western MNEs could be a step towards controlling resources in times of future shortages. Yet, one may doubt the neutrality of State actors in a landscape dominated by private business.

The controversy over SWFs is essentially about the interaction of two very different concepts of the role of government in a capitalist economy, state capitalism as opposed to market capitalism. Where elements of state capitalism interfere in a tradition of market capitalism, a potential for abuse or corruption may arguably be created by the greater proximity an SWF creates between governments and the private sector. Particularly with regard to banks and the financial sector, in which the CIC has already strongly invested, a growing network of interlinked investments between banks and

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46 *See* P. Gugler and B. Boie, *The Rise of Chinese Multinational Enterprises* EXPANSION OF TRADE AND FDI IN ASIA: STRATEGIC AND POLICY CHALLENGES 25-57 (J, Chaisse *et* al. eds., 2009).

other financial firms within China and overseas can be assumed. In practice, CIC's investment in companies such as Morgan Stanley may provide them with unfair preferential access to China's domestic financial markets, or, in return, overseas financial firms may be put under pressure to treat Chinese companies in global business preferentially compared to others. Neutrality of the business sector and a level playing field for MNEs worldwide is at stake.

The BRIC (Brazil, Russia, India and China) countries are currently witnessing 14 percent of global SWF inward investments. For instance, among the major global investors, Temasek is currently holding stakes in ICICI Bank in India.[47] Also the Norwegian Pension Fund, the world's third largest sovereign welfare fund, is keen to invest $2 billion in Indian bonds and equities.[48] The inflow has been caused by the absence of strong control over foreign SWF movements. India currently does not restrict the inflow of the SWF investments in any discriminatory manner vis-à-vis any comparable investment made by other agencies. The Ministry of Finance has noted in 2008 that foreign SWFs do not pose any threat to India's economic interests.[49]

However, the decisions to allow firms in India may sometimes be influenced by the SWF-related provisions elsewhere. For instance, Reiche (2008) has noted that the operation of the British Metal and mining firm Vedanta Resources Ltd. and its subsidiaries Sterlite Industries Ltd. and Madras Aluminum Company Ltd. have been banned in India because of their environmental and human right violation records. Interestingly however the ban was introduced after Vedanta's exclusion from the Norwegian SWF.[50]

In response to the global stream of events, the United States maintain the option of screening investments made on their territory. The considerable

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47 Ming Zhang and Fan He,17(1) *China's Sovereign Wealth Fund: Weakness and Challenges* CHINA AND WORLD ECONOMY 101-116 (2009).

48 *Economic News* GOVERNMENT OF INDIA 6 (10) (2008).

49 Sanjiv Sankaran, *No threat from sovereign wealth funds, says Finmin*, (July 22, 2008), http://www.livemint.com/2008/07/22005327/No-threat-from-sovereign-wealt.html.

50 Danyel Reiche, *Sovereign Wealth Funds as a new Instrument of Climate Protection Policy? Study of Norway as a Pioneer of Ethical Guidelines of Investment Policy*, Working Paper No. 173, (2008), WUPPERTAL INSTITUTE FOR CLIMATE, ENVIRONMENT AND ENERGY, http://www.wupperinst.org/en/info/entwd/uploads/tx_wibeitrag/WP173e.pdf.

flows of international investments occurring in Europe reflect their freer policy regime regarding movement of capital. Because of the concerns existing in Europe, the European institutions decided in 2008 to agree on the basic principles that should shape the EU approach towards SWFs. A consensus emerged towards a common approach. It has been decided not to create *ex nihilo* a new mechanism of control but to rely on the existing rules of the common market that enable Member States to derogate to the principle of freedom of movement of capital. The next part of the paper focuses on the regulatory mechanisms in the US and the EU.

A. The regulation of SWF in the United States

Though the earlier Bush Administration had been generally supportive of SWF investments, concerns were expressed at times. For instance, Christopher Cox, Chairman of the U.S. Securities and Exchange Commission (SEC), raised concerns on the following issues:

- At times, foreign governments may not be fully cooperative with insider-trading investigations.
- On certain occasions, SWFs may be the beneficiaries of economic intelligence from national security services.

The US approach since 2007 has been summarized by the former Secretary of Treasury Paulson : Who said that "money is naturally going to gravitate toward dollar-based assets because of the strength of our economy," … Paulson further noted, however, that "I'd like nothing more than to get more of that money. But I understand that there's a natural fear that they're going to buy up America."[51] This psychology has been strengthened in the aftermath of the global economic downturn.

In the US, a specific mechanism ensures the control of SWF investments in the national economy. Indeed, since 1988, the United States has had a legal framework to forbid a foreign investment if it threatens to impair US national

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51 Steven R. Weisman, *U.S. fears overseas funds could 'buy up America*, NEW YORK TIMES (August 21, 2007).

security. The Committee on Foreign Investment in the United States (CFIUS), an inter-agency committee chaired by the Secretary of US Treasury, takes part in the US investment policy analysis through reviews that protect national security while maintaining the credibility of open investment policy.

As a committee of the US executive branch, the CFIUS takes responsibility for monitoring overseas acquisitions of 10% or more of a domestic company's total ownership. Critics argue that the 10% ownership threshold for reviewing these investments is inadequate, pointing out that investors who acquire smaller ownership shares can have a dramatic impact on a company, and on an economy at large. Interestingly no definition of national security exists in CFIUS.

Filing a notice with CFIUS of a foreign acquisition is voluntary and typically done at the initiative of the parties. However, parties are motivated to file by the fact that the law empowers CFIUS and the President to dissolve the acquisition at any time in the future, even after an acquisition has been completed, if a filing was not made.

After a transaction has been filed, CFIUS conducts an initial review, utilizing the full intelligence and national security infrastructure of the US government, based on detailed information from the parties, which frequently receive questions and requests for clarification from CFIUS. The scope of these reviews focus on two key thresholds:

⇒ *Test 1*: Is there credible evidence that the foreign interest exercising control might take action that threatens national security?

⇒ *Test 2*: If yes, do laws other than the Exon-Florio and the International Emergency Economic Powers Act provide adequate and appropriate authority for the President to protect national security?

If consensus exists that no credible threat to national security exists, or threat has been mitigated, CFIUS decides, within 30 days, not to open a further investigation. If threats exist, or agencies are divided in their opinion, CFIUS conducts an investigation for an additional 45 days, after which CFIUS is required to file a report with the President. The President will have 15 days to make a decision whether or not to block a transaction.

It is always possible to negotiate during both initial and further reviews. It is observed that in the past, certain parties have dropped out of transactions when CFIUS's national security concerns have been insurmountable, made commitments regarding the composition of the Board of Directors (adding American citizens or guaranteeing that a Board will only be composed of Americans), or even committed to maintain research and development in the US. In other words, CFIUS can leverage the approval process to win concessions that further improve and guarantee US national security.

Since 1988, foreign companies have sent CFIUS several thousand notifications of intent to purchase US companies, but CFIUS has only investigated a few, and of these, it has blocked only one. That case involved the purchase by the China Aviation Technology Import-Export Corporation (the import-export arm of Beijing's Ministry of Aerospace), of MAMCO, a privately-owned, Seattle-based manufacturer of civilian aircraft parts. CFIUS's actual impact however may be greater, since many firms withdraw their offers if it looks like CFIUS may investigate them.

B. The regulation of SWF in the European Union

It is often argued that an EU committee on foreign investments is required to mirror arrangements in the US, for an EU-wide screening mechanism or some "golden shares"[52] mechanism for non-EU foreign investment. Such a mechanism is not anticipated at the European level. The internal debate experienced on this area within the EU had different aims from those of the US. There is a clear consensus of EU institutions towards a common approach. The European Commission took the initiative in a communication released in February 2008, which was supported by the European Council and the European Parliament later in the year.

52 These are non-standard shares, the ownership of which confers special rights on the holder. Recent landmark decisions of the ECJ regarding compatibility of "golden shares" with EC law are a clear indication that the concept of "golden shares" violates one of the four fundamental freedoms conferred on individuals by the EU Treaty, namely the free movement of capital. According to case law of the ECJ rules governing "golden shares", an actual exercise of any rights attached to a "golden share" by any public body must be based on criteria of non-discrimination and an effective legal remedy has to be guaranteed. The judgments do not present a straightforward prohibition of "golden shares", however, they set out strong limits on their application. *See* European Court of Justice, Commission v Netherlands, C-282/04 (September 28, 2006).

In February 2008, the Commission presented a communication entitled 'A common European approach to Sovereign Wealth Funds'.[53] In common with all the Commission Communications documents, this text is one with no legal significance sent by the Commission to the other European institutions. The aim of the Commission is to set out new programmes and policies. According to this 2008 communication, new legislative measures at Community level are unnecessary. The common approach recommended by the Commission was based on five principles:

- commitment to an open investment environment,
- support of multilateral work,
- use of existing instruments,
- respect of EC Treaty obligations and international commitments,
- and finally, proportionality and transparency.

The Commission is thus seeking to avoid legislative action and envisages soft measures, such as guidelines, accompanied by efforts at the international level to increase transparency of SWFs. It is important to note that the Commission's communication is recommending the common European approach as a complement to the prerogatives of Member States regarding the use of their national legislation.

The Council took over the ideas set out by the Commission, clarifying, in particular, two principles out of the initial five, along the following lines.

- On the one hand, rather than expressing its support for the multilateral approach in general, it preferred to express its position specifically on the work under way in the IMF and the OECD.

- On the other hand, rather than referring to the use of the existing instruments, and once again taking a more general approach, the Council thought it more appropriate to adopt as a basic principle the use of national instruments and EU instruments, if necessary.

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[53] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, A common European approach to Sovereign Wealth Funds, COM/2008/0115 final (February 27, 2008).

The European Council supported the objective of agreeing at the international level on a voluntary Code of Conduct for SWFs and defining principles for recipient countries at the international level. In this respect, they reiterated the EU's "support for the ongoing work in the International Monetary Fund (IMF) and the OECD". In any event, this is a clear rejection of a European wide screening mechanism that would echo the system in the United States.

The most important measure with respect to potential obstacles to SWFs' investment in the EU is Article 58 EC. It stipulates that the Member States have the right to put in place restrictions on grounds of public order or public security. A Member State is entitled to restrict Treaty freedoms on the basis of legitimate national security concerns. Free movement of capital, unlike the other freedoms of movement established by the EC Treaty, does not apply solely between Member States. It also prohibits restrictions on the movement of capital between Member States and third countries. This is true in respect of all investments, be they from SWFs, State-controlled companies, private companies or others. Furthermore a number of Member States have measures in place that, for example, restrict investments in the defence sector.

It needs to be emphasized here that the list of justification measures in Article 58(1)(b) EC is not exhaustive. However, whatever the ground relied on, the measure in question must be suitable for the purposes of attaining the objective which it pursues and not go beyond what is necessary in order to attain it: proportionality test. The Court has also provided criteria to assess the proportionality: national measures must aim at the protection of a legitimate general interest and foresee strict time limits for the exercise of opposition powers; assets or management decisions targeted must be specifically listed.

Article 58 has never been invoked in the context of SWFs. In other words, no Member state has ever adopted a law restricting FDI from SWFs nor has a Member State ever enforced a decision rejecting a SWF investment arguing as to the validity of the decision as an exception (Art. 58) to the principal of freedom of capital movement (Art. 57).

Recent experience shows that the opacity of some SWFs risks prompting defensive reactions. In October 2008, the Italian government announced first that SWFs wanting to buy shares in Italian companies should 'generally' stay below 5 per cent, suggesting that a new law should be passed. This was a reaction to the purchase by Italy's former colony, Libya, of a 4.23 per cent stake in the number two Italian bank UniCredit SpA.[54] However, shortly after this, Foreign Minister Franco Frattini said that while there was no need for a threshold there was a need for transparency.[55] Such a reversal should be interpreted as an abandonment of any plans to pass a new law. On the other hand, it possibly refers to the multilateral approach supported by the EU.

However the UK and France have already introduced legislation allowing them to fend off investments from SWFs. Germany passed a new law that came into force in April 2009. The Cabinet of the German Ministry for the Economy took a decision on Foreign Trade and Investment Law on 20 August 2008.[56] This decision is aimed at protecting strategic German industries from unwanted foreign takeovers. Since April 2009, the law gives the German federal government the right to veto any investment from non-EU or European Free Trade Association countries (i.e. Switzerland, Norway, Liechtenstein and Iceland) amounting to 25% or more of a company's stakes, if it deems that "public security" or "public order" is at risk.[57]

There is a risk of witnessing a different strategy being implemented in each of the Member States rather than a unique policy at the EU level, which, ultimately, would not help tackle reality. There is a need to make clear at the European level the sectors that ought to be protected from foreign takeovers and an attempt should be made to go beyond the existing vague criteria of public order and public security.

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54 G. Dinmore,Italy set to curb sovereign wealth funds FINANCIAL TIMES (October 21, 2008).

55 *No need to cap sovereign fund holdings* REUTERS AGENCY (October 23, 2008).

56 B. Benoit, *Berlin foreign investors' bill clears hurdle* FINANCIAL TIMES (August 20, 2008), http://www.ft.com/cms/s/0/ac2762d6-6eff-11dd-a80a-0000779fd18c.html?nclick_check=1 .

57 Thirteenth Act amending the Foreign Trade and Payments Act and the Foreign Trade and Payments Regulation (April 18, 2009). Based on the US model, Germany's plans could lead to further attempts across the 27-Member EU aimed at blocking foreign investment incursions into sensitive industries. US inspiration is obvious as foreign investors can now pre-notify the German administration, on a voluntary basis, before an intended acquisition to obtain legal certainty. Under Germany's proposals, "public order and security" are the principal criteria for triggering a review of foreign groups' investment plans.

Such a list of EU strategic sectors should be drafted, which may isolate energy, technologies and other relevant sectors from SWF entry. In addition, public mistrust of overseas investment and isolationist sentiment could cause an overreaction to the question of regulation. This could have far-reaching consequences not only financially, but also in terms of diplomatic and economic relationships with other nations. For instance, European leaders do not have the same policy towards Russia as they do towards the US.

As a result, there is a need to clarify the interpretation of Article 58 ECT, which provides for restrictions on the free movement of capital on grounds of public order. Because it has not been applied until now in the context of SWFs, it is worthwhile ensuring that Member States will not be tempted to make extensive use of it.

C. Multilateral rules: obstacles or opportunities?

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 do not deal 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. A bit earlier, the pioneering work of Edwin Truman, which provides a basis for evaluating the results of the IMF-sponsored dialogue, chalked out a blueprint for SWF best practices.[58]

The drive by the US and the EU to draw up the code of best practices, including a renunciation of political motives, has stirred resentment among

[58] Edwin Truman, *A blueprint for SWF best practices*, Number PB08-3 PETERSON INSTITUTE FOR ECONOMICS, (April 21, 2008).

some of the investors responsible for the funds, particularly in China and some Gulf States. The challenge for IMF in delivering this difficult task was known from the beginning, but it became even more complex in the context of the financial crisis.

The IMF principles encourage the funds to explain their investment criteria, and recommend that they avoid buying stakes in sensitive companies, such as Western defence contractors. They also vote on setting up a Standing Committee that will update the guidelines and liaise with Western governments and institutions such as the World Bank and IMF on issues of concern.

The principles make repeated mention of the need for greater transparency. The full list of principles includes recommendations that SWFs coordinate their activities with their respective governments and central banks to avoid interfering with domestic economic policy. The members have committed that funds should disclose their sources of funding and the conditions under which their owners can withdraw them. They have committed to make disclosures as applicable under local laws and regulations. Of key significance in this regard are Principles 11, 12, and 22. Further, sovereign fund managers should be independent of the fund owners, but fully accountable, publishing annual reports and undergoing annual audits.

To address the criticism among some economists that the funds' secrecy contributes to volatility in capital markets, the principles call for funds to disclose "relevant financial information" to "contribute to stability in international financial markets and enhance trust in recipient countries." Each funds' investment policies should be made public, including the extent to which they employ outside managers. The principles also address concerns about conflicts of interest arising between the funds and their government owners, calling for funds to avoid taking advantage of privileged information or influence when investing.

But the principles stop short of requiring an explicit pledge not to invest for political ends. The principles include a call for funds to abide by local rules and regulations and base their investments on financial and economic grounds. They even call on funds to disclose any investment decisions "subject to other than economic and financial considerations."

Above all the IMF guidelines are based on a standard definition of SWFs. They do not cover SOEs as made clear by a footnote. Consequently they could find themselves in the pointless situation of being rigorously adhered to, for e.g. by Norway's Government Pension Fund – Global, while Russia's Gazprom felt no need to take any notice of them. If so, the SWF guidelines will serve little more than a public relations purpose if they encourage sovereign investment to flow through other investment vehicles not covered by the guidelines.

It might then make sense to go on to redefine SWFs along broader lines. Robert Kimmit, the current Deputy Secretary of the Department of the US Treasury, suggests that SWFs could be conceived as "large pools of capital controlled by a government and invested in private markets abroad",[59] rather than as the funds that serve exclusively as investment vehicles for these pools. With "sovereign wealth fund" defined in this way, a code of conduct for SWFs would cover sovereign wealth at its source, regardless of the route it then took to reach any foreign investment target.

Edwin Truman made a preliminary assessment of the GAPP using the 33 elements in the "2008 Blueprint for SWF Best Practices". The GAPP receives a satisfactory "score" of 74. The GAPP rank within the top group of 22 pension and nonpension SWFs out of 46 such funds. It means that should each SWF comply completely with the GAPP, they would all move into that top group. As emphasized by Truman, "the fact that the GAPP does not score 100 on my rating system reflects reality. It is a compromise, a negotiated document".[60] The weakest area is with respect to accountability and transparency. Disturbingly, many of the principles are silent about disclosure to the general public or only call for disclosure to the fund's owner. That approach does not promote the needed accountability to citizens of the country with the SWF or of other countries.

It seems then that it would be in the interest of governments to make use of the multilateral code of Santiago principles, rather than being subjected to the EU or the US mechanisms. A robust implementation of the 'Santiago principles' should go far towards resolving questions about the transparency,

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59 Robert M. Kimmitt, *Public Footprints in Private Markets: Sovereign Wealth Funds and the World Economy* FOREIGN AFFAIRS (2008).

60 Edwin Truman, *Making the World Safe for Sovereign Wealth Funds* (October 13, 2008).

accountability, and operations of SWFs. The issue for the IWG is "voluntary" compliance with the GAPP. However, some signals are encouraging, since Abu Dhabi Investment Authority (ADIA) had expressed support for the Santiago Principles. Additionally, "to underline its commitment to full compliance, ADIA has established an inter-departmental committee to oversee compliance with the GAPP. Furthermore, ADIA is analyzing the feasibility of establishing a mechanism that would provide independent verification of its compliance with the GAPP".[61]

What can be seen at first sight as a burden could be turned into an advantage. Indeed complying with the Santiago Principles will mean accepting the multilateral rules accepted by all. Any SWF which would comply with such rules could expect a good treatment from both US and European authorities, and will not be subject to the uncertainties resulting from their procedures.

III. CONCLUSIONS

As the current financial turmoil demonstrates, financial liquidity is vital for Western economies. Recently firms on both sides of the Atlantic – for example Barclays and Citibank, seek out sovereign funds. Their finance was needed to allow these companies to fulfil their strategic aims. Even Russian sovereign funds have not attempted to buy into any strategic assets; they are taking very limited stakes in some companies and the European Commission and the national governments are watching this activity. But there is no evidence at the moment that these sovereign funds are being used for any nefarious purpose.

This paper does not explore all the potential rules applicable to SWF. For instance, it is questionable whether WTO law (and GATS through its mode 3 in particular) gives rights to SWFs and limit the scope of control governments have the right to exert.[62] There is a strong presumption for this but this complex issue calls for further research.

61 Available at http://www.adia.ae/ADIA_AE_press.asp.

62 Philippe Gugler and Julien Chaisse, *Foreign Investment Issues and WTO Law - Dealing with Fragmentation while waiting for a Multilateral Framework* ESSAYS ON THE FUTURE OF THE WORLD TRADE ORGANIZATION 135-171 (Julien Chaisse et al eds., 2008).

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 objective of this paper has been to depict the existing regulatory framework applicable to SWF investment in order to identify the main regulatory challenges an Indian SWF might face abroad. IMF principle 24 says that "A process of regular review of the implementation of the GAPP should be engaged in by or on behalf of the SWF". It is seems to us that there is a necessity to respect all the Santiago principles when setting up Indian SWF so as to take advantage of these minimal standards. Respecting each Santiago Principles will put Indian SWF in the category of "good SWF" and then limit regulatory obstacles it could face in the US market or the multiplicity of regulations in the EU market. Interestingly, the use of mere guidelines as opposed to hard regulation may *in fine* mark a milestone in rationalizing the integration of SWFs into the global capital markets.

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.

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.