Harnessing the Development Potential of Emerging Market Reserves

Lawrence H. Summers

The First Annual
Richard H. Sabot Lecture

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The center for Global Development

The Richard H. Sabot Lecture Series

The Richard H. Sabot Lecture is held annually to honor the life and work of Richard "Dick" Sabot, a respected professor, celebrated development economist, successful Internet entrepreneur, and close friend of the Center for Global Development (CGD) who died suddenly in July 2005. As a founding member of CGD's Board of Directors, Dick's enthusiasm and intellect encouraged our beginnings. His work as a scholar and as a development practitioner helped to shape the Center's vision of independent research and new ideas in the service of better development policies and practices.

Dick held a Ph.D. in economics from Oxford University; he was Professor of Economics at Williams College, and he taught at Yale University, Oxford University, and Columbia University. He made numerous scholarly contributions in the fields of economics and international development, and he worked for ten years at the World Bank.

The Sabot Lecture series hosts each year a scholar-practitioner who has made significant contributions to international development, combining, as did Dick, academic work with leadership in the policy community. We are grateful to the Sabot family and to CGD board member Bruns Grayson for support to launch the Richard H. Sabot Lecture Series.

Lawrence H. Summers

At the time of the lecture, Lawrence H. Summers was the President of Harvard University. An eminent scholar and admired public servant, Summers previously served in a series of senior public policy positions, including Political Economist for the President's Council of Economic Advisers, Chief Economist of the World Bank, and Secretary of the Treasury of the United States. At Treasury, Summers oversaw the design of the U.S. support program for Mexico after its 1995 financial crisis, and he lead the U.S. response to the Asian financial crisis of 1997. It was during his tenure at the Treasury that the United States experienced its longest sustained period of economic growth.

Prior to his public service, Summers was Professor of Economics at both Harvard and MIT. In 1993, he received the John Bates Clark Medal, given every two years to recognize the research contributions of an outstanding American economist under the age of 40, and he was the first social scientist to receive the Alan T. Waterman Award from the National Science Foundation. Among his many publications are *Understanding Unemployment*, *Reform in Eastern Europe*, and more than 100 articles in professional economic journals. He has written numerous columns in *The Financial Times* and other newspapers.

Summers received his B.S. from MIT and his Ph.D. in economics from Harvard. As this booklet goes to press, Summers is serving as Director of the National Economic Council and Assistant to the President for Economic Policy.

Harnessing the Development Potential of Emerging Market Reserves

It is a great honor for me to be here, and to be the first speaker at a lecture series named after the late Dick Sabot. I didn't know him well. I knew him mostly through the enormously enthusiastic things that Nancy Birdsall said about him during the time that Nancy and I worked together at the World Bank, and I knew his work on the education of girls in Pakistan, which was an important inspiration for my own efforts in urging girls' education around the world. He lived a life of great contribution, and it's a little bit daunting to be standing here tonight in his memory. He was committed to this institution, the Center for Global Development.

He was right to be committed to this institution for two reasons. First, he was right because if Keynes was correct when he said that "madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler," then in the more harried pace of modern times, almost everything that the madmen do is a modified and confused version of an email that came from a major think tank. Institutions like this one—and the ideas and the discussions that they generate—have an enormous impact on the policy debate both in this country and far beyond its borders.

He was also right to be committed to this institution because the Center for Global Development is an exemplary organization, fulfilling the promise of its mission with consistently excellent execution. The Center for Global Development stands out in its success; while other institutions may be founded on a similar concept, not all institutions execute the concept well. With Nancy's superb leadership and the superb team that works here, the Center for Global Development has accomplished much already. No one would believe that it is only four and a half years old. No one would believe that its staff is not four times as large as it is.

Clearly, the Center for Global Development is a remarkable success. It is an institution that was worthy of Dick Sabot's loyalty, and it is an institution that is worthy of all of our loyalty.

The Global Development Challenge

When a high school student picks up a history book 300 years from now to study the great social, political, and economic features of our time, they will not find very much. Think about how much you know about the period between 1700 and 1725. Think about how much space is devoted in a history book to that 25-year period 300 years ago.

I'm convinced, however, that no matter how small that section in the history books will be, at least one political and economic story will surely be included. That story is the story of what is happening now in the developing world and how the United States is reacting to it.

On the positive side, it will be the story of a dramatic improvement in human health: for the first time in all of human history, it is not implausible to imagine that one-third of humanity lives in nations where living standards will rise by 30-fold or more in a single human lifespan. By comparison, this change dwarfs the impact of the industrial revolution.

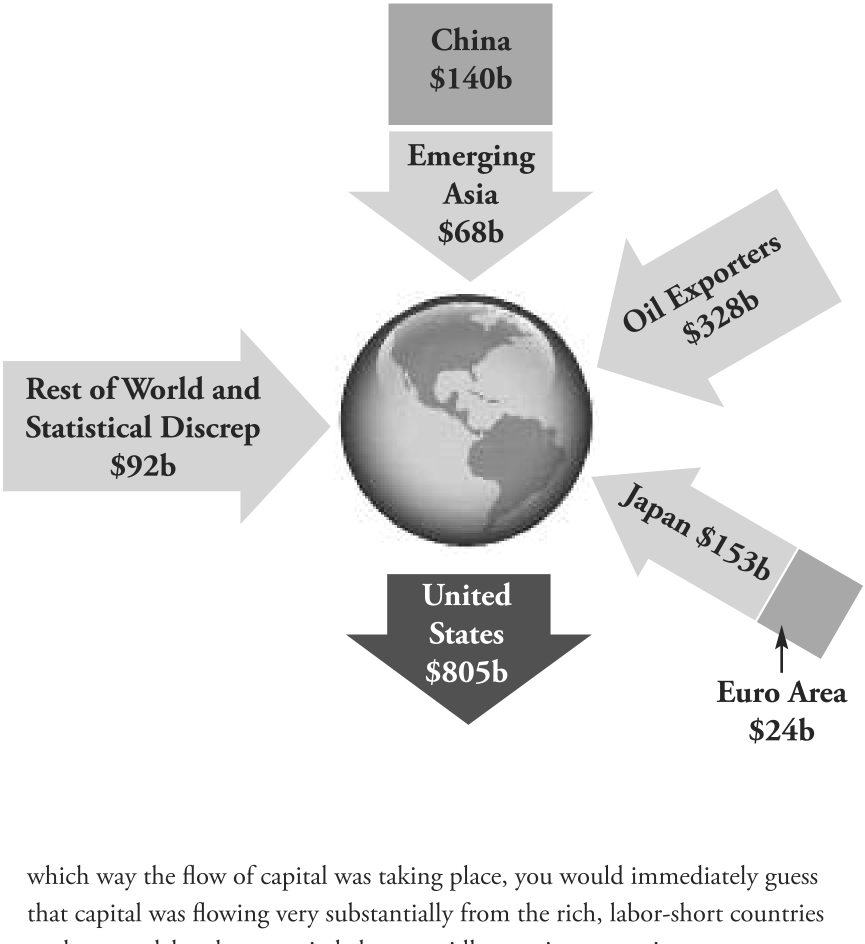
But there is another side as well. Words like AIDS, Darfur, and global warming remind us that what happens in the developing world is not without enormous risk and consequence, not just for the people who live in the developing world, but for the security of us all. Given this frightening potential for the positive changes to be offset by the negative ones, nothing is more important to think about and to work on than the global development challenge.

The Ironies of Global Capital Flows

It is this irony of our moment that forms the basis for my remarks tonight. Imagine that you are on Mars and you had not yet seen planet Earth, but you had studied economics. Imagine that someone said there are a substantial number of relatively poor countries where several billion people live, where the population is growing rapidly, and where the economic growth rate may climb to 10 percent a year. Imagine that this person told you that there are these other countries that are rich, aging, and growing between 2 and 4 percent a year, and that have slowly expanding populations. If you were asked to predict

FIGURE 1

Global Current Account Flows 2005



which way the flow of capital was taking place, you would immediately guess that capital was flowing very substantially from the rich, labor-short countries to the poor, labor-long, capital-short, rapidly growing countries.

But it is the central global financial irony of our times that capital is actually very substantially flowing from poor countries to rich countries, as Figure 1 illustrates. In particular, capital is flowing from poor countries to the world's richest and most powerful nation on a scale never before contemplated or seen. That is the first great irony of the global financial system at this moment.

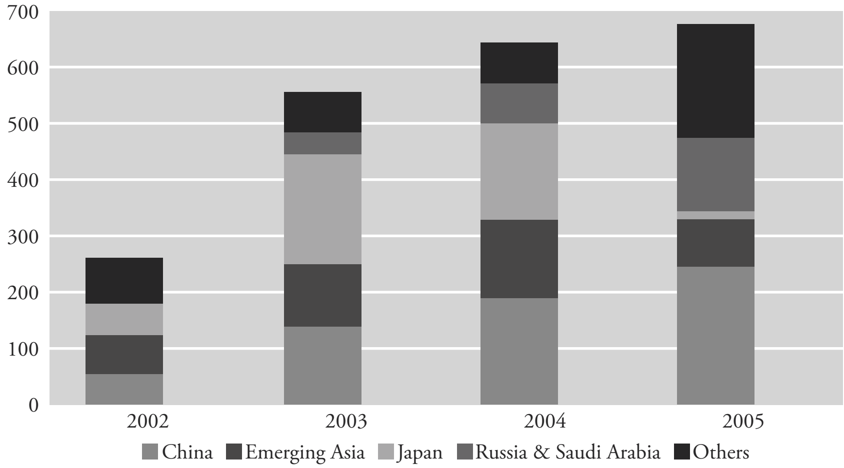
The second great irony is that this is not a phenomenon of capital flight. This is not a phenomenon that reflects people who have made fortunes in Venezuela and sensibly desire to diversify. Instead, it is largely the counterpoint of very strong and very substantial actions of governments to choose to accumulate very substantial quantities of U.S. government debt, as illustrated in Figure 2. If one did this for the next year, almost all of the U.S. current account deficit could be matched against increases in the reserves of developing countries. The irony therefore is not just that capital is flowing on a substantial scale, but that this capital flow reflects the policy choice of governments to invest huge and growing sums of money in American financial assets.

The third defining feature of this moment in the global financial system is that no one could suppose that these are going to be high-return investments. No one knows just what the future holds for inflation, and no one knows just what real interest rate will be earned on U.S. Treasury bills. If one supposed that yields on short-term instruments were in the 4.5 percent range and that

Figure 2

Global Reserve Increase, Including Saudi Foreign Assets

(IMF Data, Adjusted for Saudi Foreign Assets and Chinese Bank Recapitalization)



Source: Brad Setser and Sangeetha Ramaswamy, "RGE Global Reserve Watch," March 2006.

inflation was in the 3 percent range, then it is unlikely that one would go wrong. But if one looks at short-term indexed bonds, they are running below 2 percent, suggesting that real interest rates on U.S. paper are at 2 percent.

Now, no one can predict with certainty what the future will be. No one can predict with certainty what the future of the Saudi currency will be. Nobody can predict with certainty what the future of the ruble or the Indian rupee will be. But almost everyone who thinks about the question holds the view that those currencies, sooner or later—and perhaps later rather than sooner—will appreciate. If one supposes that those currencies will appreciate by 10 percent over the next five years—which is miniscule compared to Fred Bergsten's periodic pronouncements on this topic—then the real return that will be earned will be zero.

That means that there will no return on global investments of several trillion dollars, which are growing by $800 billion a year. This zero rate of return would occur in societies where hundreds of millions of people are still desperately poor, and for anyone concerned with the future of the global financial system, this possibility has to be the dominant preoccupation in this moment.

Facing the Ominous Financial Horizon

Now there are two profound questions that this concern raises. First, is it sustainable? Suffice it to say that one cannot rest assured that ultimately it will be sustainable or that it will end well. Every known test for whether a current account deficit is a serious problem—its magnitude, its rate of change, its relationship to consumption or investment, composition of the economy between non-tradables and tradables, the maturity structure of the debt, the role of the private sector—suggests that this current account deficit of the United States is an ominous one.

A critical element of a canonical financial crisis is a situation in which a central bank has one instrument it can loosen or tighten, and it is confronted with two problems: a sharply declining currency, which calls for reducing the supply so as to raise the price, and a severely slumping domestic economy and failing financial system, which calls for easier monetary policy. You can argue, as people do and have, about what the right response is and which one should get priority. But whatever the outcome of that argument may be, if you face that choice, the outcome is not going to be good, and the United States is surely taking a great risk of facing that choice. It is not a pretty thing to contemplate a moment in which even conservative estimates suggest that the dollar needs to fall by 15 percent over a three- or four-year period.

The ominous financial horizon leads us to a the second profound question: how is the United States going to find the political will to take the necessary steps to raise national savings and work through this serious problem? That question is not my primary topic tonight, nor is it my primary topic tonight to address what this adjustment process means for the developing world. Suffice it to say that the United States' increasing its national savings would be an event that would be associated with a reduction in global aggregate demand. It is also the case that increasing U.S. national savings, if it were associated with a decline in the dollar, would be associated with expenditures switching toward the United States and away from the rest of the world. Yet despite this remarkable level of U.S. dis-saving and borrowing, global real interest rates are low rather than high.

All of that suggests that whether it is thought of as Ben Bernanke's savings glut—or more plausibly as an investment drought in the developing world—any healthy adjustment process raises very serious questions about how aggregate demand is going to be maintained in the global economy so as to drive the global economy forward. That is an enormous task for economic coordination and for global economic policy. For those who are interested in a fuller set of my speculations on it, I'd like to refer you to the lecture that I gave in Mumbai.[1]

In addition to these two questions, there is a significant additional issue, which is a concern about giving people an almost free lunch. This concern derives from a question about how to invest reserves that are being built up. Before I discuss that issue, I want to be absolutely clear that no investment strategy for those reserves

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[1] http://www.president.harvard.edu/speeches/summers_2006/0324_rbi.html

Figure 3

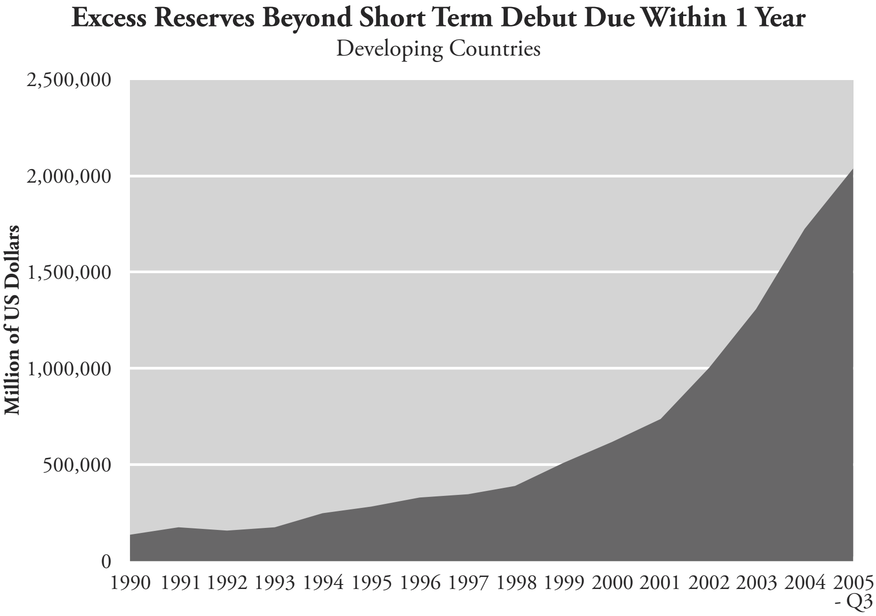
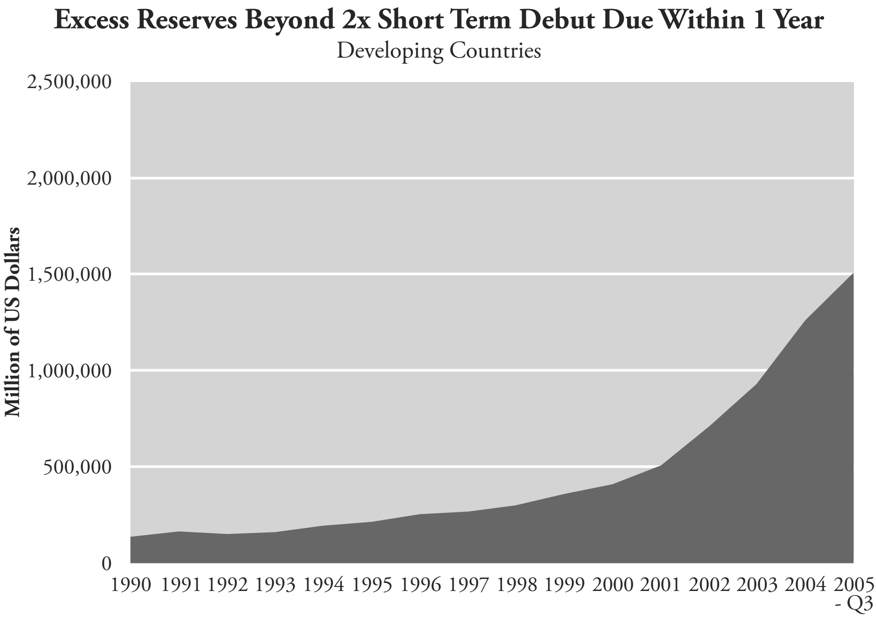


Figure 4



mitigates the very legitimate concern about the imbalances that are leading them to increase by hundreds of billions of dollars each year (see Figure 3). There is an important question, which is how much reserve does a country need to be secure in a world of volatile global capital markets, and how does that requisite level of reserves vary with the economic conditions in the country, both in terms of the quality of its financial system and in terms of the degree of confidence that it has? There is no definitive answer to that question. When capital flows were not seen as important, one traditional way of looking for this requisite reserve level was to focus on the level of imports and suggest that a healthy country would have three to six months' worth of import cover in reserves.

Today, although it may need to be adjusted for individual cases, most international financial authorities would likely agree that the Guidotti-Greenspan rule is the best single measure for determining the requisite level of reserves. It posits that a healthy level of reserves is enough to cover all foreign debt that comes due in one year. To be sure, it can be argued that this approximation is too low because it's a one-year interruption with no rollovers, or that it is too high since one could face pressure to convert a very substantial level of resources from domestic currency into hard currency. For this reason, I do not suggest that the rule may precisely fit every particular case.

Data illustrates that reserve accumulation has gone way beyond anything that can be justified by the plausible need for preventive financial action. If you compare the excess reserves beyond short-term debt due within one year (Figure 3) to the next figure, which shows double short-term debt coming due according to a hypothetical, hyper-conservative rule, what you see is that the short-term debt coming due is about $500 billion. In other words, most developing country reserves are in excess of what is necessary, according to the Greenspan-Guidotti rule. These reserves certainly dwarf, in some cases by more than an order of magnitude, any imaginable IMF program. I would suggest that it is difficult to escape the conclusion that developing-country reserves are far in excess of what is necessary to defend against the possibility of financial crisis.

In many cases, the countries that have the largest reserves in absolute terms are not the countries that have the most inordinate level of reserves relative to their economic scale. Nonetheless, a number of nations in Africa stand out as having extremely high ratios of reserves to GNP beyond whatever short-term debt is coming due even though such high ratios are usually considered to characterize the situations in Asia and in oil-exporting countries (see Tables 1 and 2).

Given these statistics, it is clear that for many countries the level of reserves is far in excess of what is necessary to meet short-term liquidity needs or to prevent financial crisis. Now one whole line of discussion—which is not the line of discussion that I'm engaging in today—is whether it's prudent to be accumulating these reserves at all and whether one would be better off not intervening and allowing appreciations to take place. That is a very good question. But another question that naturally arises is the question that I prefer to focus on now: how should these very substantial levels of reserves be deployed?

Harnessing the Potential of Emerging Market Reserves

In the beginning of my remarks, I referred to a hypothetical economist on Mars who is looking at our financial system from afar and who is likely to hold certain misguided intuitions about how that system functions. This economist would likely notice—and regard it as consistent with his misguided intuitions—that we have an international financial architecture, an international financial system, and financial modes of thought that are focused on the problem of transferring capital from the industrialized world to the developing world, even though we live in a time when much of what is going on is the accumulation of very substantial reserves by developing countries.

What is the loss here? Imagine that countries took these excess reserves and invested them in a diversified portfolio of equities from around the world. It is interesting and important to try to identify the expected risk premium, which is the expected excess return on a portfolio of global stocks relative to a portfolio of short-term financial instruments. Remember, I'm not talking about investing all their reserves. I'm not talking about it as preventing any reserve that would be necessary for one bit of short-term debt.

The historical data for the United States suggests a risk premium of about 6 percent. There are reasons to believe that this number is high: the United States has been a fortunate country by historical standards, and over the past 60 years there has been inflation in multiples unlikely to take place again. On the other hand, there are reasons to think that investments in emerging market equities and rapidly growing economies may have substantially greater returns over the long term. If I were forced to make an estimate—and I would not defend the precision of this estimate—5 percent does not seem unreasonably optimistic as a risk premium if one assumed that investments could be deployed in ways that produced extra returns beyond those that would be attainable by simply investing in a global index fund.

If this assumption were true, then that 5 percent figure would be conservative. If a country is able to deploy 10 percent of GNP in a way that produces an extra 5 percent return, then the central government will receive an additional half a percent a year in "free money." Receiving a "free" infusion of funds equal to one-half percent of GNP is significant. It is comparable to the magnitude of global international development assistance. In many countries, it is comparable to federal contributions for healthcare or education. And many countries spend less than one-half percent of GNP on combating AIDS. This money clearly has substantial value, and it is potentially available simply by investing resources more aggressively.

This idea raises a major question: would this aggressive investment involve taking excessive risk relative to what is prudent for a country over the longer term? It seems to me that there are three ways to address that question. First, one could simply take a long-run view of the calculation, given that we are not talking about reserves that are potentially needed to meet short-term liquidity problems. The standard deviation of the global index portfolio that I described is about 15 percent a year, which means that the standard deviation of the return over a 25-year period is about 3 percent a year. It follows that after 25 years, the probability that you will come out ahead by investing in stocks rather than in Treasury bills is about 90 percent. If one uses an alternative calculation, then the odds that one will come out positive in real terms is about 99 percent, given a 2 percent real return on Treasury bills. Therefore, over the long run, the odds are overwhelming that this type of investing makes sense.

The second way of seeing the same point is to recognize that the risk that comes with aggressive investing is a problem. This is a challenge that governments have on a unified basis, and it is not enormously different from the problem that state and local governments in the United States face with substantial pension liabilities. What responsible state and local government in 2005 would decide to meet all its pension liabilities simply by investing in Treasury bills because they were safe? Would this approach not be regarded as an act of financial imprudence? To be sure, the fiscal liability of pension burdens is both shorter in duration and more firmly contractual than the reliance on central bank profits to be transferred to governments.

A third way to look at this risk is to ask how much of that 5 percent return would you have to sacrifice in order to guarantee that after 25 years you were not behind in nominal terms? My estimate is that you would have to sacrifice less than 100 basis points of those 500 basis points to guarantee that at the end of 25 years the return in nominal terms would have been at least zero. Moreover, for most developing countries, the risks associated with the performance of the global stock market are not likely to be highly correlated with their own domestic economic performance, which makes the risk-aversion argument even weaker.

In sum, the reserves are large. The potential increment from more aggressive management is substantial relative to sums that are sought. The risks appear to be manageable. So if this is the financial reality, then why do we not see more aggressive investing?

The first part of the answer is that this type of investing does happen in some places and is starting to happen more. What I have advocated here essentially matches the current financial management strategies of Singapore and Norway, and I have been told that Korea is considering a similar plan.

A second important part of the answer is that aggressive investing runs into major agency problems and is staggeringly counter-cultural for central banks. Here is the agency problem. Suppose that I am the central bank governor of developing country X, and I decide to adopt a new scheme that invests in risk assets. If we have five good years, and we earn a cumulative 46 percent rather than the cumulative 22 percent that we would have earned in Treasury bills, then I will take great satisfaction in having earned the additional 24 percent. As a reward, my finance minister may say, "I'm glad that you did that." At my retirement dinner, perhaps my innovation will be noted and will be applauded. But if on the other hand, I invest in risky assets and end up behind over that five-year horizon, then I am likely to lose my job and be humiliated. Because of this incentive structure for individual bureaucrats in central banks—in which the penalties for failure seem to outweigh the potential for reward—central banks may decide not to pursue these investments, even if taking risks of this kind may be in the national interest. Clearly, the agency problems of investing in risk assets are substantial.

This type of investing also encounters resistance because it is counter-cultural for central banks. This does not seem to me to be a good reason to refuse to invest in risk assets, but it is very much an understandable reason. It is easy for central banks to defend their traditional rules: we don't speculate with our reserves. We invest our reserves in short-term, safe, liquid instruments because we need our reserves to be short-term and safe. This rule is clear and obvious, though it may not be very sensible.

My argument does admit major slippery-slope problems, and for that reason, it is rightly viewed with very considerable caution. On the other hand, we are dealing with considerable sums of money: about $2 trillion, 5 percent of which is $100 billion a year. When we are dealing with sums of this magnitude, finding ways of controlling slippery-slope problems seems in order.

Thus, even as we worry about the magnitude of imbalances, those of us concerned with the global financial system can profitably concern ourselves with the question of how reserves are invested, both in large countries that have huge reserves and in small countries that have huge reserves relative to their incomes.

At a minimum, the kind of efforts that are underway on a small scale today—in which international financial institutions provide technical assistance in reserve management—should surely be extended on a significant scale.

A second step is to develop codes of proper practice and prudent rules for investing reserves, which would serve two functions. First, it would give cover to the courageous bureaucrats who pursue investments in risk assets by allowing them to declare that they have invested according to an international best practice sanctioned by the group of central bankers meeting in conjunction with international financial institutions, rather than a flaky scheme designed independently. Establishing a firm set of rules and best practices would also provide the possibility of controlling the slippery slope problem by giving central bankers a reference point when their political counterparts suggest that they juice up the aggressiveness of policy in order to provide revenues. There is surely a case that establishing best practices and legitimacy in the international community would be an important second step with respect to this problem.

A third and more adventurous step would be for an international entity to accept fiduciary responsibility for handling the management of these reserves on behalf of countries. Such an idea might provide further legitimacy, and it might provide a means for controlling what would otherwise be non-trivial control problems that emerge once someone is in charge of actively managing reserves. Given the sum of money involved, such an entity could generate substantial resources if it charged a very small fee. These resources would be significant compared to the resources currently available for the promotion of global public goods.

This idea has been caricatured as the IMF setting itself up as a hedge fund. I want to be absolutely clear that that is not my intent, in the same way in which it was once explained to me that one reason for the success of Harvard endowment's management over the years is its absolute independence from the views of members of the economics department. In the same way, the last thing I would counsel would be that the IMF establish itself as a hedge fund.

Nonetheless, one can envision that there could be great advantage gained from providing some kind of international public cover to the relatively mundane, yet important, task of managing reserves into an indexed global portfolio.

Let me conclude where I began. It is an oddity of our moment that the flow of capital is so large from developing countries to developed countries. That oddity is likely to be with us for some time. Several trillion dollars are now being held by developing countries in forms where they will earn close to zero in domestic terms. In those reserves lies the very substantial opportunity to make developing countries and people who live in them better off by doing better than earning zero.

The Center for Global Development

The Center for Global Development is an independent, nonprofit policy research organization dedicated to reducing global poverty and inequality and to making globalization work for the poor. Through a combination of research and strategic outreach, the Center actively engages policymakers and the public to influence the policies of the United States, other rich countries, and such institutions as the World Bank, the IMF, and the World Trade Organization to improve economic and social development prospects in poor countries. The Center's Board of Directors bears overall responsibility for the Center and includes distinguished leaders of nongovernmental organizations, former officials, business executives, and some of the world's leading scholars of development. The Center receives advice on its research and policy programs from the Board and from an Advisory Group that comprises respected development specialists and advocates. The Center's president works with the Board, the Advisory Group, and the Center's senior staff in setting the research and program priorities. The Center is supported by an initial significant financial contribution from Edward W. Scott Jr. and by funding from philanthropic foundations and other organizations.

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