Abstract

In recent years, foreign exchange reserves of some of the central banks are increasingly being switched into investments in riskier assets that have been perpetually meant for liquid and safe instruments. Those reserve funds are mainly derived from excess liquidity in the public sector stemming from government fiscal surpluses or from official reserves of central banks of emerging market economies constituting as Sovereign Wealth Funds (SWFs). The estimated assets currently managed by the SWFs exceed the combined pool of assets by hedge funds and private equity firms but smaller than the pension funds and mutual funds taken together. The rapid accumulation of low-risk foreign exchange reserve assets by many emerging market economies has generated debate on how such assets could be invested in order to improve the return without taking excessive risks. If SWFs grow as estimated by various agencies and their international diversification continues, liquidity inflows into a wide range of asset classes can be expected at higher order. A substitution away from central bank reserves invested in liquid sovereign paper to SWFs invested in higher yielding and dividend-bearing private securities is a likely situation in the coming years. In this pursuit, India is also vying for establishment of SWFs. At the same time, demand for asset management and investment banking services is also set to increase. Keeping in mind the advantages that the rise of SWFs may bring, there is also good reason to introspect implications for global financial market stability, corporate governance and national interest in the backdrop of current international financial turmoil.

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