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1. INTEREST RATE POLICIES IN DEVELOPING COUNTRIES

Executive Directors considered a staff paper on interest rate policies in developing countries (SM/82/213, 11/12/82; and Cor. 1, 11/30/82).

Mr. Finaish said that economic theory had to be suitably qualified or adapted in the light of empirical evidence and particular circumstances if it was to serve as a basis for making policy decisions. That was particularly true when a theoretical apparatus conceived largely with the advanced industrial economies in mind was being used for policy formulation in the less developed countries. In the case of a variable such as the interest rate, the theory was still weaker as a sole guide to policy formulation because it did not allow the observer to predict conclusively on an a priori basis.

It was important to bear in mind the diversity of developing countries, Mr. Finaish remarked. They were characterized by substantial differences in stages of economic development and institutional features; differences in the stage of financial development were especially relevant to the present discussion. No hard and fast generalizations could be made. The appropriateness of interest rate policy in any given situation ought to be assessed in the context of the overall framework of economic policies and the set of socioeconomic objectives being pursued, rather than in isolation or based on a narrow notion of market efficiency.

It was often said, Mr. Finaish noted, that the theoretical arguments employed by the Fund staff tended to overemphasize the potential role of price changes in economic performance in the less developed countries. While, in SM/82/213, the staff recognized some of the limitations on interest rate changes as a policy tool for promoting economic growth and stability in those countries, it still gave the impression at several points of exaggerating the effectiveness of interest rate policies. Since the paper covered ably the positive impact on growth and stability that could potentially be achieved through interest rate policies in developing countries, his remarks on individual sections of the paper would concentrate mostly on qualifications to the argument set forth, or on limitations on the effectiveness of the policy under consideration.

In Section II of SM/82/213, the staff listed several channels through which interest rate changes could affect economic performance, Mr. Finaish continued, most notably through affecting the demand for domestic financial assets and the level and composition of saving and investment. While it was true that the interest rate, as an economy-wide price, could have a broad range of effects, it was important to remember that the variable was in each case a function also of several other factors. It had been theoretically established that the interest rate was a factor in several key economic relationships, and there was little controversy in the literature on that point. What was, however, controversial was the relative importance of the interest rate as a determining influence in those relationships, a question difficult to settle on purely theoretical or a priori grounds. The question had to be examined empirically, and it had to be related to the specific circumstances under consideration.

The staff also stated in Section II, Mr. Finaish noted, that most developing countries maintained some degree of regulatory or administrative control over interest rate determination. Nevertheless, interest rates in many of those countries had been administered quite flexibly, broadly in line with changing conditions in financial markets. Aside from the question whether the sample of countries included in Table 1 of SM/82/213 was representative of the totality of developing countries, and abstracting from the difficulties involved in measuring real interest rates, it was worth noting that the data in the table showed that the rates had been positive in many of the countries, even in the highly inflationary situation of recent years. Thus, real interest rates had been positive in 1978/79 in a little under half of the countries included in the table. While that proportion had fallen considerably in 1979/80, in part reflecting the relatively sharp acceleration of inflation in many countries, real interest rates had returned to positive levels in a little over one half of the sampled countries in 1980/81.

An important argument for higher interest rates in developing countries was that they might stimulate savings, Mr. Finaish observed. However, as recognized in Section III of the staff paper, there was "considerable disagreement" over the influence exerted by interest rates on the volume of savings. Indeed, economic theory did not provide conclusive evidence regarding the direction of the relationship between interest rates and savings, the indeterminacy in the theory arising mainly from the opposite influences that the income and substitution effects of an interest rate change exercised on the propensity to save. The net impact on saving would depend on the relative strength of those two effects, a question that could be determined only empirically. However, empirical tests of the relationship had yielded mixed and inconclusive results; if the available evidence pointed in any direction, it would be that the net impact of interest rate changes on saving tended to be rather insignificant, a conclusion that was also recognized in the paper. Therefore, the assumption made on page 7 that the substitution effect predominated appeared quite arbitrary. He invited the staff to comment on the basis for that assumption.

Thus, the case for higher interest rates as a means of raising the propensity to save did not appear to be a strong one, Mr. Finaish argued, either theoretically or empirically. That fact could help to explain why a more active use of interest rate policy to mobilize savings had not been made in many developing countries. He did not completely rule out interest rate policy from being used to stimulate savings; however, no generalized assumptions could be made, and the matter had to be judged on its merits in the light of a given situation.

In developing countries, the relationship between the interest rate and saving could be further weakened by institutional or other factors, Mr. Finaish went on, some of which were noted in the paper. They included, inter alia, relatively underdeveloped financial institutions, a large role for the public sector in the process of saving and investment, and the predominance of small, independent entrepreneurs in economic activity to an extent that savings decisions for a majority of households were motivated by investment plans, so that higher interest rates might discourage both investment and savings. In poorer countries, the low level of income might allow little scope for additional savings by a large part of the population, unless its income position improved through growth or redistribution. In addition, there were strong religious or ideological beliefs in many countries against the practice of charging interest.

There was a reasonable amount of empirical evidence to support a positive correlation between interest rates and savings in financial assets, Mr. Finaish remarked, although the evidence was quite variable on the strength of the correlation. Clearly, an increase in financial savings might not necessarily mean an increase in total savings, as it might represent only a portfolio shift from real (or physical) asset accumulation to financial asset accumulation. However, as noted in the staff paper, even a portfolio shift from real to financial assets could represent a positive development, as it could help to raise the quality of investment by increasing the flow of investible resources through the financial system, thereby enlarging the scale of financial intermediation. But the extent to which positive results could be expected through that channel was limited by, among other things, the degree of financial development and the proportion of interest-bearing assets in the total financial asset portfolio. In low-income countries, both tended to be low. Furthermore, the effect of a change in interest rates on total financial asset accumulation would be weaker if the change took place primarily within the financial asset portfolio, instead of representing a shift from real to financial assets. In many developing countries, moreover, the growth of financial intermediation might be more a function of investment in financial infrastructure--thereby making financial facilities accessible to larger segments of the population--and general economic and social development than of incremental changes in the rates of return on financial assets.

Although increasing financial intermediation might be conducive to a better use of investible resources, Mr. Finaish added, some regulation or control of interest rates and the flow of credit, where financial markets suffered from imperfections, might not necessarily be socially inefficient. It was unnecessary to invoke second-best arguments, as the imperfections could stem from structural deficiencies in the initial conditions: for example, thin and oligopolistic financial markets and close links between large industrial groupings and the major banks could lead to excessively large spreads between deposit and lending rates and to a highly skewed distribution of credit. Of course, it remained true that attempts to regulate interest rates and credit allocation could also lead to substantial inefficiencies in the system, especially when they became excessive.

The staff cast doubts on the effectiveness of preferential interest rates and selective credit controls in redistributing credit in favor of lower-income groups or weaker sectors of the economy, Mr. Finaish noted. While some of the doubts raised were indeed valid, the outcome need not always be unfavorable. With regard to the example given in the paper of preferential interest rates on farm credit, the possibility that a large proportion of the preferential credit might go to large landowners could be checked through the use of quantitative ceilings and floors on the amount of credit in different categories of loan size. Alternatively, preferential rates could be limited to small farm loans. Moreover, where preferential interest rates had the effect of depressing the rates on deposits, whether a group would make a net income gain from the lower interest rates on both loans and deposits would depend greatly on whether the group was a net creditor or debtor to the financial intermediaries--i.e., on the structure of the flow of funds--a factor that was itself influenced by preferential credit allocation. In short, the net redistributive effect of preferential interest rates on loans would depend a good deal on the nature of the arrangement, its implications for the level and structure of deposit rates, and the structure of the flow of funds.

Another point raised in the paper, Mr. Finaish observed, was that, even if preferential interest rates for lower-income groups or weaker sectors could achieve the desired distributional objective, they might not be the most efficient means of redistribution. The staff noted that direct government assistance through public outlays was likely to be a more efficient way. However, if an increase in the public sector deficit or the crowding out of private sector investment was to be avoided, a commensurate increase in public revenue might be required, a development not always possible over the relevant period. At times, the choice of policy instruments for attaining a given socioeconomic objective might be between what was feasible and what was not, rather than between what was optimal and what was suboptimal.

Section IV of the paper contained a useful discussion of the implications of interest rate policies for economic stability and the conduct of demand management, Mr. Finaish commented. It was true that inappropriate interest rate policies could aggravate stabilization problems in the less developed countries. However, stabilization problems in those countries could stem from a host of factors, both internal and external, the latter having been especially important in recent years. Accordingly, the emphasis accorded to interest rate reform in stabilization programs should not exaggerate its role in the problem being addressed. In addition, macroeconomic stability might be undermined, not only by excessively depressed interest rates, but also by excessively high rates, or by sharp and volatile movements. Where the financial system was not sufficiently developed or broad-based, some degree of regulation of interest rates might be necessary to prevent destabilizing movements. Recent experience showed that such movements could also occur in highly advanced financial systems.

The staff noted the increasing role of interest rate reform in Fund-assisted adjustment programs in recent years, Mr. Finaish remarked. In that connection, it had mentioned the increasing number of programs in which some interest rate policy action had been specified or in which interest rates had been a factor associated with economic performance. However, it would have been useful if the staff, in the light of its experience, had also indicated how effective the interest rate policy action had turned out to be under the same programs. He invited the staff to comment on that aspect.

An important variable in considering the impact of interest rate changes on the external sector, Mr. Finaish argued, was the effect on inward and outward capital flows. Clearly, the effect would be limited when international capital movements were subject to strict controls. However, relatively free capital movements might depend on several factors, including interest rate differentials. The staff noted that several member countries had found capital flows to be very responsive to interest rate variations. It would be interesting to know whether the same could be said of most of the developing countries permitting capital movements. Perhaps the staff could elaborate a little on the kind of evidence currently available on the relative importance of interest rate differentials as a determinant of capital movements into and out of developing countries.

The concluding portion of the paper gave a useful account of the short-run transitional problems that could arise as an immediate result of interest rate reform, Mr. Finaish continued. One of the points emerging from the discussion was that a sharp upward adjustment in interest rates could lead to severe transitional problems for the economy, including interest rate overshooting, a sharp economic contraction, high adjustment costs for both financial and industrial enterprises, and destabilizing capital movements. Care should, therefore, be exercised in determining the speed of interest rate adjustment, once the case for adjustment had been established. Interest rate adjustment should also be properly integrated into an overall stabilization or structural adjustment program. As the staff noted on page 21, the appropriateness of undertaking interest rate reform should be judged on the basis of a careful evaluation of the social benefits and costs that could result from its implementation; and such an evaluation could be properly made only on a case-by-case basis. Clearly, the subject did not justify a doctrinaire approach.

The evidence presented in Appendix III on a positive correlation between the growth rates of financial savings and GDP was highly tentative, Mr. Finaish observed, as the staff itself acknowledged. A mere comparison between two series, both of which were influenced by a host of factors, might not reveal much about the true relationship between them. To establish a firm correlation, a properly specified model was needed that would also include the other possible variables influencing the data.

On Islamic attitudes toward interest and the measures taken by some countries to reform their financial systems in conformity with Islamic principles, which had been touched on briefly in the staff paper, Mr. Finaish recalled, he had made some comments on previous occasions in connection with the Executive Board's discussions of staff papers relating to some of the Islamic countries. The matter was obviously an important one: it was relevant to a large number of countries and could have a potentially substantial effect on their economies. The sentiment for a fuller application of Islamic principles to social and economic activities and institutions in those countries had been becoming stronger in recent years.

Islam prohibited interest, Mr. Finaish continued, as it forbade charging a predetermined fixed return on the use of money. In line with that attitude, reforming steps had been taken in a number of Islamic countries. Interest-free banking had been initiated experimentally in parts of some countries, mainly in the form of opening profit-and-loss sharing (PLS) accounts with the banks. While evidence on the working of those schemes was still relatively scarce, there were indications that interest-free banking schemes were able to compete well with the traditional banking schemes. The opening of PLS schemes on an optional basis--i.e., as a supplement to the existing traditional schemes--appeared to have a beneficial effect on savings through enlarging the choice of savings instruments available to savers, and inducing more people to save and invest through the financial system. There was also some evidence that PLS schemes could have a beneficial effect on investment by promoting entrepreneurship and a broader distribution of real investment opportunities.

However, a progression from the introduction of partial interest-free banking to a full-scale transformation of the banking system to an interest-free basis, Mr. Finaish commented, raised a number of difficult practical issues, many of which remained unresolved. Such issues included, for example, the allocation and remuneration of short-term financing and the implications for the conduct of monetary policy in general. While a fair amount of work had gone into the study of a transition from traditional to interest-free Islamic banking, the subject clearly deserved further research, both in the Islamic countries themselves and in the relevant international institutions, particularly the Fund. He was appreciative of the study entitled "Islam and Financial Intermediation" that had been prepared in the Fund in 1981 (DM/81/92, 12/22/81). Among other things, the study had identified several important but still unresolved practical issues relating to a transition to interest-free banking. Further work in the Fund to build on that study would clearly be helpful.

Mr. Salehkhou stated that he fully shared the staff's view that, because of the complexity and wide scope of the issues involved, a single paper could not deal effectively with all facets of the question. However, because of the importance of a number of policies, he had expected at least a preliminary reference to them in the paper. One such issue, considered only *en passant*, was the profit-and-loss-sharing schemes in some Islamic countries. They deserved further study; the article on the subject referred to by the staff could be a first step in that direction. In that article, the analysis of the profit-sharing experiences in certain Islamic countries could perhaps have been more fully explored, so as to elucidate the principles that underlay the concept. As it was, the paper in fact raised more questions than it answered. The performance of such profit-and-loss-sharing enterprises that were already operational, and the likely problems associated with them, should not be construed as a judgment on the concept itself. Since serious attempts to experiment with the idea had been undertaken only recently, it was inevitable that problems would arise that would gradually disappear once greater insight was gained into its practical implementation. Within an Islamic economy, usury was considered a major cause of inflation and a fundamental weakness of the economy. The existence of usury, lack of information regarding market forces, inadequate banking systems, speculation, and arbitrage made it difficult to arrive at an appropriate rate of interest. Within the Islamic system, therefore, great encouragement was given to banks to act more like mutual funds or unit trusts.

While the theories and assumptions in the staff paper might have been inevitable, Mr. Salehkhou continued, they presupposed full competition and an already advanced financial market. The staff could have attempted to accept the status quo and the existing economic realities in developing countries as given, and it could have tried to suggest new ways of adapting to that situation, instead of expecting the countries to adapt to the theories.

In discussing case studies and experiences of a few countries, Mr. Salehkhou suggested, the misgivings of the developing countries concerning high interest rates should have been tested against actual experience, to determine their plausibility. One such concern was that a rise in interest rates could be inflationary, either through its direct impact on costs or through its indirect effect on expectations. Complete data and statistics were difficult to collect in the developing countries. However, an attempt could have been made to establish whether the interest cost element in producer prices had risen commensurately with the rise in interest rates, thus further fueling inflation, in those countries that had pursued a policy of interest rate liberalization. In Appendix II, it would have been useful to have had at least some preliminary data on the interest cost structure in countries pursuing monetary liberalization policies. Similarly, in the discussion of the effects of interest rates on both the volume and the productivity of investment, reference could have been made to empirical studies in the countries mentioned in the Appendix. As it was, in both cases, the paper mentioned that it was difficult to assess empirically the effect of interest rates on the volume and productivity of investment. However, without such empirical tests, any a priori reasoning was bound to be inconclusive.

There was little reference in the paper to international interest rates, and to their effects on the policies of the developing countries, Mr. Salehkhou observed. In a number of countries, particularly those with a relatively high degree of openness to capital movements or with more liberal exchange rate regimes, the freedom to impose any given interest rate became limited, mainly as a result of destabilizing capital movements, if the authorities failed to take foreign interest rates into account. Despite those criticisms, the staff had made, on the whole, a worthwhile attempt to tackle an admittedly complex and little-explained issue, for which he was grateful.

In many developing countries, the choice of monetary and interest rate policies was frequently associated with the economic, social, and historical perspectives of the country or region, Mr. Salehkhou remarked. The degree of independence and the freedom of that choice might, therefore, be limited. Historical association with industrial countries, membership in currency or monetary unions, and religious and social attitudes were all relevant. In other countries, the degree of monetization of the economy might be so limited that further extension of the banking network and greater monetization of the economy should take precedence over interest rate changes and other tools of monetary policy. With such divergences of interests and differences in attitudes and perspectives, it might be unsuitable to group such countries together; a uniform set of monetary and financial tools might not always apply to them. For example, the unavailability of local, rather than national, finance might constrain investment; in such cases, extending the financial network became a higher priority, perhaps more important than interest rate changes or even changes in the money supply.

A major concern of central banks in the developing countries, Mr. Salehkhou commented, had been avoidance of interest rate volatility because it entailed greater risks for borrowers and lenders, disrupted the investment process, and decreased output and employment. A further consideration was that monetary policies often had to be geared to the large public sector borrowing requirement. The arguments for or against a large public sector borrowing requirement were beyond the scope of the present discussion, and it was certainly true that in many cases the resulting external imbalances and inflationary tendencies had necessitated the adoption of adjustment and stabilization programs. However, for many governments, the size and activities of the public sector, and consequently its financial needs, were given, at least in the short term.

Another consideration was that a large portion of the credit extended to the private sector in developing countries was probably used as working capital and for import financing, Mr. Salehkhou went on. Only a relatively small portion of total credit might be used to finance expansion of the productive capacity of the country. Therefore, governments had sometimes resorted to direct intervention through administered interest rates, selective credit controls, and accompanying measures. The extent of such policies or the degree of intervention differed from country to country, depending on the degree of imperfections and the presence of externalities. At times, imperfections could also include political and ethical considerations. The use of interest rates or other tools of monetary policy should necessarily take account of such limitations.

Those issues became highly relevant in the context of the Fund's adjustment programs, Mr. Salehkhou considered. When performance criteria did not take such special features and limitations entirely into account, they could impose severe burdens upon the country, and they could undermine the success of the program. The existence of such conditions had, at times, enabled authorities to impose interest rate targets independent of monetary aggregates, and such flexibility had enabled them to channel resources to the priority development of sectors that would not otherwise have received their required allocation. Thus, priority credit allocation had been an important feature of credit policies in many countries. However, the degree of latitude and independence was probably limited by the broad scope of monetary policy, and monetary policies were often closely related to fiscal and incomes policies. In developing countries, the increase in the money stock was usually influenced by the size of the government deficit, and the expenditure and investment programs of the public sector were based on criteria not always consistent with monetary management. Therefore, fiscal policy per se was not often regarded as an instrument of demand management. Because of the lack of financial instruments, a large part of the fiscal deficit was usually monetized, again underscoring the close association between monetary and fiscal policies. The role of interest rates had to be considered within that broader context.

Similarly, monetary and fiscal policies pursued by one country would, in the long term, be influenced, through trade and capital flows, by policies adopted in other countries, Mr. Salehkhou observed. From a theoretical viewpoint, interest rates should reflect both the economy's marginal productivity of investment and its time preference, if misallocation of resources was to be avoided. Developing countries' financial markets, as currently constituted with the special characteristics he had referred to, made the influence of interest rates on savings and investments somewhat complicated. On the savings side, the staff had referred to the indeterminate relationship between interest rates and savings, stating that there was considerable disagreement about the influence exerted by interest rates on the volume of savings and that empirical tests revealed only a weak response of savings to interest rates. Furthermore, institutional influences such as contractual savings, dampened the impact of any rise in interest rates on savings. Such a consideration, however, in no way diminished the importance of private savings and their crucial impact on economic growth. Indeed, according to available studies, some 80-83 per cent of all investment expenditure in developed countries was financed by domestic savings, both private and public. As the governments in many LDCs ran budget and current account deficits and, hence, became dissavers, private sector savings became the main vehicle for economic growth. However, it was also true that, in many countries, private savings could best be stimulated by other means such as increased monetization, higher incomes, and social and demographic factors.

High interest rates affected the profitability of investment, Mr. Salehkhou continued. As the so-called cut-off point rose, potentially profitable investment projects were abandoned, an experience undergone in many countries since the rise in world interest rates. Thus, in their desire to raise the volume of productive investment, improve its allocation among sectors, and keep financial costs down, the authorities of many countries had tried to shield their economies from high interest rates in world markets through selective interest rate and credit measures. The recent problems of debt rescheduling and debt maturity had demonstrated the negative effects of high interest rates in industrial countries on the economies of all countries. The Chairman had referred to the problem in his Philadelphia speech of November 9, 1982, mentioning that, apart from the impact on the cost of servicing existing external debt, interest rates also affected the profitability of investment projects financed by foreign borrowing. The Chairman had also mentioned that low or negative real interest rates might induce overborrowing through inadequate attention to investment priorities by underpricing future resources relative to present resources. That concern was fully warranted, and the point was crucial to the optimal allocation of investment resources. However, until market conditions reached such a level of sophistication, governments remained the sole alternative for accomplishing the task through judicious credit allocation based on the overall growth strategy of each country.

There was a need for further Fund research into the principles of Islamic economy in general, Mr. Salehkhou considered, and into various policy issues like interest rates in particular. The Islamic countries comprised almost one third of the Fund's members, so that further in-depth studies of the principles of Islamic economy would be of great interest to a wide range of the Fund's membership. It would be appropriate if the Fund could show its interest in that area by organizing seminars, by inviting Islamic scholars and theoreticians to present their views, and by giving educational grants and scholarships to stimulate such studies.

Mr. Gomel noted that the Board's discussion gave Directors the opportunity to scrutinize carefully the nature of interest rate policies, as well as their role in the design and execution of stabilization programs and in the formulation of medium-term development strategies. SM/82/213 usefully explored the many interconnected issues related to interest rate policies in developing countries and provided some common analytical ground for Directors to appraise the Fund's rationale for recommending policies of a certain flavor to countries applying for its assistance.

The staff reports and the Board's discussions sometimes gave the impression that, with regard to interest rate policies, there was often an inclination to accept oversimplified prescriptions, somewhat lacking in analytical and empirical support, Mr. Gomel suggested. It was frequently stated that, once interest rates were raised to "realistic" levels, the outlook for a country's economy would improve. It seemed that, often with little justification, a single instrument--although a pivotal one--was expected to achieve too much: less excess demand, more saving, more investment, more capital inflows, and a stronger balance of payments.

Another general point concerned the question of administered interest rates, Mr. Gomel remarked, that was addressed in the opening pages of SM/82/213. The staff refuted a familiar "second-best" argument for controlling interest rates, claiming that it would be undesirable to deal with existing distortions by bringing about further distortions. Yet the standard theory of the second best, correctly applied, would lead to the conclusion that, in a world where many distortions prevailed, policies designed to remove any one of the distortions would not ensure that the economy moved closer to an optimum position. Therefore, in real-world economies, great care had to be taken in recommending, for example, a transition from regulated to market-determined interest rates. The difficulty was implicitly admitted in SM/82/213 when, reviewing the potential cost and shortcomings involved in the desired transition to interest rate reform, the staff recognized that other restrictions or direct controls might be necessary, such as floors for deposit rates, ceilings for lending rates or capital controls. The transitional period referred to in the paper might turn out to be quite long. A cost/benefit analysis to assess the welfare gains of such a proposed reform yielded very uncertain results.

Commenting on the question of savings, investment, and interest rate policies as they affected economic growth, Mr. Gomel said that there was little conclusive evidence that savings were responsive to interest rate changes, as the staff correctly pointed out. Yet, such a presumption--that savings were interest-elastic--was essential for the interest rate to be an equilibrating mechanism between savings and investment, according to the established theory espoused in the paper. Moreover, the proposition on page 9--"elimination of the state of financial repression improves the long-run capacity of the economy to finance domestic investment"--was certainly true. In a developing economy, actual investment was somewhat constrained by savings. Nonetheless, an increase in savings was not a sufficient condition for new investment spending. The desired investment would depend on many other factors that were often uncertain and difficult to measure. A policy aimed at raising interest rates might be able to mobilize more domestic financial savings, but it would not necessarily lead to new investment in physical capital, supposedly the desired outcome of such a policy.

In that context, Mr. Gomel remarked, it was worth considering some of the conclusions drawn in Appendix III of SM/82/213 concerning the interplay between interest rates, accumulation of financial assets, and income growth. The evidence cited there seemed to indicate a statistical association between positive interest rates, high financial savings, and high rates of growth. No causal nexus, tentatively hinted at in the paper, seemed to be warranted, however. Indeed, a degree of causation running from either growth or financial savings to interest rates could not be totally ruled out: first, for at least some countries in the sample that undertook financial liberalization, interest rates were market related, and therefore endogenous; second, even if interest rate policies were exogenous, i.e., under the full control of the authorities, interest rates might be affected by growth through some policy reaction function.

Furthermore, neither of the causal mechanisms suggested in the paper linking positive rates and economic growth seemed to have sufficient empirical backing, Mr. Gomel considered. The first--going from positive real interest rates to greater quality of investment and to faster growth--hinged on a fairly vague notion of the quality of investment that was supposed to be improved by higher real rates. The second, more conventional, causal mechanism--going from positive interest rates to savings to output growth--was based on two questionable assumptions: that savings were sensitive to interest rates, and that financial savings automatically generated new physical capital. There was no reason why the increased savings would bring about a net addition to a country's capital stock if there was no additional demand for new investment goods. He shared the staff's view that, since investment decisions were influenced mainly by expectations, a prolonged state of financial represion might adversely affect expected rates of return on capital, and, through that channel, discourage investment. That was, however, a different matter. Countries should then be advised to adopt policies geared to boosting expected profits; raising the real cost of finance would not by itself serve the purpose.

Commenting on the question of interest rate liberalization in connection with stabilization policies adopted under Fund-supported programs, Mr. Gomel agreed with the staff's assessment of the potential benefits associated with an interest rate reform vis-à-vis inflation, public finances, and the balance of payments. There were however grounds for caution with regard to two of the staff claims: first, the prediction that the deflationary impact of a higher demand for financial assets would more than offset the inflationary effect of a rising public deficit; and second, the prediction that the balance of payments would improve, since a stronger capital account would outweigh a worsened current account. If the analysis was stretched to the medium term, the expected outcome became even more uncertain.

The detailed classification and discussion in Section IV, subsection 3 of the cost and difficulties associated with interest rate liberalization were welcome, Mr. Gomel stated, especially with reference to the possibility of "overshooting" bank lending rates. The impact on firms' production costs could lead to liquidity problems or pressures for price increases. The staff stated on page 27 that the monetary expansion arising either from increased financing of the fiscal deficit or from subsidies granted to banks carrying over low-yield-earning assets might be absorbed by the higher demand for financial savings. Such a development could or could not take place, depending upon a number of relevant factors. He invited the staff to elaborate on the conditions under which it would take place. Finally, the staff suggested in its conclusions that interest rates ought to be geared not to the current rate of inflation but to the rate expected to prevail as new policies took hold. He agreed that nominal rates should be adjusted for expected inflation, but, if inflation was high and rising, such a policy might send a wrong signal to economic agents. Further comment by the staff would be welcome.

Mr. Grosche stated that the importance of flexible and positive interest rates had too often been neglected in shaping policies aimed at stable and balanced growth in developing countries. The staff had analyzed the the topic under two principal headings: the effects of interest rate policies on savings and investment, and the role of interest rate policies in demand management. He stressed that he had found the staff's analysis logical and convincing. However, while the analysis and the conclusions were true for a great number of developing countries, the general conclusion that high real interest rates always played an important role in all developing countries was too strong.

The staff gave the impression that the only policy that really mattered in developing countries was to allow interest rates to be determined by market forces, Mr. Grosche continued, and that developing countries would rid themselves of all their problems easily by following such a policy. Directors knew that the real economic world was, unfortunately, not quite so simple. Perhaps the aim of the paper to cover all developing countries had proven too ambitious. The staff appeared to have focused a little too much on large countries that were on the threshold of becoming industrialized, or on small, relatively developed countries. The staff's arguments were no less valid for that reason, but they might not apply to all countries to the same degree.

For example, Mr. Grosche said, the staff argued that interest rates affected the capital account of the balance of payments. Of course, the statement did apply to many developing countries, but did it apply to countries dependent on development aid or to countries that could not attract capital inflows irrespective of the level of interest rates, because the economic and political situation was too unstable and too risky? A second example concerned the effects that interest rate changes had on investment decisions. The staff argued that "the reduction in interest rates stimulates the desire to invest, as projects that were previously unprofitable now become attractive." Leaving aside the fact that the level of interest rates was only one among various factors determining investment decisions, he noted that there were developing countries that did not have a large variety of investment alternatives. For example, many countries had to improve their infrastructure by building roads and ports and by enhancing the educational system before other investment alternatives could even be considered. National authorities also had to take into account their country's degree of economic development when undertaking financial reform policies. A policy change from "financial repression" to market-determined interest rates could be carried out only if a minimum network of financial institutions had been established previously.

Commenting on selective credit policies, Mr. Grosche agreed that they had often proved to be unsuccessful, but they should not be rejected under all circumstances. Selective credit arrangements might, for example, be considered if a country favored a particular group, such as small farmers or small industries, in order to achieve more balanced development. Such a policy could be implemented successfully only if, as the staff correctly pointed out, the policymakers could control the use of funds allocated to the favored groups. The staff argued that selective credit policies and preferential interest rates led to the wasteful use of investible resources because scarce resources were not concentrated on high-return projects. However, the experience in some developing countries had shown that the concentration on high-return projects in the short term did not guarantee high sustainable rates of growth in the long run. On the contrary, it could lead to an economy too heavily dependent on fluctuations in global supply and demand. In the long run, developing countries would benefit most by broadening their economic base, taking into consideration those projects that yielded appropriate returns in the long run in accordance with development and social needs.

It was not always easy to determine the appropriate level of real interest rates, Mr. Grosche remarked. In a number of developing countries, a variety of price indices existed; for example, for rural and urban areas. They could be difficult to match to only one interest rate. Could the staff comment further on that question? His authorities supported the staff's view that in many developing countries, interest rate policies aiming at a suitable level of real interest rates played an important role in carrying out stabilization policies and in promoting economic growth. They had repeatedly supported that view in the Board's discussions on consultations and on Fund programs. However, interest rate policy could not be considered a panacea serving as a remedy for inappropriate fiscal, income, exchange rate, or structural policies.

Mr. de Maulde observed that the staff aimed at an excessive degree of generalization, and it frequently used inappropriate language in its presentation of financial systems. It was remarkable that the staff appeared to overlook the diversity of economies normally classified as developing. A number of points in the paper were of little relevance to the lower-income countries, or even perhaps to a portion of the middle-income developing countries. The selection of countries examined in the appendices suggested that the paper was in fact dealing with what were normally described as the newly industrialized countries. The scope of the paper should not be expanded indiscriminately beyond that limited group.

The derogatory expression "financial repression," to describe a system in which deposit rates were placed under the supervision of the authorities and lending rates were used selectively to achieve given economic goals, was inappropriate, Mr. de Maulde stated. Such policies were implemented to a greater and lesser degree in all kinds of financial systems, including those of all OECD countries. A further general point was that the paper made no distinction between short-term and long-term interest rates, although it was obvious that the distribution of interest rates over the spectrum of possible maturities was an important factor in determining the role of interest rates in the financial system and in the workings of the economy.

The main conclusion of the section on interest rate policies and economic growth, Mr. de Maulde remarked, was that national authorities could stimulate increased savings by adopting adequate deposit rates, while investment activities would also generally benefit, both in quantity and quality, from a high level of interest rates. However, it was well known that there was no clear relationship between high deposit rates and high savings ratios. Empirical studies in developed countries were inconclusive on that point, and the experience derived from developing countries, such as those mentioned in the paper, was also unconvincing. The main reason was probably that experiences of financial reform had been conducted in a context of acute financial deterioration, in cases in which interest rates were so negative in real terms, sometimes by as much as 40 per cent, that any return to positive real rates was bound to have a substantial effect on savings patterns. He was not convinced that the findings derived from such extreme cases were easily transferable to the great majority of countries where interest rates were only slightly positive or were negative in real terms.

A more sensible way to increase savings would be by developing the basic institutions and mechanisms for receiving and managing deposits and for channeling them toward productive uses, Mr. de Maulde suggested. For example, cooperative or mutual credit associations, as well as postal savings systems, had proved to be instrumental in attracting small savers and familiarizing the population with the basic elements of a banking system. The convenience, effectiveness, and friendliness of such systems was certainly at least as important as the level of interest rates in generating financial resources.

In the same context, Mr. de Maulde continued, he had serious doubts about the validity of the conclusion that lending rates should be, in principle, kept at a high level. The argument was that high lending rates were a means of ensuring an adequate selection of investment projects while avoiding the need for recourse to selective distribution of credit through administrative methods. However, the historical experience of industrial countries at the time when they had themselves been developing countries provided a number of examples supporting the opposite view, namely, that the growth of those countries had often been made possible by the existence of low lending rates. In fact, development success stories had frequently been based on low lending rates, made possible by a high degree of maturity transformation by the financial system combined with the acceptance of a high degree of financial leverage. It might even be argued that low lending rates were an indication of the dynamism of a fast-growing economy, while high rates were typical of a situation of economic maturity, perhaps even economic senescence. Maturity transformation, highly leveraged balance sheets, and low interest rates were three aspects of the same process, namely, a maximum use of short-term savings in a context of scarce capital and overabundant investment opportunities and plentiful entrepreneurial spirit. Furthermore, state intervention, through the use of selective rates and various support measures geared to assist the financial system in providing sufficient resources to the most dynamic sectors of the economy, had played a significant complementary role in a number of countries. The staff's critical view of selective credit allocation thus appeared to be based more on doctrine than on a broadly based observation of the historical evidence.

The section on interest rate policies and demand management contained a number of questionable conclusions regarding the consequences of not allowing interest rates to be determined only by market forces, Mr. de Maulde considered. The staff argued that a low level of interest rates complicated demand management and tended to promote a vicious circle once a serious imbalance emerged between aggregate demand and supply. The argument was another example of a case that applied convincingly only to situations of extreme gravity in which the distortions became so great that the only way out was a drastic financial reform along the lines implemented in a few selected countries. He strongly supported the view in industrial countries, a relatively high level of long-term interest rates, sufficient at least to make them positive in real terms, was an important element of demand management. But the case was much less convincing when dealing with developing countries. In particular, with reference to the extreme cases described in the staff paper, it was not clear to what extent the degree of disequilibrium brought about by negative rates in real terms of a magnitude of 20-40 per cent was a cause rather than a consequence of the widespread domestic and external imbalance in the economy.

A fundamental question was whether the transmission mechanisms existing in industrial countries could be made to work in less sophisticated systems, Mr. de Maulde went on. The efficiency of interest rate policy in developed economies rested principally on the speed and accuracy with which the financial markets were able to transmit to the real economy the effects of variations in the level and structure of interest rates. The sophisticated way in which variations in interest rates led to reactions in the price structure and in the level of activity in specific sectors of the economy in such countries as the United States could be duplicated only in a country that had duplicated the New York Stock Exchange, a rather difficult task. Short of that, it should be recognized that selective action and the distribution of credit through administrative means might prove, if correctly managed, an efficient way of helping demand management policies to work in the required direction.

The staff was absolutely correct, Mr. de Maulde remarked, in concluding that developing countries should try to avoid the kind of vicious circle exemplified by the cases selected by the staff, in which excessively negative interest rates in real terms unquestionably contributed to the complete destabilization of the economy, mainly through the consequences for the external balance. However, it would be more interesting to consider the examples in which interest rates were only moderately negative in real terms, for such examples constituted the great majority. Pragmatism and the avoidance of preconceptions were called for in that regard. Historical experience suggested that rates on both the deposit and the lending side should preferably remain at a level somewhat below what would be considered appropriate in the case of a more mature economy. That would be feasible only to the extent that an appropriate combination of short-term and long-term rates were able to promote both a healthy level of domestic savings and sufficient amounts of inexpensive investment resources. In that regard, controlling the maturity transformation by the financial system was a key element, often dependent on the existence of alternative savings instruments, subsidies, and other regulations.

Finally, care should be taken in the use of language, Mr. de Maulde suggested, since unsuitable expressions could lead to inexact thinking. For example, the term "financial reform" was unfortunate because it suggested that the only financial reform feasible would consist of imposing, in all countries, higher interest rates determined solely by the interplay of market forces. However, should the Board try to impose on developing country members an ideal that did not exist, for a number of valid reasons, in any of the industrial members? He was glad that, in reality, the Fund tended to recommend more flexible solutions in its programs. It was also appropriate that the staff should provide the Board, on occasion, with papers such as SM/82/213 to remind Directors that policies had to be adjusted to the real needs of the real world.

Mr. Joyce commented that SM/82/213 was a welcome companion to the staff paper on exchange rates in developing countries discussed by the Board in March 1982. The staff had comprehensively outlined the many important considerations that had to be taken into account in shaping interest rate policies in developing countries, and the relevance of interest rate prescriptions to Fund programs and surveillance activities. The issues were not straightforward, and the subject defied easy generalization. He welcomed the staff's acknowledgement that the correct interest rate policy for individual developing countries could, and probably should, differ, if for no other reason than the fact that the degree of development of the financial system varied considerably among countries. It was therefore important, as the paper pointed out, for the Board to remain flexible in its approach. The Fund had to look at the interest rate problems of developing countries on a case-by-case basis.

He had been surprised, like Mr. de Maulde, by the use of the term "financial repression," Mr. Joyce continued, to describe a policy of preventing interest rates from rising to their equilibrium levels. It was not a familiar term, and, although the staff said that it was used in the literature, it seemed a rather perjorative description of a policy that was followed, sometimes for economic reasons as much as political ones, in many developing countries. It was a matter of judgment in each particular case whether a country had been right or wrong to follow such a policy, but certainly none of the governments considered that it was pursuing a "repressive" policy. Indeed, looking back at real interest rates in many industrial countries during the 1960s and early 1970s, he would maintain that that particular policy stance had not been confined to developing countries. Real interest rates had been negative during much of the period in some industrial countries as a result of the over accommodative monetary policies that the authorities had pursued in an attempt to keep some, if not all, nominal interest rates from rising. It was doubtful if finance ministers in those countries would have described their policies as "repressive." A more evenhanded description would have been preferable.

Commenting on Section III of SM/82/213, Mr. Joyce suggested that the staff had been correct to state that interest rate policies could have an influence on savings and on the volume and productivity of investment. Indeed, for developed countries and for developing countries with relatively well-developed financial markets, the influence would be significant. That judgment appeared valid, on the basis of logic, despite the paucity of empirical evidence on the subject. It was particularly likely to be true in cases in which the private sector was responsible for most of the lending and investment decisions. The staff paper mentioned that some studies existed, based primarily on empirical data for industrial countries, but that they revealed only a weak response of savings to interest rates. It would have been useful to have had in the paper more information on the studies; he invited the staff to comment further on the issue, particularly the extent to which such studies were applicable to the situation in developing countries. At first glance, the results cited seemed to run counter to the evidence in Appendix II and Appendix III, particularly the results observed in Argentina, Brazil, Korea, and Turkey.

In some middle-income and higher-income developing countries, as well as in most industrial countries, Mr. Joyce continued, a relatively large proportion of savings was generated through the operations of social security plans and pension funds. As the paper correctly noted, the savings were not sensitive to interest rate developments and would occur regardless of the rate of return on them. The phenomenon would be much less pervasive in the poorer developing countries. The overall thrust of the paper showed an undue preoccupation with those developing countries that clearly mirrored the classical patterns usually identified with industrial countries' experience. The paper did not deal adequately with the situation of the small and poorer developing countries.

The latter group shared a number of characteristics, Mr. Joyce stated, the first of which was, inevitably, that large sections of the population were desperately poor. They had little or no wealth put aside, and their main priority was simply to survive. For people in that situation, the choice between consumption and savings was often somewhat academic. Changes in interest rates were unlikely to bring about any significant increase in savings precisely because there was so little to save. Second, the financial markets in those countries were not developed or, if they existed at all, a large proportion of the population might have little or no access to financial institutions, often because they did not live in the capital city. In such countries, changes in interest rates would have only a limited impact on the level of savings. In many cases, large sectors of the economy were not monetized, a factor that might also apply to some of the larger, higher-income developing countries.

Third, in most poor countries, and in virtually all small poor countries, public investment tended to predominate, Mr. Joyce remarked, often because there were few resources that the private sector was interested in developing. In such countries, it seemed unlikely that higher interest rates would contribute to increased productivity of investment because profitable investment opportunities themselves were scarce. Moreover, investment was frequently constrained in such instances more by lack of the means of implementation, such as skilled labor or adequate infrastructure, than by policies of "financial repression." In many of those countries, the bulk of investment was often dependent on concessional aid flows for its financing, and hence the level of local interest rates might not be very relevant.

Public sector investment might be dominant in a country because the private sector had been restrained or excluded as a matter of deliberate government policy, Mr. Joyce noted, either through nationalization or through the requirement that there should be a high percentage of public ownership in joint ventures. In addition, an unfavorable environment for private investment might have been created as a result of imprudent fiscal and external policies. In such cases, while changes in interest rates could have some impact, the real determinant of the level of new private investment would be the authorities' willingness to change the social climate or to adjust their fiscal and external policies. A further point was that private sector investments in some developing countries were undertaken mainly by large multinational firms; the sources of funds of such firms were not necessarily related to the availability of private credit in the country in which they were investing, and to that extent they might not be influenced particularly by domestic real rates of interest.

In many poorer developing countries, it was often difficult to implement a policy of increasing interest rates, Mr. Joyce continued. The problem of interest rate changes was especially difficult if the banking sector was dominated by foreign branches of international banks, which might have their own views concerning the level of deposit rates and lending rates that they regarded as suitable to their continued active participation in the economy.

In sum, in cases in which interest rates were significantly negative in real terms, Mr. Joyce said, the Fund's prescription of increased interest rates might, in some circumstances, do little more than provide a signal that additional savings were required and that the authorities should attach importance to emphasizing the need for more productive investment. It was not at all clear that such a policy prescription would increase either savings or the volume of productive investment to any significant degree. That being said, he still supported the general view that in most cases there remained a presumption that artificial restraints on interest rates were likely to have adverse consequences, especially over the longer term.

Commenting on Section IV of SM/82/213, entitled "Interest Rate Policies and Demand Management," Mr. Joyce noted that government policies on interest rates might have significant implications for the conduct of demand management policies only in medium-income and upper-income developing countries in which the financial systems were relatively well developed and in which a relatively large share of investment was undertaken by the private sector. In those countries, if interest rates were maintained at levels significantly below the rate of inflation, there was a real danger that funds would be unavailable for investment and that economic performance could be seriously weakened. Nonetheless, other considerations also had to be taken into account.

First, serious adjustment problems could be encountered when interest rate policy was directed toward returning rates to their equilibrium levels, Mr. Joyce suggested. That was particularly true in cases in which nominal rates had been kept well below the rate of inflation for a prolonged period, or in which the public did not have confidence in the government's determination to carry through its stated policy. Such adjustment problems could, potentially, be extremely serious, and they were a factor that the authorities inevitably had to take into consideration. He agreed with the staff that the existence of such problems did not lessen the desirability of implementing appropriate interest rate adjustment. The adjustment problems reflected the pressures that had built up during the period in which interest rates had been kept abnormally low. An attempt to forgo interest rate adjustment in order to avoid such problems would be short-sighted; the end result would only be that the pressures resulting from the distortion associated with existing policy would continue to grow, with increased strain on the economy, making any future adjustment in interest rate policy all the more difficult.

Second, the staff noted that there was an interdependence between interest rate policies and other economic policies, Mr. Joyce observed, a view that he fully shared. It was particularly true that, as stated on page 18 of SM/82/213, "interest rate policies determined to a considerable degree the appropriate stance of other demand management policies." In fact, the staff might have gone further and emphasized the particularly close linkage between exchange rate policies and interest rate policies, particularly in those countries that had open economies and were dependent on foreign trade and international capital flows. The staff had looked at the impact of interest rate policies on the current and capital accounts of the balance of payments, but the paper did not really bring out the interactions between interest rates and exchange rates. Perhaps the authors had not intended to do so.

The staff correctly stated that the impact of interest rates on economic activity varied among developing countries, Mr. Joyce considered, and that a flexible case-by-case approach was required, taking into account such factors as the degree of economic development of financial markets, the relative size of public investment compared to total investment, and the degree of openness of the economy. It was important in such cases that interest rates be given the opportunity to effect a balance between the supply and demand of investible funds. In cases in which interest rates had been maintained by the authorities at levels significantly below the rate of inflation, he supported the staff view that, subject to taking into account the particular problems in particular countries, interest rates should be raised to positive levels in order to restore economic stability and to attain sustainable rates of economic growth. Nevertheless, for a number of the smaller developing countries in which per capita income was low and financial markets were not well developed, it did not necessarily follow that increases in interest rates would encourage significant additional savings or would be conducive to more rapid economic growth. The particular position of smaller countries was an important consideration to bear in mind.

Mr. Feito commented that the analytical core of the paper was the interaction between interest rates, on the one hand, and savings and investment decisions, on the other. However, while the different effects brought about by interest rate movements were generally well explained, the process by which one effect predominated over others was not always made explicit. For example, on page 7, it was correctly stated that raising interest rates induced not only a substitution effect that tended to stimulate savings at the expense of consumption, but also a wealth effect that tended to reduce savings by lowering the amount of wealth necessary to buy a given amount of future consumption. It was then stated without further explanation that throughout the paper it would be assumed that the first of those effects predominated. It would have been most desirable if that assertion had been accompanied by some summary of the available empirical studies or of the theoretical reasons that might lead one effect to be relatively more important than the other.

More generally, Mr. Feito continued, the paper contained some broad conclusions on interest rate policies that could not be logically derived from either the theoretical treatment or the empirical evidence given in the paper. He wondered whether for future seminar discussions the staff could provide an appendix summarizing the available empirical studies bearing on the subject under consideration.

The type of economy for which the staff's analysis and conclusions of the paper were supposed to be relevant was an interesting issue, Mr. Feito observed. In the introduction, the staff stated that the main consideration underlying the demand for the study was the need to clarify some issues regarding the role of interest rate policies in stabilization programs undertaken by member countries. The economies of member countries looking for Fund resources were usually performing far from the zone of economic equilibrium, however that zone was defined. Thus, Directors wished to know the proper role of interest rate policies in economies in a state of profound disequilibrium. Under such circumstances, it was important to pay special attention to the stochastic nature of the decision-making process of individuals, and, in particular, to the role that the perception of risks and uncertainty played in financial decisions. He did not believe that either factor was sufficiently emphasized in the paper, although both were integral elements of financial analysis and interest rate determination. In fact, he had missed any reference to the role of the expected rate of interest and the expected term structure of interest rates on savings decisions. He invited the staff to comment on the relationship of its deterministic framework of analysis to the probabilistic structure usually used in the analysis of interest rate phenomena. The matter was of more than academic interest, being of special relevance for the kind of economies usually seeking the use of Fund resources.

An example might clarify the issue, Mr. Feito stated. If an economy was running into a financial crisis, the rate of interest necessary to stimulate or maintain domestic financial savings tended to infinity, regardless of the real international equilibrium rate. In such situations, the expected rate of return was what was important and what had to be stabilized through policies aimed at strengthening the institutional framework of the economy. Similar considerations applied to a country that was far from both economic and political equilibrium, or that was situated in a region where the risk of political and social instability was high. Some countries in his constituency currently carrying out programs with the Fund faced such circumstances. What level of interest rate was needed in those countries to establish equilibrium with the international rate?

The examples he had cited were not exceptions to the rule that countries should attempt to achieve equilibrium interest rates, Mr. Feito emphasized, but interest rate reform was only one piece, not necessarily the most important, in a process of financial reform. There were occasions when priority had to be attached to improving the financial institutional framework or the overall macroeconomic framework of society. In the type of economies he had referred to, widespread interest rate reform could be launched only after the institutional framework had been adequately buttressed. As other speakers had pointed out, in such countries, investment in financial infrastructure was a prerequisite to interest rate action.

Given those qualifications, Mr. Feito commented, two major conclusions could be drawn from the staff paper. First, economic policies had to permit and promote the achievement of equilibrium interest rates. It was worth mentioning, however, that real equilibrium interest rates did not necessarily mean positive real interest rates, as the staff assumed. The possibility of negative equilibrium real interest rates ought not to be excluded, for example in Islamic countries. More important, in some cases the equilibrium interest rate might be lower than the actual one, and interest rate policies should be aimed at reducing rather than increasing the rate of financial return. Under normal circumstances, however, he shared the staff's view that subequilibrium interest rates were a common feature of some developing countries, even though it was difficult to establish precisely the value of the equilibrium rate. As other Directors had suggested, national authorities should take into account market imperfections and weaknesses in the institutional framework in carrying out interest rate and financial reforms.

The second conclusion to be drawn from the paper, Mr. Feito continued, was that the timing of a financial reform and the speed of adjustment were issues deserving careful consideration. As so frequently occurred with economic reforms, there was a conflict between the long-run potential benefits and the short-run private and social costs. It seemed that gradual adjustment of interest rates to equilibrium levels was warranted and that, therefore, in designing and implementing programs with member countries, the Fund should try to smooth the transition process to equilibrium in the financial markets. The financial system was an extremely delicate and fragile mechanism. As recent financial crises made clear, policies derived from models that took no account of the complexities and imperfections of the real world might be dangerous. Even more than in other areas of economic policy, the Fund had to recognize the limits of economic knowledge, and the gap between the artificial world of models and the complex phenomena that took place in the real world. He hoped that the precautionary remarks made by the staff in SM/82/213 and the comments made by Directors in the course of the discussion would have some influence on the philosophy and practice of the financial programs carried out by members.

Mr. de Vries commented that, on the whole, he shared the staff's conclusions; indeed, he might go further than the staff on certain points, although the way the staff argued its case at times created difficulties. There was a rich experience of the application of various kinds of interest rate policies in Fund member countries, and many of the staff's arguments would have gained in persuasiveness if they had been illustrated by more examples from that experience. The language of the analysis could also be improved; for example, the staff obviously gave some Directors the impression that it believed that if only interest rate policies were set right, the world's problems would disappear, regardless of what happened to other policies. He did not believe that the staff intended to give such an impression; it was, perhaps, a matter of drafting. Furthermore, the staff should not argue that because certain policies were pursued in industrial countries, they were therefore correct.

Historically, interest rates had rarely been viewed favorably, Mr. de Vries continued. Some Directors had referred to the Islamic tradition, and a similar tradition could be found in Christian culture, not only in the Middle Ages. There was a natural human tendency for debtors to resent creditors. However, in the real world, interest rates played a crucial role in determining economic development in both developed and developing countries. After the wage rate and the exchange rate, the interest rate was perhaps the most important economy-wide price. Therefore, the staff was correct to argue that an economy was likely to function inefficiently if that important price was set at an artificial level. That normally meant too low a level, and, therefore, the staff appeared to be arguing for higher interest rates generally. However, as the staff would acknowledge, if the interest rate was too high, similar considerations applied. Some arguments could be made to qualify the case for realistic interest rates in developing countries, but they were not, on the whole, convincing. Indeed, because many developing countries were dependent on retaining the capital of their own nationals, the possibilities of maintaining a structure of interest rates very different from the international level were limited. If the authorities attempted to do so, the result was often instability. Therefore, they had to take market interest rates into account, either by letting rates find their own level or, if the financial structure was rudimentary, by setting rates to take account of market rates internationally.

At the moment, real interest rates were high, Mr. de Vries noted, the result of the extraordinary level of budget deficits relative to GNP in the world as a whole. Although developing countries themselves had large budget deficits in terms of GNP, the deficits in the industrial countries were the major reason for the gap between world savings and world demand for savings, and the resulting high interest rates.

Commenting on the relationship between interest rates and savings, Mr. de Vries remarked that the staff argued convincingly that when interest rates got far out of line, in either a positive or negative direction, from what would be an equilibrium level, they had an important influence on savings. A number of Directors had clearly agreed with that important conclusion.

In developing countries, appropriate investment was the fundamental basis of growth, Mr. de Vries observed. The policies that the staff had referred to as "financial repression" artificially reduced the prospective return on investment, and hence the propensity to invest in developing countries. Thus, such low-interest policies, and their associated regulatory measures, tended to reduce rather than promote investment in the long run. As the staff had pointed out, the argument in favor of a low-interest policy rested on the assumption that the funds necessary to finance higher investment would be available. However, reducing the prospective return on investment invalidated that argument. The divergence between private and social return was, of course, a powerful argument against letting the interest mechanism work, and it was regrettable that there was such a large difference between private and social returns in some cases. However, experience tended to show that if governments tried to improve the situation, they often made matters even worse. Governments were poor at judging the social return of investment projects; as a result, when they attempted to lower interest rates to what would be ideal in terms of the calculated social return, they tended to widen the gap in the long run. It should be concluded, however, that all government influence on investment decisions was adverse.

The staff had argued that lower interest rate policies tended to transfer income from small savers to large borrowers, Mr. de Vries continued, but he had found that section of the paper less convincing. The influence of international capital movements on the balance of payments made it difficult in practice for developing countries to maintain an administered interest rate structure. Capital inflows would slow down, capital outflows would increase, and more regulatory measures would become necessary, creating further distortions in the economy. Administrative management skills were among the scarcest resources in developing countries; hence, many regulatory measures tended to be counterproductive in the end. It was worth noting that the management of monetary policy continued to be difficult even in the developed countries.

The staff had drawn his attention to the importance of interest rates and monetary policies in developing countries, Mr. de Vries said. He believed that following an appropriate fiscal policy should be the first concern of governments, but the paper had convinced him that the application of realistic interest rates and monetary policies was an important supplementary instrument that could help developing countries--as well as industrial countries--to promote sustainable growth in the long run.

Mr. Hirao stated that he shared the thrust of the views presented by the staff in SM/82/213, but that he had some difficulties with the way the topics were handled. The paper presented generalized views and observations, but it did not offer policy guidelines applicable to individual economies that operated under a variety of circumstances.

The staff correctly observed that, in many developing countries, interest rates were determined administratively rather than in the market, Mr. Hirao continued, and that there was a tendency for such rates to be lower than current rates of inflation. The policy of holding interest rates at low levels might not always be unwarranted, depending upon the situation. Since there were varying degrees of imperfection in the financial markets of developing countries, there might be a need to correct market imperfections by setting interest rates at low levels. However, the arguments against such a policy were strong, especially at a time when countries were faced with the need for balance of payments adjustment. Subequilibrium interest rates not only discouraged financial savings in favor of the accumulation of goods or foreign assets, but also encouraged businesses to undertake investment with low rates of social return, rather than use the resources to build new productive capacity. Negative, or excessively low, real interest rates, particularly at a time when a country was faced with balance of payments difficulties, would probably have adverse effects on the entire economy by intensifying inflationary pressures and by making the task of restoring economic stability more difficult.

Interest rate policies should be seen in the context of overall monetary policies, Mr. Hirao considered. An important question was how far artificially low interest rates could affect the overall stance of monetary policy. In more developed financial markets, where interest rates were more freely determined by market forces, lower interest rates were likely to be associated with excessive expansion of the monetary aggregates. The same effect might not apply in an administered financial market. If that was so, in addition to the efforts to keep interest rates at a desirable level, equally serious attention should be given to better control of money growth in a developing economy, in which the priority should continue to be that of bringing inflation under control. Since both the money supply and the interest rate were influenced significantly by the way in which fiscal deficits were financed in individual countries, attention should also be given to restraining fiscal deficits.

Commenting on the relationship between interest rates and investment, Mr. Hirao observed that the staff seemed to suggest that the level of interest rates had a more critical influence on the distribution of investment between domestic financial assets and the accumulation of goods, than on decisions affecting the level of productive investment. The staff also suggested that, if interest rates were regulated, the necessary real credit expansion would not be forthcoming to finance the increased investment demand and that the financial system would have to resort to various rationing schemes to allocate the available credit. It was conceivable that low interest rates might induce a high level of desired investment, but actually reduce realized investment because of the possible adverse effects on the available financial resources.

A related interesting point, Mr. Hirao continued, was the staff's discussion of the productivity and quality of investment. Two aspects were worth emphasizing, although a number of other factors affected the quality of investment, some of them perhaps more important than the level of interest rates. First, low interest rate policies, if accompanied by administrative rationing of scarce financial resources, could make it difficult to identify priority sectors. Second, low interest rates encouraged transfers of financial resources into inflation hedges by businesses. They also encouraged capital outflows or discouraged workers' remittances from abroad, as foreign assets with higher yields became comparatively more attractive.

The appendices to the paper had been particularly interesting, Mr. Hirao remarked. The staff seemed to suggest that a change in interest rate policies could have an important impact on the rate of accumulation of financial assets, and that the changed rate of accumulation in turn had a positive impact on growth. Further analyses could be undertaken to determine the causal relationships among interest rates, financial savings, and growth. Perhaps at a future date, time series analyses could be attempted, in the form of case studies of a few countries with wider data bases.

Executive Directors agreed to resume their discussion in the afternoon.

LEO VAN HOUTVEN
Secretary