India must set up pvt MF for overseas investments: IMF

Priti Patnaik
14 November 2005
The Economic Times

NEW DELHI: The chief economist of the International Monetary Fund (IMF), Raghuram Rajan, has asked India and other forex rich countries to launch closed-end, privately-controlled mutual funds to invest abroad, to earn better returns for their reserves.

In a recent paper, Mr Rajan and senior economist Eswar Prasad have said this will free central banks from having to park a large part of their funds in US dollars. The fund should be open for domestic investors to subscribe to.

This would not only help domestic investors to get higher returns by being able to invest overseas, it would also retain the government’s control over the capital account. This would ensure protection against sudden capital outflows and yet make the economies move towards greater foreign exchange flexibility.

The paper has proposed that the central bank could either license a private fund management company, or use a foreign fund manager, to start the closed-end MF. The fund would raise money by issuing shares to domestic investors in the local currency and then use the proceeds to purchase foreign exchange from the central bank for investing in overseas stocks and bonds.

There have been concerns in international markets on whether the dollar would be able to retain its pre-eminent position, despite the huge current account deficit of the US government. This is reflected in the US current account deficit, now at over 6% of its GDP. In absolute terms, it is a staggering $164.7bn in the third quarter of last year, of which nearly 10% was on account of China alone.

India’s forex reserves stand at nearly $143bn currently. According to forecasts by JP Morgan for ‘05, it is set to increase to $150bn, while other Asian countries like China, Korea, Singapore and Hong Kong are projected to have $831bn, $211bn, $108bn, and $126bn of reserves, respectively.

Mr Rajan has also said that using forex reserves to translate domestic currency funds into dollars, euros or yen for overseas investment, would address inflationary concerns and remove excess money from the banking system that comes from currency interventions.

"Countries can move towards eventual full capital account convertibility in a carefully calibrated manner, without exposing the domestic financial system to risks associated with uncontrolled outflows," the authors have said.

Global imbalances in international accounts which have developed are partly attributed to the large forex reserves held by Asian countries. They said it would be vital to maintain a clear gap between the government and the fund management companies.

"Having a clearly defined legal arrangement that minimises expropriation risk would be necessary to avoid the risk premium investors will demand if they feared that the fund’s assets could be taken over by the government at will," the economists said.

The economists said the reserves can insulate a country against shocks only to a certain extent. A build-up of reserves could become a strain on government finances and create a perception of exchange rate manipulation in some cases, they added.