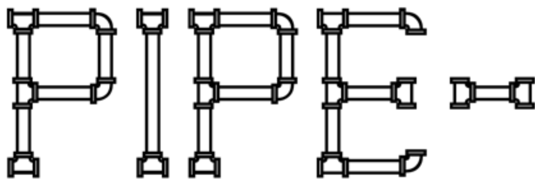

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Bernhard Reinsberg

Sovereign Wealth – No Fund
The Decisive Role of Domestic Veto Players

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Abstract

Sovereign Wealth Funds (SWFs), government-owned investment funds, are of growing importance in international finance. They are a vehicle to manage foreign exchange reserves and wealth which have been accumulating in the emerging world, particularly in the BRICs. However, while China and Russia set up SWFs over the last decade, India and Brazil still lack such funds. In analysing thoroughly the Indian case, this paper seeks to contribute to recent literature on the determinants of SWFs with two main findings: First, it confirms conventional economic theory which shows the requirement of excessive foreign reserves for the set-up of SWFs. Second, it suggests that political systems matter, as demonstrated by the lively debate in India on whether that country should have such a fund. In this way, influential societal actors, in particular the central bank and regulating agencies as well as business associations, have dominated the public discourse and successfully lobbied the government to waive initial plans in support of an alternative wealth management scheme.

JEL Classification: E58, F30, F31, F36

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List of Abbreviations

BRIC	Brazil – Russia – India – China
BJP	Bharatiya Janata Party
CIC	China Investment Corporation
CII	Confederation of Indian Industry
FEDAI	Foreign Exchange Dealers Association of India
FEMA	Foreign Exchange Management Act
FICCI	Federation of Indian Chambers of Commerce and Industry
FDI	Foreign Direct Investment
FSB	Fundo Soberano do Brasil
FX	Foreign Exchange
GDP	Gross Domestic Product
INC	Indian National Congress Party
IPE	International Political Economy
ISC	Inter-State Committee
MSCD	Most Similar Cases Design
NDC	National Development Council
NWF	National Welfare Fund (the SWF of Russia)
PBoC	People's Bank of China
RBI	Reserve Bank of India
SEBI	Securities and Exchange Board of India
SOE	State-Owned Enterprise
SPV	Special Purpose Vehicle
SWF	Sovereign Wealth Fund
UNIDO	United Nations Industrial Development Organisation
V&A	Voice and Accountability (World Bank Governance Indicator)

1. Introduction

Sovereign Wealth Funds (SWFs), government-owned investment funds, are of growing importance in international finance. Their accelerated set-up has appeared in tandem with the accumulation of large foreign reserves over the last decade in emerging market economies, with Brazil, Russia, India and China (BRICs) accounting for the bulk of growth. SWFs have been already considered the "natural institutional blueprint" (Park 2008b: 2) for managing excessive foreign reserves, but sovereign wealth in the BRICs has been treated somewhat differently. While China and Russia set up SWFs over the last decade, India and Brazil still lack such funds. Given that both countries display similar macroeconomic contexts compared to those which would conventionally evoke the creation of SWFs, they constitute an empirical puzzle, which this paper seeks to address in analysing thoroughly the Indian case. Asking why India still lacks a SWF, this paper seeks to contribute to recent literature (cf. Aizenman/Glick 2008) on the determinants of SWFs with two main findings: First, it confirms conventional economic theory which shows the requirement of excessive foreign reserves for the set-up of SWFs. Second, it suggests that political systems matter, as demonstrated by the lively debate in India on whether that country should have such a fund. In this way, influential societal actors, in particular the central bank and regulating agencies as well as business associations, have dominated the public discourse and successfully lobbied the government to waive initial plans in support of an alternative wealth management scheme.

The lessons from the Indian case inductively lead to the argument that SWFs are less likely to be set up in democratic political systems with opposing and internally coherent veto players, magnified by less favourable foreign reserve patterns compared to situations of FX abundance such as for China or Russia. Given similar findings for the Brazilian case as an ad-hoc control case, this paper underlines the need to more systematically capture the political systems and the domestic institutional contexts in addition to pure macroeconomic fundamentals underlying SWFs.

2. The Political Economy of Sovereign Wealth Funds

SWFs are at the heart of international political economy (IPE) – at the "intersection of high finance and high politics" (Drezner 2009: 115). Their recent growth has been tremendous, and they are expected to grow further in the near future.[1] Currently, SWFs manage roughly USD 3 trillion (BdF 2008: 3), raising concerns in the industrialised recipient economies. Their growing importance for global financial markets has fuelled a debate on their determinants (cf. Aizenman/Glick 2008).[2]

Sovereign Wealth Funds (SWFs) can be defined as government-owned investment funds, which are drawn from foreign exchange assets and which invest globally in a purposeful way.

This definition reflects some core elements mentioned in the literature: SWFs have to be financed by foreign reserves and to invest globally. This cancels out public pension funds or sovereign pension funds,

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[1] The literature converges to an amount of USD 12 trillion in assets under management (AuM) at the end of 2015 (cf. Jen 2007). Therefore, SWFs already outperform hedge funds as regards AuM (IFSL 2008: 3).

[2] The phenomenon of SWFs is well-known: The first funds occurred earlier in history, in the Middle East in the 1950s and later in East Asia in the 1970s (Monitor Group 2008: 17-18; Kern 2007: 7). However, the label „SWFs“, shaped by Rozanov, has appeared only recently and reflects the unprecedented growth in their number and their assets under management (cf. Rozanov 2007).

which draw upon domestic currency contributions, for example from citizens, and locally-investing government holdings or state-owned enterprises (SOEs).[3]

However, in differing slightly from conventional definitions, this definition is advantageous for the purpose of this paper. In particular, the rather general requirement to invest in a purposeful way allows capturing both economic and political objectives to be pursued through a sovereign fund; SWFs thus can be seen as a vehicle for long-term wealth management, as well as for short-term political power play.

In line with this definition, SWFs run counter to other forms of sovereign finance: SWFs have to be distinguished from SPVs, or Special Purpose Vehicles, which indeed are financed from foreign exchange, but invest at home rather than abroad. Their name indicates that the use of foreign reserves is strictly confined to a special domestic purpose which entails domestic expenses.

SWFs inevitably base on excessive foreign reserves. Those have been accumulated at unprecedented growth rates in the last years, particularly in emerging market economies (Griffith-Jones/Ocampo 2008: 4). They have been driven by two factors.[4] On the one hand, persistently high commodity prices have produced huge US-Dollar surpluses in the Middle East, Latin America, and particularly Russia (Griffith-Jones/Ocampo 2008: 17).[5] On the other hand, reserves have grown throughout Asia, particularly in China and India, as a by-product of deliberate central bank interventions that have been serving various purposes. One is "precaution", providing a buffer for the country in times of a speculative attack on its currency (Cruz/Walters 2008: 666). Another purpose is "political autonomy", as governments opting for open capital accounts try to maintain some monetary independence, mitigating domestic adaptational pressure and reducing the dependence on international financial institutions (Cruz/Walters 2008: 667).[6] One final motivation is based on an "export-led growth model", which aims at export promotion through undervalued exchange rates (cf. Dooley et al. 2003).

Excess foreign reserves are a necessary condition for the rise of SWFs. In addition, with respect to sufficient conditions, economists and political scientists have pointed to particular purposes sovereigns may pursue with SWFs.

How to manage the newly-aroused sovereign wealth?[7] As SWFs "have a long history of […] maximi[zing] risk-adjusted returns", they provide a "natural institutional blueprint for shifting surplus reserves from liquidity management toward profit-seeking investment" (Park 2008b: 2). From an economic perspective, the rationale for a SWF differs sharply with the origin of its assets – a bipolar distinction is made between SWFs drawn from natural resource exploitation (commodity funds) and for SWFs drawn from exchange rate intervention (non-commodity funds) (cf. Rozanov 2007).[8]

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[3] As pension funds are legally restricted in their investments and government holdings invest locally, they are not conceived as a potential threat and thus did not occur in the current debate on SWFs (cf. Setser 2008; Drezner 2009).

[4] In their study, Aizenman and Glick run a formal probit analysis with respect to the set-up of SWFs on the basis of an economic explicative model. They find that fuel exports, the current account, and foreign reserves, each as a share of GDP, strongly correlate positively, whereas for example per capita GDP is insignificant (Aizenman/Glick 2008: 41).

[5] Those windfall revenues from resource extraction normally fuel the budget of the government, either as their owner or via heavy taxation on extraction profits (cf. Aizenman/Glick 2007).

[6] The necessity to acquire foreign reserve assets then follows from the "unholy trinity" in IPE that has been developed by Mundell and Fleming.

[7] Instead of creating wealth, SWFs serve the purpose of wealth management (Monk 2008: 8).

[8] Jen and Bindelli further add funds drawn from capital imports (cf. Jen/Bindelli 2007).

Commodity funds have been traditionally used for the purpose of revenue stabilisation, dampening the price volatility of a major exported commodity (Balding 2008: 12).[9] For this reason, they invest in relatively liquid assets (US Treasury 2007: 1).

Given persistently high levels of commodity prices, many funds have increased their capital base and have started with inter-generational saving. In this way, they help resource-rich economies to succeed in transforming rents into productive assets (UNIDO 2008: 3). Fully converting excess foreign currency into domestic currency would run contrary to sustainable development, as either under-investment, widely-known as the "Dutch Disease", or over-investment would be produced (Gieve 2007: 197; Griffith-Jones/Ocampo 2008: 17-22).[10] For this reason, foregoing a portion of excess foreign reserve assets, known as balance-of-payments sterilisation, helps to conserve wealth for future generations (cf. Kimmitt 2008). SWFs provide a solution to the problem of balancing under-investment and over-investment in resource-rich economies by seeking higher returns abroad and diversifying from domestic projects.[11]

Non-commodity funds contrast sharply with commodity funds – excessive foreign exchange accumulation in this case is the consequence of the deliberate and strategically chosen policy of running an undervalued currency. The motivation for non-commodity funds typically stems from the desire to cover the opportunity cost incurred by the foreign exchange intervention. In order to avoid domestic inflation, central banks have to issue public debt, in this way absorbing the domestic liquidity increase (US Treasury 2007: 1). However, those opportunity costs rise with the amount of debt outstanding, as domestic debt holders demand higher returns on their investment.

The need for higher returns calls upon a sovereign fund, whose net return equals the difference between the yield earned abroad and the yield paid on domestic debt (cf. Kimmitt 2008). In the case of China, for example, the interest rate differential between domestic debt and US Treasury bonds exceeded two percent in 2006, leaving opportunity cost of around two percent of GDP (Martin 2008: 6; Farrell/Lund 2007: 6). Given the generally high marginal propensity to save throughout Asia, SWFs can be conceived as an instrument for risk-adjusted return on foreign exchange.[12]

With the rise of SWFs, the direction of international capital flows has reversed, contradicting conventional wisdom.[13] Massive foreign reserve overflows also reflect global imbalances, particularly with the United States of America as the largest debtor in the world. Political scientists therefore debate on political rationales for SWFs and which purpose they might serve.

According to the liberal view of international political economy, SWFs are generally seen positive through their impact on long-term development and global peace. This view is supported by the example of a resource-rich society: Their economy lacks downstream integration, given the high standardisation of commodity outputs (UNIDO 2008: 4). SWFs can help to diversify the economy through direct investment abroad or through the indirect effect of foreign exchange sterilisation. Moreover, SWFs reflect

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[9] Stabilisation funds help to smoothen national income from resource exports through a price cap: Above a certain price level, excess revenue is channelled to the fund, whereas below they are used up to support the budget.

[10] First, under-investment occurs if national income is preferably used for consumption. Then demand for non-tradable goods increases. This either shifts resources to the further resource extraction and the production of non-tradable goods, or results in rising inflation and thus contracting investment (UNIDO 2008: 4).
Second, over-investment is the case of over-preferring investment, causing a construction boom. Investment demand exceeds capacities, hence productivity falls and returns become negative (UNIDO 2008: 4).

[11] Russia is an ideal-type example: In the midst of the global resource boom, Russia has supplemented its stabilisation fund with an inter-generational saving fund.

[12] These SWFs thus are supposed to realise at least the domestic rate of return (e.g. CIC) (Martin 2008: 6).

[13] This is widely-known as the Lucas paradox – capital was supposed to flow to where it receives the highest yields, notably from the developed world to the emerging markets (Gieve 2008: 197).

common interests of sending and recipient countries through the set-up of long-term financial ties (Setser 2008: 4). Nonetheless, liberals worry about state capitalism (cf. Lyons 2007).[14]

The neo-realist view conceives SWFs as a mere foreign policy tool that can be used for shareholder activism for the purpose of indirect pressure on foreign governments.[15] They have thus the potential to challenge the current power distribution among states. In an anarchical international system, rational and unitary states seek their survival and are incited to set up their own SWFs if a neighbouring state has done so. The overall level of security is thereby worsened, increasing further the incentive to set up SWFs. This is known as a security dilemma (Herz 1951: 4).[16] However, restricting foreign investment as a possible response results in financial protectionism, giving rise to a welfare dilemma (Rittberger/Zangl 2003: 281).[17]

The core doctrine of mercantilism is the pursuit of national independence and self-sufficiency, which historically gave rise to the "import-substituting growth model" (Singer 1969: 347). SWFs play a role in the acquisition of knowledge necessary for development and import substitution through stakes in the industrialised world. On the recipient side, there is the fear of strategic vulnerability (Setser 2008: 5), giving rise to the formation of national champions (Lavelle 2008: 132). Furthermore, SWFs increasingly act as global lenders (Karake-Shalhoub 2009: 366), contributing to a diminishing role of international financial institutions.

3. Sovereign Wealth – No Fund

Following empirical evidence, an excessive FX level is necessary for the creation of a SWF, though insufficient on its own, as there are at least two countries which nonetheless lack SWFs ("no-SWF option"). According to a recent large-N study, SWF countries on average "are characterised by relatively low democracy performance" (Aizenman/Glick 2008: 26). On the one hand, this low democracy score within the SWF universe suggests democracy as a determinant for the no-SWF option. On the other hand, as a matter of fact, Norway and Chile were both democratic when they set up their SWFs.[18] Therefore, the relationship between regime type and SWFs under FX abundance is far from clear-cut and needs to be refined, calling for a general discussion of the domestic political contexts underlying the set-up of SWFs. The most promising way to proceed is to combine the democratic veto player concept, which has been developed by George Tsebelis, with existing work on political rationales for SWFs outlined earlier.[19]

Veto players are actors whose formal or informal approval is required for policy change. They are more likely to resist policy change if the prospective outcome departs from their optimal position with respect to the status quo and if they enjoy higher levels of internal homogeneity (Tsebelis 1995: 289).[20] The veto player concept builds a link between influential veto players and particular policy outcomes, giving rise to the following hypothesis:

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[14] Particularly, state capitalism contradicts the idea of limited government intervention (Setser 2008: 19). SWFs tend to distort the market, as their owners regulate the markets from which they operate (Rose 2008: 53).

[15] This fear is widely spread among market participants, as a recent survey has shown (Drezner 2009: 117). Another means related to SWFs is the sudden interruption of foreign currency acquisition (Setser 2008: 20).

[16] For a concise introduction to neo-realism, refer to Segbers et al. 2006: 13-14.

[17] The welfare dilemma occurs as states facing foreign regulation start building up barriers to investment.

[18] Norway scored highest (10; 1990) and Chile almost highest with upward trend (9; 2006) (cf. Marshall/Jaggers 2009c; swfinstitute 2009).

[19] The paper implicitly adopts the following preliminary assumption: In a given democracy, policy outcomes evolve from the interplay of competing societal interests, subject to the discretionary power of an (institutionally constrained) sovereign. The latter is thus exposed to the risk of failure to achieve its preferred policy outcome.

[20] In either case, it becomes more costly for the sovereign to buy out the discontented veto group.

> For a given democracy, the more there are veto players that prefer the no-SWF option over the set-up of a SWF and the more homogenous they are, the more likely is the absence of a SWF to persist.

The veto players differ from one political system to another. Distinctions can be made between individual and collective veto players, constitutional and informal veto players.[21] Further theory-building is necessary on the question which groups systematically oppose SWFs, and how likely they are to succeed in a given institutional context.[22]

First, parliaments frequently have the right to vote financial bills. Therefore, they qualify as constitutional veto points. They are expected to oppose SWFs, as those funds "impair democracy promotion efforts", "abet the persistence of rentier states", and spread the attitude that "governments do not need citizens to raise revenue" (Drezner 2009: 125). Parliaments tend to represent a broad constituency and thus to be heterogeneous.

Second, central banks have an institutional self-interest of holding the monopoly for reserve management, causing opposition against SWFs for two reasons. First, they could lose this monopoly as they traditionally lack expertise in sovereign wealth management. Even if they have expertise in wealth management, sovereigns possibly decide to separate this task from reserve management, which is an internationally acknowledged best practice (cf. Truman 2008).[23] Second, central banks fear to be blamed for the more likely failure to respond to a currency crisis, given a shortage in foreign assets they approved in the past.

Third, local governments in some cases possess considerable autonomy and power vis-à-vis central governments, particularly in terms of fiscal federalism. They usually have to respond more directly to the concerns of the district they represent in order to be re-elected. Instead of investing abroad with a SWF, they may wish to channel funds to social expenditure or infrastructure projects for their constituency. Even if they are indifferent towards the set-up of a SWF, they can strategically exploit their veto power and claim additional concessions from the central government for their approval.

Fourth, in neo-corporatist state settings, for example, some unions and corporate associations have preferential access to the state and thus constitute veto points. Worker unions are generally expected to oppose the set-up of SWFs. Labour suffers from the drawbacks of international capital mobility through increased wage pressure and job precariousness, which are hardly escapable due to the immobility of labour and land. Furthermore, spurred by privatisation and financialisation (Wade 2007: 259-264), domestic ownership of the economy has in some countries shifted to foreign ownership.[24] As a consequence, economic nationalism among unions has been on the rise, providing an option to keep control over national assets. Hence, while they promote locally-investing state-owned enterprises with the aim to minimise foreign control, they oppose SWFs. In their eyes, SWFs are the purest form of state-led "neo-liberalism", extracting money from domestic sources for global investment, seeking the highest possible returns.

With regard to private business, SWFs are supported if the associated profits rise or tax burdens ease. First, as SWFs envisage long-term revenue, tax cuts in the short run seem more improbable within a period of short-term loss. Second, the opening-up of foreign markets through outward investment rather

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[21] For example, formal veto players include parliaments, coalition partners, independent central banks, supreme courts, while informal veto players comprise influential societal actors such as think tanks, corporations, business associations and unions.

[22] The paper adopts the assumption that both actors and institutions constrain and enable individual behaviour (Segbers et al. 2006: 15), extending the pure rational choice logic. It is hence interested in "veto points", made up of veto players and institutions.

[23] Compliance with this best practice can help to mitigate perceived governance risks in recipient countries.

[24] For a detailed description of such liberalisation led by mainly US-American multinationals, reference can be made to "The rise of disaster capitalism" (cf. Klein 2008).

benefits the directly involved acquirer – usually a state-owned enterprise – rather than the broad economy via multiplier effects. For these reasons, private business and related associations rather resist a SWF, whereas beneficiary corporations favour it. There are many other possible intra-economy distinctions (with similar results) that this paper skips;[25] in a nutshell, the consequences of political decisions on investment seem to be decisive, as investment inevitably stems from public or private saving, additional taxation, saving abroad, and foreign exchange (cf. fig. 1). SWFs seem to be incompatible with domestic investment promotion efforts in terms of their common use of foreign reserves.

Having considered a wide range of potential veto points, the above-outlined mechanisms only operate in the realm of democracy, because autocratic leaders usually ignore actual veto points without consequences. The democratic veto player hypothesis, in contrast, is a necessary and sufficient condition for explaining the no-SWF option.

4. Sovereign Wealth – No Fund: The Indian Case

Sovereign wealth has been treated differently throughout the BRICs, which have produced 70% of the recent FX overload (Farrell/Lund 2007: 6). SWFs as defined in the second chapter currently exist in China (CIC[26]) and Russia (NWF), in contrast to India and Brazil where they are yet to be established.

The following comparison in MSCD between China and India is intended to highlight the empirical puzzle posed by the case of India. Indeed, the Brazilian case would serve almost equally well in this role, however, it is a less outlying case than the Indian one with respect to conceptually interesting factors such as "FX pattern" and "regime type".[27] Furthermore, China and India have important economic commonalities which are lacking in the Brazilian case relative to any other BRIC country, making such a MSCD comparison highly illustrative.[28]

India, like neighbouring China, was a relative beneficiary of the Asian financial crisis in the late 1990s, as it had previously set up capital controls and thus escaped a macroeconomic debacle. The crisis impacted both countries in a similar way, leading to aggressive foreign exchange accumulation (Denoon 2007: 22). There is consensus among scientists that the current foreign reserve levels exceed what is needed for stabilisation and crisis management.[29] In 2006, India had acquired USD 170 billion (equalling 18% of its GDP), China had even acquired USD 1,066 billion (equalling 39% of its GDP).[30] These figures clearly show that India belongs to a high-reserve country group along with China, whose higher relative reserve level can be seen as a consequence of its higher share of trade as of GDP (Gu 2007: 366).

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[25] An early one is from Hirschman, distinguishing economically advanced and backward sectors of the economy which both pressure for investment. Hirschman points to the fact that investment can stem either from "new and higher taxes" or from "other permanent revenue-raising devices" (Hirschman 1969: 264, 293-294).

[26] China exhibits six sovereign funds, with CIC being the most recently set up fund and the most active investor up to date. CIC has acquired stakes in Blackstone, Morgan Stanley and other financial institutes (cf. swfinstitute 2009). For a detailed report, reference can be made to Martin (cf. Martin 2008).

[27] First, the Brazilian "mixed economy" (Aizenman 2008: 13) is less comparable to both the Russian and the Chinese one. As to regime type, India appears more exceptional than Brazil as well, given the "miracle" of over half a decennium of stable and vivid democracy some observers point to.

[28] MSCD aims at identifying high variation for a particular dependent variable (under otherwise equal conditions). This variable then explains variation of the dependent variable (van Evera 1997: 57).

[29] There are different concepts for determining the optimal degree of foreign reserves. For example, both the Greenspan-Bindetti rule and the number of import months covered by foreign exchange indicate that the levels are exaggerated in China and India (cf. Jeanne 2008; Farrell/Lund 2007: 6).

[30] The figures are from UNdata, reflecting the most recent available (cf. tab. 3).

India displays a similar macroeconomic environment like China. Apart from excessive foreign reserve accumulation, their economies are characterised by high domestic saving and persistent export-led growth, entailing similar motivations to set up SWFs. Their international political weight underpinning their economic power has been increasing and shaping their global interests in a similar way.

China and India both pursue the export-led growth model, enabled by undervalued exchange rates and high domestic saving. India gradually shifted away from import-led growth during the late 1970s, and growth accelerated rapidly in the early 1990s, in the aftermath of a severe balance of payments crisis (Ahluwalia 2007: 87; Mukherji 2007: 119-129). Likewise, the Chinese authorities initiated the "outward opening" in the 1960s and officially introduced an export-led growth strategy in 1987 (Fischer 2007: 334). Therefore, a non-commodity SWF would be equally beneficial to India as it already is to China, given the preceding strategic policy choices to intervene in the FX market in both cases.
China and India both possess the asset of high domestic saving. While the Chinese population traditionally saves around 40%, Indian gross domestic saving has steadily increased from 23% in the late 1990s to 35% in 2006 (cf. Economist 2009a). Together with undervalued exchange rates and outward capital controls, national wealth is "concentrated in state hands" (Setser 2008: 39).[31] This in turn enables sovereign investment. Moreover, private and corporate saving from abroad as a share of GDP similarly endow China and India (cf. UNdata 2009).
Due to their economic success, China and India are both considered as "rising powers" that have the open ambition for world power status (Denoon 2007: 115-119).[32] Both have the potential to challenge the "soft power" of the leading industrialised countries and international financial institutions (Setser 2008: 33).[33] As follows from their vast internal market, they basically have less incentives to integrate globally, and this has raised concerns and fears abroad. From a liberal perspective, they could seek global financial integration in order to mitigate those concerns.[34] From a neo-realist perspective, SWFs for both India and China could enlarge the set of foreign policy tools, as both equally are destinations for sovereign investments from abroad (cf. Raphaeli et al. 2008). From a mercantilist perspective, SWFs could contribute to technology acquisition from abroad, possibly in the field of energy supply (cf. Müller-Kraenner 2008). The mercantilist argument holds even more for India, where foreign investment more often lacks a technological component.[35]

The previous comparison in MSCD has shown commonality of both cases in the economic realm, contrary to fundamental divergence in terms of regime type and the treatment of sovereign wealth. As discussed earlier, it points to regime type as a potential explanatory factor (cf. fig. 2), which however has been cancelled out in favour of the more advanced framework of democratic veto players earlier in this

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[31] Undervalued exchange rates "[…] reduce the inventive for private investors […] to hold foreign claims" (Setser 2008: 39), forcing investors into government-issued securities.
[32] According to a thorough analysis by Denoon, they equally have the potential for sustained world power status (Denoon 2007: 150).
[33] Drezner 2009: 117. The "soft power" concept was formulated by Nye, meaning that a state can shape the interests of other states through various forms of diplomacy and without recurrence to (military) pressure (Nye 2008: 1).
[34] The Chinese have done so through regional integration (Fischer 2007: 349), and its SWF can be seen as an attempt to further integrate through the "soft power" of the market.
[35] Contrary to China, foreign investment in India is more often aimed at taking over existing capacities ("mergers and acquisitions") rather than at generating new projects (Patnaik 2007: 75).
FDI is one possibility for technology acquisition, among imports and licence purchasing from patent holders (Thirlwall 2003: 248-250). Another neglected option is the acquisition of stakes through SWFs.

paper.[36] The remainder of this section seeks evidence for the democratic veto player hypothesis through process-tracing of the Indian case, dealing with politics and polity as equally important aspects of the empirical puzzle.[37] The initially excluded Brazilian case then serves as an ad-hoc test case for the pertinence of the democratic veto player hypothesis.

The institutional set-up of the Indian democracy is complex. First of all, there are considerable intra-executive constraints, as epistemic-community-like[38] agents like the Reserve Bank (RBI) and the Security and Exchange Board (SEBI) that influence their government through ex ante advice. Once a proposal is sent to the legislature, as in most policy-making processes in India, it undergoes an elaborated procedure through two chambers.[39] Approval is required in both the lower house (Lok Sabha) and the upper house (Rajya Sabha), but both chambers tend to represent different interests. Even if both chambers approve the proposal, it still needs the signature of the president in order to become law. Thus three actors, two of them collective, are involved in the legislative process.

In the context set out above, the Indian party system has been changing for the last decade. As regional parties are on the rise, both the Indian National Congress Party (INC) and the Bharatiya Janata Party (BJP) as the two main national parties are increasingly forced into atomised coalition governments (Wagner 2008: 113). This engenders both their convergence to a "centrist" policy stance and their catering to particularistic interests (Wagner 2008: 37-38). Those interests mostly reflect the needs of agriculture and the rural poor (Denoon 2008: 72).[40]

Furthermore, Indian federalism has received a "distinct meaning" in the aftermath of the reforms of the early 1990s (Patnaik 2007: 72). Charismatic regional political leaders increasingly succeed in mass mobilisation of the lowest castes and in opposition to the central government.[41] Their leverage for regionally-oriented policies builds upon their potential pivotal role in a governing coalition or in the upper house. In contrast, some formal federal institutions like the National Development Council (NDC) or the Inter-State Committee (ISC) hardly offer such leverage (Wagner 2008: 90).

The importance of societal and interest groups remains relatively low, because their efforts have been largely incorporated into the party system (Wagner 2008: 164). Unions play a minor role, some business associations gained influence in the aftermath of the economic liberalisation in the early 1990s. Financing development in India is a matter of private actors, contrary to China, and their undercapitalisation renders collective action likely (Denoon 2007: 71). Major business associations to consider are the two long-established Federation of Indian Chambers (FICCI) and the Associated Chambers (ASSOCHAM) (Kochanek 2007: 414-415), as well as the Confederation of Indian Industry (CII) (Wagner 2008: 161-163). Particular successful influence on policy-making has proven their significance – for example, the CII successfully lobbied the modernisation of foreign exchange regulation (FEMA) via excellent links to the prime-ministerial office (PMO) and the concerned ministries (Wagner 2008: 163).

[36] As a methodical remark, the MSCD study bears the risk of over-determinating regime type as an explaining variable. As a notice on content, democracy seems to be very broad and thus needs conceptual refinement.

[37] In the light of the importance of the regime type variable in the MSCD study, process-tracing therefore follows a second-level or domestic approach as opposed to an international approach (Segbers et al. 2006: 6).

[38] An epistemic community is a group that is characterised by common knowledge about causal relations in a technical policy field, leading to a high level of internal coherence of its members.

[39] In case of "monetary bills", concerning taxation and international credit, the upper house only possesses recommendatory power (Wagner 2008: 53).

[40] In India, sustained public investment is necessary for private investment especially in the backward sector. This helps to increase legitimacy of rural claims for investment (Patnaik 2007: 82).

[41] Mayawati, the governor of Uttar Pradesh, the largest state, sheds light on this fact (cf. Blume 2009).

Though vividly debated in India, only a few actors deal explicitly with SWFs and reserve policy. The debate can be located in a pre-parliamentary phase[42], and officials admit that there is "an increasing number of people supporting the creation of an SWF" (SEBI 2009: 290). Critics of the current foreign reserve policy, whose number "is rising in tandem with the reserves" (cf. Narasimhan 2008), point out that "it is time for the Indian government to evaluate options to get the best risk-adjusted return on the wealth which ultimately belongs to Indian citizens" (cf. Weling 2007). Likewise, Rajan sees no reason "to shy away from debating the issue seriously", despite some "prickly issues" to be resolved in the realm of a "democratic and open society" (cf. Varottil 2008).

Nonetheless, the set-up of a SWF in India faces strong domestic opposition (Setser 2008: 32). Opposing arguments are brought up by technical agents like the Reserve Bank (RBI) and the Security and Exchange Board (SEBI), and business associations like the Federation of the Indian Chambers (FICCI) or the Confederation of Indian Industry (CII).

The RBI, the Indian central bank, assumes a large spectre of central banking functions.[43] Fully government-owned, RBI has complete autonomy in the pursuit of its mandate. In principle, it acknowledged the technical feasibility of a SWF, but invoked some concerns. RBI's governor Y.V. Reddy earmarked three points: First, the bank fears dynamic liquidity risks and sticks to the principle of "reserve adequacy"[44]; second, the Indian economy "has twin deficits", and the export basket lacks a "dominant exportable resource output"; third, India has followed the path of "modest surplus" for "very few years", with reserves built "mostly on account of capital flows like […] FDI, portfolio flows […], external commercial borrowing and short-term credit" (Reddy 2008: 6-7). For these reasons, RBI has taken up a hesitant stance towards a SWF, awaiting "more comfortable current account" and "significantly improved fiscal situations" (Reddy 2008: 7).

The major objections invoked by the RBI also resonate in a bulletin on SWFs from the SEBI, a public regulatory institution whose role is to protect investors' interests and act as an advisory organ to the government. From their point of view, Indian reserves "are built on capital inflows […] and hence subject to capital flight". Furthermore, an Indian SWF "may be subjected to mismanagement and as a result, there would be complaints of corruption or even underperformance" (SEBI 2009: 290).

In addition, agreement on this reasoning has been formulated by scientists and influential private actors which closely cooperate with the RBI such as the FEDAI, the main partnering association for the creation of an Indian foreign exchange market. FEDAI's chairman Sridharan considers neither a stabilisation fund nor a SWF warrantable in light of potential "real sector shocks to the current account". In his opinion, India lacks "a dominant exportable good", is "vulnerable to shocks on account of oil price and fluctuations in food grains production", and additionally, "a large part of the capital flows are portfolio flows and […] FDI is in the nature of private equity […] and not in greenfield projects" (Sridharan 2007: 7).[45] The reactions of the business unions have stressed the primary need for financing development. FICCI declares that "public investment needs to be accelerated to pump prime the economy through increased infrastructure projects"; the association even pleads for a "sectoral stabilisation fund where […] liquidity is not forthcoming". CII co-organised an economic summit dealing with infrastructure, and has

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[42] The pre-parliamentary phase merits great attention, as it is the most crucial phase of policy-making in political systems with abundant veto points – initially postulated for Switzerland by Leonhard Neidhart in 1970.

[43] RBI exercises domestic money and foreign exchange management as well as supervisory and promotional functions on behalf of the Indian government that it advises technically (cf. RBI 2009).

[44] RBI is mandated to "maintain reserves with a view to securing monetary stability" (cf. RBI 2009). Hence, a prudent position on the use of foreign currency is no surprise.

[45] FEDAI is brief for "Foreign Exchange Dealers Association of India" (http://www.fedai.org.in).

declared it a priority shortly after the recent elections (ThaIndian 2009). These claims contradict the idea of state-led investment abroad.

The Indian government responded to these divergent claims with the set-up of an advisory group on a potential fund (IBEF 2008: 1). Through this delegation, intra-governmental conflict was hold down, but at the price of a somewhat indecisive and erratic policy response to civil society positions. Addressing the claims of the proponents, it considered the set-up of a SWF in February 2008. The Planning Commission Adviser said that "the fund will invest in overseas energy assets like Temasek of Singapore does". Asked about the need for such a SWF, the official responded, referring to costly liquidity in foreign currency: "Beyond a point, however, costs cannot be justified and therefore we need to find other ways to earn revenue" (cf. Indopia 2008a). However, the government put on hold a final decision (SEBI 2009: 290).
Meanwhile, the upper chamber launched a query to the government. In his written response in May 2008, the finance minister denied that plans for a SWF were "under consideration of the government at present" (cf. Indopia 2008b). Eventually, he confirmed this stance on a meeting of an insurance scheme for the rural landless in October 2008 (cf. Indopia 2008c).
Doubtlessly, the Indian government nourished plans for a sovereign energy fund. However, its design has not been clear and left to open discussion, as is suggested by memoranda of the finance ministry. Therein, it is stated that an arrangement must come along "without the risk of monetary expansion", without state involvement, and with the aim of "meeting the requirements of the Indian private sector for infrastructure projects in India by drawing upon foreign exchange reserves […]" (Reddy 2008: 7).
The current state of affairs is an agreement between the government and the RBI, according to which reserves are fuelled to an overseas subsidiary of the India Infrastructure Finance Corporation (IIFCL). The necessary funds stem from RBI, which contributes USD 5 billion per annum to the fund. This foreign currency can be used by IIFCL for the purchase of imports required for domestic infrastructure projects. However, it is important to note that this agreement is a "Special Purpose Vehicle" (SPV) (Malik 2008: 1), neither a "Sovereign Wealth Fund" nor a "State-Owned Enterprise" (SOE): Instead of investing abroad like SWFs, there is investment at home. Instead of domestic currency used for constructing a SOE, foreign exchange is used for enabling the functioning of the private infrastructure sector.

5. Making Sense of the Indian Case: The Democratic Veto Player Hypothesis

The in-depth study of the Indian case has provided two insights: First, few actors have participated in the public debate, though the number of stakeholders involved is supposedly larger. For this reason, as a second insight, the weak enthusiasm of the government reflects intra-governmental dissent (IBEF 2008: 1), and a high level of uncertainty about the position of "residual actors" and thus about the overall success of a SWF proposal within a complex institutional setting. The track record of Indian politics has shown that the government is responsive to those interests at an early stage. For example, in the 1980s, the decline in fiscal discipline occurred in parallel with the emergence into political power of the Other Backward Classes (OBC) (Rudolph 2008: 238). Although unions and business associations are conceived as minor players, their position is taken into ex ante consideration by the government.
The set-up of the SPV in India can be seen as a compromise to the main stakeholders. First, the finance ministry envisaged the set-up of a pure SWF and thereby responded to the growing number of proponents. Second, it feared criticism from the upper house and denied the proposal, nonetheless facing

the pressure to increase the return on foreign exchange holdings.[46] Third, the government committed itself to develop domestic infrastructure, thereby accommodating the claims of FICCI and CII as business unions and of regional political leaders in the upper house.[47] However, a detailed institutional design was not allotted. An initial suggestion to convert foreign exchange into domestic assets for infrastructure failed to gain approval of the RBI (cf. Narasimhan 2008). Therefore, the government accommodated the claims of the RBI and RBI's influential allies in the private sector (i.e. FEDAI) to preserve both price stability and reserve adequacy. This has been achieved through the small size of the contribution (USD 5 billion) and the institutional design of the SPV. The SPV solution is adequate in the sense that it eases the chronic shortage of capital private firms have been coping with. In how far the return on foreign reserves will increase remains to be seen.

To conclude, the democratic veto player hypothesis is indeed a way to make sense of the Indian case. The Indian experience has shown the dramatic impact of a high number of involved stakeholders and their homogeneity (although most of them remained "residual" and thus constituted points of uncertainty for the sovereign); RBI and SEBI as sceptical and internally coherent technical agents have played a major role, whose position has been echoed by FEDAI in the private sector, and FICCI and CII as advocates of narrow private business interests, equally internally coherent, have perpetually contributed to scepticism from a different angle. The democratic veto player hypothesis accounts not only for the puzzle why India still lacks its SWF, but also for the particular outcome of a SPV.

6. Robustness Checks of the Democratic Veto Player Hypothesis

Economists have pointed to another argument which they deem decisive for explaining the no-SWF option: foreign reserve assets drawn from capital inflows (cf. Jen/Bindelli 2007). Like export earnings, capital inflows engender foreign reserve accumulation under a fixed exchange rate. However, as they are more volatile, SWFs from capital inflows imply "borrowing short to invest long" (Patnaik 2007: 76-77), which can be dangerous in times of financial distress. Therefore, higher reserve levels out of precaution can be justified.[48]

Even so, the SWF option can be reasonably advocated for India. Many stakeholders find the current account deficit "manageable" and artificially high as a consequence of inadequate measurement (cf. Weling 2007).[49] Accordingly, the reserve level still exceeds the cushion needed to cover capital flight. This is indicated by the conventional economic measure of Greenspan-Guidotti (Farrell/Lund 2007: 6), as well as in comparison to Brazil which shows less than half of the Indian reserve ratio as a portion of GDP. Indeed, both India and Brazil are exposed to similar risks with respect to their reserve levels: The Brazilian economy is seen as a mixed economy (Aizenman 2008: 13) without a dominant exportable good and a

[46] In its response to the upper house, the government might have also considered potential risks from militant opposition – it is widely acknowledged that "naxalites", non-institutionalised groups fighting for welfare and developmental issues, pose a factor of uncertainty which needs to be anticipated (Kochanek 2008: 415). This is all the more likely given the low Indian per capita income (a third of the Chinese one) and the share of the population below the poverty line of almost 40% (cf. UNdata 2009).

[47] In the upper house, the deputy Singh (United) stressed the necessity for infrastructure development as a "key driver for sustenance of India's growth" (cf. ThaIndian 2008).

[48] This reasoning is supported empirically. Aizenman shows that economies experiencing FDI inflows sterilise less than those endowed with a trade surplus or non-FDI flows (Aizenman 2008: 1).

[49] According to Weling, "software and services income" are excluded, thus underestimating the current account.

higher quota of net capital inflows as a share of GDP compared to India (cf. tab. 5).[50] Therefore, a stand-alone version of the capital-inflow hypothesis fails to explain the no-SWF option.
Nonetheless, the capital-inflow argument can be captured as a "magnifying condition" to the democratic veto player hypothesis (van Evera 1997: 10).[51] SWFs fuelled from capital inflows remain highly contested, and the critics therefore have to be persuaded with valuable counter-arguments. This has been difficult in India, a vivid democracy with relatively internally coherent veto players, given that the finance ministry never took up a clear stance on the issue. From the previous analysis follows that the democratic veto player hypothesis fully accounts for the Indian puzzle.[52]

The democratic veto player hypothesis sheds light on the cases of Norway and Chile as well, which infirmed democracy as a sufficient condition for the no-SWF option earlier.[53] At this point, it is important to recall that the democratic veto player hypothesis consists of a polity and a politics dimension. Even though the polity for potential opposition to the set-up of a SWF exists, veto players have to invoke criticism within a political debate. This is more likely for higher levels of tensions over the use of excessive foreign exchange.[54]
Both the Norwegian and the Chilean governments were institutionally restricted at the time of the creation of their SWFs. For example, in Norway, formal approval of the parliament was required. However, instead of a heated debate in advance of the set-up, there was wide-spread agreement, indicating that potential veto players converged to the position of the government.[55] Furthermore, the institutional complexity of Norway and Chile can be seen as manageable, reducing ex ante uncertainty about the positions of "residual actors" – contrary to the complex setting of India. As a consequence, the democratic veto player hypothesis would have predicted a low likelihood of opposition against SWFs in Norway and Chile, in line with their experience.

How about Brazil? Initially excluded from a thorough analysis, this case is equally important for a robustness check of the democratic veto player hypothesis, as it belongs to the BRICs where 70% of the excessive FX in the last half-decade has been accumulated.
Brazil managed to recover from a financial crisis in 2001 and started running a current account surplus since 2003 (cf. tab. 4). The related accumulation of excess foreign reserves has called for the set-up of a SWF, most actively pronounced by the finance minister. However, influential private actors (mostly banks) pointed to severe risks, such as foreign liquidity shortage and decreased international creditworthiness (Fitzpatrick 2007: 1). Moreover, growing distributive claims of the middle class as the central actor to democratisation constituted another drawback (cf. Economist 2008b). Like in India,

[50] "Net capital flows" are more pertinent than "capital inflows", as national governments can halt capital outflows via capital convertibility restrictions (as happened in India).
[51] In this way, the capital-inflow argument is incorporated into the democratic veto player hypothesis.
[52] Another potential intervening variable is the GDP – in this regard, the China is three times bigger than India. Aizenman and Glick have found that the distribution of SWF countries is equally likely along the different GDP levels, rebutting GDP as an intervening variable (Aizenman/Glick 2008: 41).
[53] Technically, given a wider democracy definition, Venezuela would have to be added to this list. However, according to the Polity data, it slipped into autocracy in 2000. The small sub-national oil-SWFs from Alaska and Alberta could be added, for analytical reasons they are excluded here.
[54] Possible background conditions which exacerbate these tensions comprise: fiscal restraint, high poverty and low propensity to save, and experience of a former currency crisis. Norway and Chile exhibit less of these aspects than India (cf. UNdata 2009).
[55] In the pamphlet on the Norwegian Petroleum Fund, the dominant framing is that of national unity on the necessity of wealth management – no single societal group is mentioned (cf. Eriksen 2006).

severe tensions over the use of foreign currency accentuated in the realm of a complex institutional setting and impeded the creation of a SWF.
Lacking legislative approval, the president Lula da Silva decreed the provisional set-up of the "Fundo Soberano do Brasil" (FSB) in April 2008 (cf. swfinstitute 2009). The parliament eventually confirmed the creation of the FSB and endowed it with the relatively small amount of USD 5.9 billion (cf. WSJ 2009).
Though puzzling at first sight, the shift of the parliament towards approval is explainable: FSB "is intended to defend Brazil from future financial crises and assist Brazilian firms to increase trade and expand abroad"; furthermore, FSB acts "as an anti-cyclical mechanism to help investments in Brazil", focusing on "corporate debt instruments rather than equity stakes in firms" (cf. swfinstitute 2009). Again, this solution seems to respond to domestic claims on how to use excess foreign exchange. Together with the recent discovery of a huge oil field off-shore which potentially fuels the FSB in the future, the Brazilian parliament eventually condoned the decree (cf. Winterpg 2008).
The Brazilian case is consistent with the democratic veto player hypothesis, because the FSB is a SPV, not a SWF – investing at home and supporting the private sector respectively (cf. swfinstitute 2009); an observer confirms FSB as a SPV indirectly, arguing that India's SPV has "provided the example to Brazil" (cf. Kalavritinos 2009). Overall, the democratic veto player hypothesis seems equally plausible for the Brazilian case, which has displayed an enormous political dynamic just as India.

7. Conclusion

This paper has tried to contribute to the debate on the determinants of Sovereign Wealth Funds (SWFs). Given a country abundant in foreign exchange, which factors determine whether such a fund is created? In light of recent empirical findings stating that constituencies with SWFs tend to be more autocratic, this paper has suggested democracy as an explanatory factor for the no-SWF option. It has embarked with a comparative study of India and China on the democracy hypothesis. Both India and China have experienced excess foreign reserves within the context of strategically undervalued exchange rates, which should equally motivate them to set up a non-commodity SWF. However, only China managed to do so. Comparing India and China, democracy has been decisive to explain the difference. But democracy has only proven to be a necessary, not sufficient condition for the no-SWF option, in light of the experience from democratic SWF countries.
For this reason, a more refined relationship between regime type and SWFs under FX abundance has been developed. Accordingly, the absence of a SWF in a democracy is more likely to prevail, the more oppositional and internally coherent veto players there are. This democratic veto player hypothesis has been confirmed in India and constituted indeed the major solution to the Indian puzzle: The analysis has shown the decisive role of sceptical and internally coherent technical agents and private narrow-interest actors that pushed the government back from the SWF option in favour of a SPV. In this context, their main argument has been the peril of funding a SWF from capital inflows. Even though the capital-inflow argument itself can be contested, it increased the difficulty for the government to pursue the SWF option.
The democratic veto player hypothesis engenders the advantage of tying up political economy rationales with societal actors, constituting a plea for seeing economic and political theory in conjunction and for thoroughly analysing the specific political contexts around SWF decisions. If strategic FX intervention is in practice prior to the decision whether to create a SWF, political tensions seem to be exacerbated. As regards India, the case for and against a SWF can be made with equal sincerity, leaving the outcome to be determined by politics. If the future brings more robust economic fundamentals for India, the proponents

possibly win over the sceptics, enabling the creation of an Indian SWF. The democratic veto player hypothesis has been similarly made plausible for the Brazilian case, which served as an ad-hoc robustness test.

Future research desirably has to focus on the current trend towards SPVs that this paper has revealed for India and Brazil rather incidentally, in particular on the question how SPVs fit into the conceptual framework of SWFs. Indeed it seems that emerging market economies, especially if they are democratic and institutionally complex, become more sensitive to societal needs and simultaneously more professional in managing sovereign wealth to their benefit, which will cause new forms of financial arrangements to emerge. [6595]

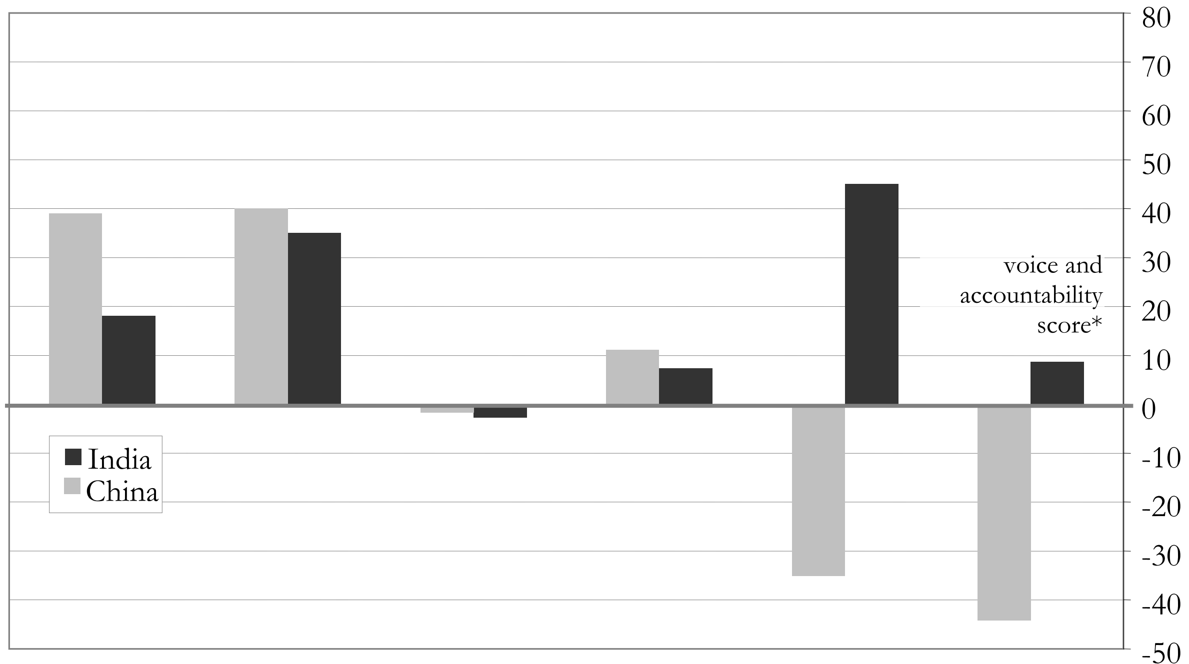
Figure 1: The political economy of Sovereign Wealth Funds

National Accounting according to Mundell-Fleming	
Y = C + I + (G-T) + (X-M)	Y … national income
Y = C + S	C … consumption
it follows	S … saving
C + S = C + I + (G-T) + (X-M)	I … investment
and then	G … government expenditure
I = S - (G-T) - (X-M)	T … taxation
	X … exports
Investment is caused to rise in three ways:	M … imports
increased private saving (S)	
increased public saving (T-G)	
increased imports / borrowing abroad (M-X)	

Given that domestic and foreign resources are insubstitutable at least in the short run, some portion of foreign reserve assets has to be used up for imports - which finance investment - under a fixed exchange rate. The demand for investment thus can contradict the desire to set-up a SWF.

If resources are considered as substitutable, then foreign exchange assets are an additional means apart from new taxation or increased saving in order to spur domestic investment.

Figure 2: India and China in Comparison



Data: UNdata 2009 / World Bank 2009 / Gurr and Jaggers 2009.
* computed as of initial score minus 50 (World Bank)
** computed as of intial score times 5 (Gurr/Jaggers)

This figure visualises the controlled comparison (MSCD) of the Indian against the Chinese case, displaying commonality in the economic realm, contrary to fundamental opposition in terms of the political system and the institutional set-up.

Table 1: GDP in current billion USD

cf. UNdata 2009

	China	India	Russia	Brazil
2002	1'454	507.9	345.5	505.9
2003	1'641	601.8	431.5	552.5
2004	1'932	695.9	591.7	663.8
2005	2'244	805.7	764.5	882.5
2006	2'668	906.3	986.9	1'068

Table 2: Foreign Reserves in billion USD

cf. UNdata 2009

	China	India	Russia	Brazil
2002	286.4	66.99	44.05	37.41
2003	403.3	97.62	73.17	49.11
2004	609.9	125.2	120.8	52.74
2005	818.9	131.0	175.7	53.55
2006	1'066	170.2	295.3	85.55

Table 3: Foreign Reserves as a Share of GDP

cf. UNdata 2009

	China	India	Russia	Brazil
2002	19,7%	13,2%	12,8%	7,4%
2003	24,6%	16,2%	17,0%	8,9%
2004	31,6%	18,0%	20,4%	7,9%
2005	36,5%	16,3%	23,0%	6,1%
2006	40,0%	18,8%	29,9%	8,0%

Table 4: Trade Balance (Exports net of Imports) in billion USD

cf. UNdata 2009

	China	India	Russia	Brazil
2002	35.42	7.060	29.12	-7.637
2003	45.87	8.773	35.41	4.177
2004	68.66	0.7802	59.51	11.74
2005	160.8	-7.835	84.44	14.20
2006	249.9	-2.748	95.32	13.28

Table 5: Net FDI flows to developing countries as a share of GDP

cf. UNdata 2009

	China	India	Russia	Brazil
2002	3,9%	1,1%	1,0%	3,2%
2003	3,3%	0,8%	1,9%	1,8%
2004	3,4%	0,8%	2,6%	2,7%
2005	4,3%	0,8%	2,0%	1,7%
2006	3,3%	0,9%	2,8%	1,8%

Table 6: Voice and Accountability (World Bank Governance Indicators)

cf. World Bank 2009

	China	India	Russia	Brazil
2003	8,2	27,2	33,2	62,5
2007	5,8	58,7	20,2	59,1

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