Y V Reddy: Forex reserves, stabilization funds and sovereign wealth funds – Indian perspective

Address by Dr Y V Reddy, Governor of the Reserve Bank of India, at the Golden Jubilee Celebrations of the Foreign Exchange Dealers' Association of India, Mumbai, 8 October 2007.

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Shri Sridharan, Chairman, FEDAI, Ladies and Gentlemen

I am happy to be here today with the members of the Foreign Exchange Dealers Association of India, popularly known as FEDAI in the industry. FEDAI completes 50 years in 2008 and the Reserve Bank and FEDAI have shared a unique and symbiotic relationship all these years. Since the beginning of the reforms, FEDAI has partnered with the Reserve Bank to ensure adoption of best practices in the profession of foreign exchange dealing. FEDAI also plays a very important role as a communication channel between the Reserve Bank and the banks authorised to deal in foreign exchange. FEDAI continues to provide valuable insights in this vital segment of our financial markets.

I am happy that on the occasion of its Golden Jubilee Celebrations, FEDAI is releasing a monograph on its 50 years' history and a brochure on foreign exchange facilities, which will assist resident individuals who access these facilities. This is also expected to provide greater understanding and awareness among the Authorised Dealers' branch level staff dealing with customers and enhance the quality of customer service. The topic for the panel discussion today is pertinent in the current context and we in the Reserve Bank look forward to obtaining a feedback of these discussions.

There has been, in the recent past, a growing interest in the magnitudes and working of what may be broadly characterized as national foreign asset funds. Despite several overlapping features, they broadly consist of foreign exchange reserves, stabilization funds and sovereign wealth funds. While these funds have the characteristics of being in the public sector, the motives for establishment, sources of funding and institutional arrangements for managing them vary considerably though there is a great degree of consensus on these aspects as far as foreign exchange reserves are concerned. While there are difficulties in generalizations in regard to these funds, other than foreign exchange reserves, due to the sheer variety and complexities of features and arrangements in different countries, it is essential to appreciate the broad characteristics of these funds, in view of their growing importance in global financial flows. For the purpose of today's talk, "funds" would refer to Stabilisation Funds and Sovereign Wealth Funds (SWFs) that are to be considered separately from the foreign exchange reserves. Management of the foreign exchange reserves is subject to international best practices and disclosure standards and traditionally vests with the central banks or monetary authorities of the country. The distinction between Stabilisation Funds and SWFs is not very clear in practice but, for analytical purposes, such a distinction is useful.

The accepted definition of foreign exchange reserves includes external assets that are readily available to and controlled by monetary authorities for direct financing of payments imbalances, for indirectly regulating the magnitude of such imbalances through intervention in foreign exchange markets to affect the currency exchange rate, and/or for other purposes. To meet this definition, reserve assets need to be liquid or marketable foreign currency assets that are under the effective control of, or "useable" by, the reserve manager and held in the form of convertible foreign currency claims on non-residents. The management of the foreign exchange reserves is typically the preserve of the central bank or the monetary authority of the country.

Stabilization Funds, or commodity funds, are augmented mainly by "windfalls" from commodity exports, more commonly petroleum. These funds may invest in a wider range of assets than those in which the central bank would invest the foreign exchange reserves. However, considerations of liquidity and moderate risk are also relevant because Stabilization Funds may be drawn upon when such "windfalls" disappear and contingencies warrant. A Stabilization Fund is designed primarily to achieve medium-term macroeconomic stabilization objectives, arising out of domestic economic and financial effects of volatility in export earnings. However, if there are sustained "windfalls" on export front and consequently there is no draw down of funds, a Stabilization Fund may be converted into an endowment fund as done by Norway by rechristening the Petroleum Fund as Government Pension Fund.

SWFs generally refer to special purpose investment vehicles created to manage national savings to generate higher returns. The non-commodity SWFs are usually carved out of the official reserves of a country. Countries having large balance of payments surpluses have been able to transfer excess foreign exchange reserves to such investment vehicles. Typically, countries that have set up SWFs have surplus on the current account due to "windfall" or sustained current account surpluses, and usually a fiscal surplus as well.

Consistent with their objectives, the official foreign exchange reserves are generally deployed in low-risk liquid assets. Typically these reserves are invested in debt instruments representing sovereign/sovereign-guaranteed liability, in deposits with other central banks, Bank for International Settlements (BIS), supranationals and with highly rated foreign commercial banks. In some circumstances official foreign exchange reserves are also used as a tool of domestic liquidity management by way of forex swaps.

Stabilization Funds are normally expected to constitute a macro hedge against a sharp fall in the export receipts from commodities that are mainly exported. They are set up primarily to insulate the budget and the broader economy from excess volatility, inflation, Dutch disease, etc., by smoothening revenues flowing to the budget i.e. saving during a revenue windfall and dis-saving during a price slump.

SWFs seek returns over and above that required to preserve the real value on a sustainable basis. SWFs attempt to invest in a wide spectrum of high yielding assets, for example, longer term government bonds, agencies and agency-backed securities, corporate bonds, equities, commodities, real estate, private equity, hedge funds, etc. The investment horizon is extended so as to enable sharing of wealth across generations or to achieve other long-term objectives. To illustrate, the Economist of September 29-October 5, 2007 refers to the SWFs as "The new Rothschilds" and sub-titles the write up as "State-run funds are pumping money into the financial sector".

Whatever might be the medium-term or long-term objectives of Stabilization Funds or SWFs, they could be utilized as official reserves as they are either under the control of the monetary authority or can be made available to the monetary authority in case of need. Hence, these funds are sometimes described as "quasi reserves". It is, therefore, useful to view all the three as components of national foreign asset funds.

In most countries, the allocation of roles and responsibilities of agencies overseeing the foreign exchange reserve management function are explicitly stated in the laws and guidelines governing the reserve management entity. While it is usually the central bank or the monetary authority which is entrusted with the task of management of the foreign exchange reserves, in some countries, where foreign exchange reserves are owned by the government, management responsibilities between the central bank/monetary authority and government are clearly spelt out and disclosed. As custodians of the official reserves, the central banks are accountable to their governments or central legislatures even if the degree of autonomy of the central banks varies from country to country. In addition, central banks, by virtue of their relationships with international organizations, like the International Monetary Fund and the Bank for International Settlements, benefit by sharing best practices in

reserves management, in particular, and central banking in general, all of which greatly contribute to fostering transparency and stability in the international financial system.

In contrast to the foreign exchange reserves, Stabilisation Funds and SWFs may or may not be subjected to such rigorous accountability and transparency tests, internally, by the governments concerned. The main reason for lack of clarity is that global benchmarks for disclosure are yet to evolve, to which they may be expected to conform.

Even as the size of the official sector reserves and the stabilization/sovereign wealth funds has grown considerably in recent years, fundamental issues like what really constitutes “international reserves” are yet to be settled. It is universally accepted that, to be included as part of the international reserves, the foreign assets of the Stabilization Funds / SWFs should be easily available to the monetary authorities in the form of liquid foreign currency claims on non-residents. In simple words, if the assets are part of the balance sheet of the central bank and fulfill certain other criteria, then they are to be treated as international reserves. If, however, the same assets are held by a long-term fund, which is a separate corporate entity, then they may not be reckoned as part of the international reserves from liquidity point of view. However, since these assets are either under the control of central banks or can be made available to central banks, it cannot be said they are not available when needed as reserves.

Basically, all foreign asset funds are owned by the public sector and, depending on the country context, these are allocated among the Stabilization Fund and SWF. It is not uncommon for a part of a wealth fund to be created out of foreign exchange reserves or Stabilisation Funds. Much depends on a view being taken about the “windfall” gains component due to commodity prices justifying a Stabilisation Fund and the transferring of commodity wealth into a more permanent flow of income for future generations. SWFs may also be carved out of foreign exchange reserves, to have a special focus on enhancing returns by accrediting more flexibility. The choices between and allocations among these vehicles of foreign assets in public sector are thus essentially a matter of domestic policy. In this context, analytically it will be useful to address the links with fiscal policy, in terms of rules governing inflows and outflows form fiscal to these funds. Similarly, there could be links with monetary policy when the funds are carved out of foreign exchange reserves held by the central bank. The investment policies of the funds are perhaps most critical from the point of view of public policy. In all cases, it is reasonable to presume that, being part of public sector assets, the funds would be subject to the appropriate standards of governance, transparency and accountability. However, there may be legitimate concerns in case such a fund is observed to be operating in a non-transparent manner or with predominantly non-commercial considerations.

It is argued that some of the asset funds are similar to hedge funds and they themselves invest in hedge funds, thus inviting regulatory concerns similar to those pertaining to hedge funds. The major issue is whether there should be a presumption in favour of or against a foreign public sector vis-à-vis a foreign private fund. The critical issue relates to standards of governance and transparency that are adopted by such funds and the extent of comfort that investee countries have in this regard.

The role of central banks in the establishment and operations of these funds cannot be ignored. In some cases, central banks advise the government in the design and establishment of Stabilisation Funds or SWFs. In some other cases, they also operate as fund managers, but subject to formal principal-agent agreements. In a few cases, the central bank creates a separate unit within itself to manage a fund. In view of the expertise and credibility, involvement of a central bank in such funds to a significant extent appears logical.

In India, under the RBI Act, 1934, the Reserve Bank of India has been entrusted with the responsibility of managing the country’s foreign exchange reserves. The Reserve Bank also consults the Central Government on important matters relating to the management of foreign exchange reserves. It follows the internationally accepted measures of compilation and

dissemination of data relating to foreign exchange reserves. The Reserve Bank has voluntarily opted for IMF's Special Data Dissemination Standard (SDDS) that enjoins upon it adherence to internationally accepted best practices in this regard. In 2004, after a review of the main policy and operational matters relating to management of the reserves, including transparency and disclosure, the Reserve Bank decided to compile and make public half-yearly reports on management of foreign exchange reserves for bringing about enhanced level of disclosures. These reports are being prepared with reference to the positions as of 31st March and 30th September each year, with a time lag of about 3 months. Again with a 3-month lag, the Reserve Bank places on its website sources of accretion to foreign exchange reserves. In addition, the Reserve Bank has been disclosing its risk management policy with regard to foreign exchange reserves in its "Annual Reports" for the past several years. To summarize, the country's foreign exchange reserves are managed according to the law; the Reserve Bank adheres to the internationally best practices of measuring the reserves and data dissemination standards; and the Reserve Bank follows appropriate prudential norms in the management of the foreign exchange reserves.

However, of late, there have been suggestions that India should consider setting up a wealth fund on the lines of either a Stabilization Fund or a SWF. As mentioned, the objectives of establishing Stabilization Funds are to mainly smoothen the revenue flows arising out of volatility in commodity export proceeds. India's export basket is diversified and does not have a dominant "exportable" natural resource, which might bring "windfall" gains. Further, India has experienced consistent current account deficits, barring a modest surplus for a few years. Hence, creating a Stabilisation Fund may not be justified on the basis of current situation. SWFs are generally created amidst current account surpluses when the foreign exchange reserves attain a level higher than what is perceived as "adequate". If we follow this global experience, consideration of an SWF for India may ideally await "more comfortable current account" and "significantly improved fiscal" situations.

It is sometimes argued that in the context of significant growth in foreign exchange reserves in recent years, the portion of the reserves that is in excess of a certain recommended level may be carved out and invested separately for maximizing returns. In this regard, it is necessary to view the concept of "excess reserves" from several angles, including from the perspective of possible real sector shocks to the current account and the nature of capital flows. India is vulnerable to shocks on account of oil price and fluctuations in food grains production, which is still largely dependent on monsoon conditions. Additionally, a large part of the capital flows are portfolio flows and a significant component of Foreign Direct Investment is in the nature of private equity or for acquisition of existing firms and not in greenfield projects. In a sense, therefore, capital account shocks, which would be independent of the economic fundamentals of the country or domestic macroeconomic environment, cannot be fully ruled out.

Concluding remarks

To sum up, it is necessary to recognize that Stabilisation Funds and SWFs are playing an increasingly important role in global capital flows. The operations of these funds have generated considerable interest among the policy makers and central banks. India has a stake in the on-going debate by virtue of its increasing importance in the global capital flows. More generally, in India, we have been seeking comfort in respect of the nature of investment associated with capital inflows through hedge funds channels and participatory notes. Similar issues could also be relevant in respect of private equity flows. While it is essential to recognize the public sector nature of the Stabilisation Funds and SWFs that may be investing in India, it is also useful to study the evolving global practices of investee countries' approaches to these funds.

At this moment, as mentioned in the foregoing, circumstances in India do not seem to warrant a serious consideration of establishing either a Stabilisation Fund or a SWF.

However, if and when such a consideration is given, it would be essential to put in place sound governance, transparency and accountability standards that would provide necessary comfort to the domestic fiscal and monetary authorities and, additionally, to the investee countries.

I would like to thank the organizers for giving me the opportunity to share some of my views on a subject of emerging importance and in regard to which we have just begun the learning process.

I wish the FEDAI's Golden Jubilee Celebrations a grand success.

On the occasion of FEDAI's Golden Jubilee, I have the pleasure of presenting to FEDAI, on behalf of RBI, a set of Commemorative Coins brought out on the occasion of the 50th Anniversary of India's Independence.

Thank you.