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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Seminar 82/10

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F. Sangare	
	J. L. Feito
	L. Vidvei
Zhang Z.	

L. Van Houtven, Secretary
J. A. Kay, Assistant

Also Present
B. Legarda, Consultant. Asian Department: E. Gurgen. Central Banking Department: L. M. Koenig, Deputy Director; V. Galbis. European Department: P. L. Hedfors, P. C. Hole. Exchange and Trade Relations Department: M. Allen. Legal Department: Ph. Lachman. Middle Eastern Department: G. Tomasson. Research Department: A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; A. Lanyi, D. G. Rwegasira, R. Saracoglu, V. Sundararajan, P. Wickham. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: E. A. Ajayi, C. J. Batliwalla, L. Ionescu, H.-S. Lee, I. R. Panday. Assistants to Executive Directors: R. Bernardo, M. Camara, T. A. Connors, R. J. J. Costa, G. Ercel, M. Hull, P. Leeahtam, W. Moerke, V. K. S. Nair, Y. Okubo, J. G. Pedersen, G. W. K. Pickering, M. Z. M. Qureshi, J. Reddy, C. A. Salinas, H. Suzuki, A. Yasseri, Zhang X.

1. INTEREST RATE POLICIES IN DEVELOPING COUNTRIES

The Executive Directors, meeting in seminar, continued from the previous session (Seminar 82/9, 12/10/82) their discussion of a paper on interest rate policies in developing countries (SM/82/213, 11/12/82; and Cor. 1, 11/30/82).

Mr. Dallara commented that most of the points in the paper about the importance of interest rates were generally well known to economists, although they were not often presented in such a thorough and well-balanced manner. Unfortunately, the benefits of a rational interest rate structure backed by other appropriate policies, and the cost of an inappropriate interest rate structure, did not always seem to be fully appreciated in the policy formulation process. As with certain other policy instruments, the long-term benefits were not always easy to perceive or, where they were perceived, they were not always easily explained to various interest groups or to the population at large. Part of the task of the Fund was to articulate forcefully to national authorities its views on the importance of a rational interest rate structure. The Fund could not and should not be dogmatic or make overreaching generalizations about developing countries, which obviously varied considerably in a number of important respects; the arbitrary application of theories based on assumptions which might not be wholly relevant to the circumstances of an individual country would clearly not be helpful.

Nevertheless, despite the many qualifications that could be made, he could not escape the conclusion that a rational interest rate structure was desirable in virtually every case, Mr. Dallara mentioned. It could be marginally beneficial to growth prospects while facilitating external adjustments even in the absence of a broad range of supporting policies, and even in economies with a narrow institutional base. Put more directly, even in the most difficult circumstances, the benefits of a rational interest rate structure appear to generally outweigh the cost. With appropriate supporting policies and the development of new institutions, a rational interest rate policy could become a central element in minimizing the short-term costs of balance of payments adjustment, promoting an efficient allocation of resources, and stimulating growth in virtually every case.

His authorities supported the thrust of the staff paper and its conclusions, Mr. Dallara stated. It was important to note that, while the staff made convincing arguments in favor of a rationalized unrepressed structure of interest rates, it did not by any means pretend that a movement toward appropriate interest rates was a panacea. He would share the concern expressed earlier by Mr. Joyce and Mr. de Vries if he felt that the staff had used the term "financial repression" in any pejorative sense. He did not so feel, however; he therefore had no reservation regarding the use of the term, which he was sure was wholly within the context in which it was used in the economic literature.

The interest rate was one of the most important prices in an economy, with a major effect on the level of output and on the allocation of resources, Mr. Dallara remarked. An unrepressed financial system together with an appropriate array of prices throughout the economy, and an appropriate exchange rate, could be an excellent foundation for growth and development.

Naturally, as the staff had indicated, it was important to bear in mind that interest rates alone could not be expected to mobilize significant financial resources without appropriate supporting policies, including making financial institutions accessible to the urban and rural populations alike, Mr. Dallara noted. The fact that the effectiveness of interest rate reform was found by the staff to be dependent, in part, upon the degree of development of local financial markets underscored the need to encourage the establishment and growth of domestic capital markets. The Fund's technical assistance, in cooperation with the capital markets departments of other international financial institutions, could help to foster such developments.

Another important conclusion to be drawn from the paper was that considerable damage could be done to an economy when an inappropriate interest rate structure was maintained, Mr. Dallara observed. With repressed interest rates, households and firms were provided with incentives to hold excessive inventories of real assets that were likely to be better inflation hedges than financial instruments. He had seen that phenomenon in a number of recent cases that had come before Executive Directors.

Commenting on the role of interest rates and the productivity of investment, Mr. Dallara said that the staff's observation that subsidized interest rates, coupled with above-equilibrium wage rates, tended to lead to a bias toward capital intensive techniques was correct. Overvalued exchange rates often coexisted side-by-side with subsidized interest rates and above-equilibrium wage rates. Such an arrangement would make imported capital cheaper in local currency terms, but it would exacerbate a country's problems further as well as having an adverse impact on employment opportunities.

On the subject of the distributional effects of various interest rate levels, Mr. Dallara noted that while the staff's conclusion that the overall distributive impact of such interest rate policies was probably not substantial seemed likely to be correct, it had apparently missed the essential point, which was that if a government wished, for whatever reason, to redistribute income, there were many less distorting alternative instruments than manipulating interest rates.

Taking up the section of SM/82/213 on interest rate policies and demand management, Mr. Dallara observed that the staff had made it clear that the problems caused by interest rate distortion soon spilled over from the domestic part of the economy to the external sector. If the authorities persisted in trying to administer interest rates at levels seriously below equilibrium rates, they were often forced to extend damaging controls to trade and payments. In general, extensive and lasting controls on important economic variables were generally incompatible with efficiency. Many countries that came to the Fund for assistance in formulating a stabilization program appeared to have reached the same conclusion. SM/82/213 made convincing arguments for believing that interest rates would indeed continue to be a topic of discussion between the Fund and countries in Article IV consultations, and in connection with adjustment programs. He associated himself with the thrust of Mr. de Vries' remark to the effect that that aspect could benefit from increased attention. The staff was clearly aware of the short-run problems that might arise from interest rate reform, and he hoped that it would take them into account in discussing with member countries either in connection with Article IV consultations or with the formulation of adjustment programs.

Mr. Taylor said that he welcomed the opportunity to discuss interest rate policies in developing countries at a time when many interest rates still appeared to be well below what might be considered realistic economic levels. The staff paper was well reasoned, and he could agree with the broad thrust of the analysis.

There could be no doubt, Mr. Taylor considered, that interest rates played a significant role in many developing countries, and that the role was increasing as financial markets became more sophisticated. The staff found that many countries practised what it called "financial repression," but what he would prefer to call a "cheap-money policy." The staff also found that that type of policy had been a factor contributing to the misallocation of resources, to balance of payments difficulties, and to high inflation rates. Without agreeing with everything that the staff had said, he thought it evident that its conclusion was an important one that deserved serious consideration.

The Managing Director assumed the chair.

The staff had said nothing about centrally planned economies, Mr. Taylor went on. The role of interest rates probably decreased in importance the more centralized or heavily planned the economy that was being considered. But even in the most centrally planned economies, the plan needed to have an implicit or shadow interest rate reflecting the social cost of capital in order to calculate rates of social return in the various plan sectors. Furthermore, even in highly planned economies, some decisions were still left to enterprises, and they did seem to be affected by the real cost of credit given or received at the enterprise level. The shadow rates and the actual rates of interest in a planned economy should clearly not be vastly different if reasonable allocative efficiency was being aimed at. It was nevertheless true that certain centrally planned economies, including at least one that had a multiyear arrangement with the Fund, were among those that had actual interest rates that had been heavily negative in real terms, and he took it that those economies would not come into the category that would normally expect to have a negative rate of interest. While not all economies would expect a positive rate of interest in real terms, most centrally planned economies presumably would.

Taking up the topic of demand management, Mr. Taylor said that the staff had rightly emphasized that the adoption of more flexible interest rates was one of a combination of policy measures that would also include fiscal and monetary policy and, perhaps, exchange rate adjustment in the pursuit of economic stabilization. The paper had however not addressed the question of the appropriate mix between fiscal policy and monetary policy and exchange rate policy in a developing economy, or how the mix might differ from what would be appropriate in developed or industrial economies, although that was a question that Executive Directors often found it difficult to answer in dealing with the problems of particular countries. For any given country, there was possibly a quite complex trade-off between different policies to achieve a given demand management stance, with given parameters in the private economy. In other words, there were connections between interest rates and the exchange rate, and a trade-off existed between them. It was an interesting question how countries should attempt to conduct that balance. In the United States, there had been a combination of what was widely regarded as a fairly accommodative or expansionary fiscal policy, together with what had been by normal standards regarded as tight monetary policy. That mix of policies had brought about rather high real exchange rates. Was it relevant to ask what kind of balance a developing country should be aiming at?

An attempt at an answer might be obtained, Mr. Taylor suggested, by recalling that developing countries often had large fiscal deficits and uncomfortably high real exchange rates. But, in such cases, the high real exchange rates seemed to be the product not of tight monetary policy but of pervasive exchange and import controls. A solution to the difficulty might consist in dismantling the system of protective controls that surrounded the balance of payments, while simultaneously adopting higher interest rates and a tighter stance of monetary policy. That kind of approach would make it possible not only to reduce controls but to offset the impact by the adoption of tighter policy in other fields. In brief, developing countries might turn to interest rate policy as an instrument for managing the exchange rate and the balance of payments on a rather more extensive scale, thus shedding some of their reliance on administrative controls. Naturally, such a solution would hardly work in a country that had few financial assets denominated in domestic currency for savers to hold. Moreover, interest rate action on its own was most unlikely to be an adequate policy response to balance of payments problems in many countries; action in the fiscal field would often be needed as well. In any event, the staff might have paid more attention to policy questions of that kind.

A number of previous speakers, Mr. Taylor commented, had observed that the empirical evidence did not support the view that savings were very responsive to interest rates; they had therefore put forward the suggestion that much of the rationale for having high or realistic or market-determined interest rates tended to disappear, particularly in developing countries. On the other hand, the staff had made the point that, in many economies, financial intermediation was responsive to interest rate incentives. It did seem that economic development required an increasing separation of savings and investment decisions as the economy became more complex. It was therefore only logical that economic development and growth would benefit if interest rates offered savers a rate of return that was not incommensurate, after allowing for risks and rewards for enterprise, with the returns that were available on physical investments.

Second, there had been some speakers who had argued that the staff's analysis was not really relevant to the smallest and poorest of the developing countries because household savings in such economies were negligible or because the principal investment decisions in those economies were largely in the hands, if not of government, at least of the public sector or parastatal enterprises, Mr. Taylor observed. Furthermore, those speakers had argued, interest rates were sometimes not within the control of the authorities in small countries with rudimentary financial systems, either because they faced powerful foreign-based banks or because they were members of currency unions. He could agree that interest rate policy was probably not a very effective instrument of economic stabilization in the smallest economies, at least until they developed further. Fund programs for those small economies would therefore have to concentrate on other areas and other instruments, in particular on fiscal policy and institutional improvements. But he had not heard anybody suggest that interest rates should be kept at significantly negative levels in real terms even in those economies. Moreover, few speakers had suggested that there were arguments for extremely sharp changes in nominal interest rates when they were manifestly out of line. Any change should clearly be made at a reasonable pace. Nevertheless, change had to be brought about, and special justification would have to be given for persisting with unrealistic interest rates in cases discussed by the Executive Board.

What the staff had shown was that when a member believed that interest rates were important for its economy, the Fund had a responsibility to help the members improve the working of its interest rate mechanism, Mr. Taylor commented. It was difficult to escape the conclusion that in a system of capital markets and goods markets linked by a common set of prices, interest rates provided the most satisfactory method of discounting the future, even with all the imperfections of market economies. Once a member of the Fund had decided to expand its capital markets and the authorities became interested in interest rate policy, the Fund should encourage it by providing technical assistance when necessary and by reviewing the changes in the capital markets and the role of interest rates as part of Article IV consultations or in connection with Fund programs.

There was a range of cases, Mr. Taylor believed, in which interest rate adjustments should feature explicitly in Fund programs, sometimes with prior conditions, sometimes perhaps only as fairly precise continuing commitments, to which countries could be held in the course of the program.

There was considerable merit and interest in the paper, Mr. Taylor considered. It contained a great deal of material that would be of interest to a wider audience; and he would be happy to see it published if there were any thought of doing so, subject to minor revisions here and there.

Mr. Zhang described the staff paper as interesting and provocative. The object of his comments was to draw attention to some issues that needed further consideration.

The staff did not sufficiently discuss the characteristic differences between financial institutional structures or the public demand for savings assets, as between a less developed and more developed market economy, Mr. Zhang remarked. The authors should have emphasized more strongly that developing countries could not be regarded as a meaningful grouping for economic purposes. It was not satisfactory to suggest that interest rates in organized financial sectors like those of Portugal or Singapore played the same role as they did in Zambia or Nepal.

Second, Mr. Zhang went on, the staff had tended to overstate the importance of holding down interest rates in organized financial markets as a means of creating a preference for certain forms of wealth in low-income countries and of similar policies and as a primary cause of disruption of macroeconomic stability. Third, in providing an account of the problem of achieving a level of interest rates that did not inhibit investment in a low-income country subject to economic and political instability, the authors had not considered some crucial elements, such as risk. It was possible to conceive of a situation in which a mistrust of financial institutions was so great that even very high real interest would not persuade people to hold their savings in banks instead of gold or foreign exchange. Relative risk was an important consideration.

Fourth, Mr. Zhang went on, the treatment of the connection between macroeconomic policies and the use of interest rates and credit controls was, in places, inadequate. In the section on the implications of interest rate policies for demand policies, for instance, he had not found a full account of how freely determined rates would behave in the context of demand management policies. Further, in Section IV, the staff had implied that controlling interest rates had been the primary consideration of demand management policies, rather than a concomitant of fiscal and monetary policies that were being pursued for other reasons. As a result, there was a tendency to ascribe to interest rate policies the adverse consequences of a whole set of policies. On page 19, for instance, repressed interest rates were treated as the cause of economic instability. He was inclined to believe that, in the scenario discussed, the appearance of severe financial repression was a consequence of demand management policies, not of the existence of controls per se.

Taking up specific points, Mr. Zhang observed that one question that required more consideration was the effect of interest rates on financial assets in an economy where a large proportion of investment did not involve financial intermediation through the banking system and organized financial markets. He wondered to what extent in those countries most savings and investment decisions were taken separately. It would be interesting to know what proportion of investment was carried out by self-financing in small enterprises, or by borrowing from family members, from local partnerships, and in informal markets. Where there was close contact between borrowers and lenders, favorable business prospects and strong incentives for investment might promote increases in personal savings rather than consumption, thus encouraging lending and investment in place of the acquisition of tangible assets such as gold. Another important question was what proportion of all savings and investment was accounted for by the multinational corporations that dominated economic activity in the modern sector of many developing countries. Experience had shown that savings and investment decisions were determined largely by considerations other than financial ones in developing countries. Without that type of information, it was not clear whether the interest rates on a narrow range of financial assets in those countries did represent the cost of financing fixed investment, or whether an increase in interest rates resulting in higher financial savings did not in fact represent an increase in the cost of financing the fixed investment for the country as a whole.

He wondered exactly what the staff was advocating as a desirable interest rate policy, Mr. Zhang stated. Did it wish a country to avoid financial repression, meaning interest rates below some market-determined rate with a considerable degree of freedom for capital movements? Was the staff suggesting that interest rates ought to serve the purpose of bringing the underlying demand for funds into equilibrium with their supply? If so, what did the staff mean by "underlying"? Should interest rates not be freely determined by short-term market conditions?

The staff had concluded by stating that there should be interest rate reform whenever real interest rates became negative, Mr. Zhang noted. The preceding discussion showed the difficulties of applying such a proposition. Real interest rates ought to be judged in the light of the rate of inflation that was expected to prevail some time in the future; hence, it might not be easy to decide whether the real interest rate had become negative if there was a sudden upsurge in prices due to some factor such as oil shocks. The staff treated real interest rates as negative when nominal rates were below the current rate of interest as measured by some price index. The staff had suggested that the experience of a number of countries concerned with the dependence of domestic financial savings on interest rates, and the statistical evidence in Appendix III, gave support to the view that in the long run positive real interest rates contributed to the growth of real output. It was further suggested that the growth of real output might come about either because higher interest rates raised the quality of investment, thus increasing the growth rate and the growth of financial savings, or alternatively that higher interest rates led to more financial savings and thus to a growth of output. In fact, the table on page 40 of the staff paper suggested that the line of causation could have run from real autonomous factors to the growth of real financial savings and thence to the possibility of positive real interest rates, without damaging real output growth. The table showed that it was not necessary to have real positive interest rates in order to achieve rapid growth of real financial savings. Generally speaking, all the eight countries that had experienced rapid growth of real financial savings were in Eastern Asia, except for Morocco. It was tempting to believe from the evidence that real autonomous factors, common to the countries of the area, such as the stimulus of export markets and inflows of international liquid funds during the period 1971-80, had been conducive to the rapid rise of financial savings. Borrowers were apparently prepared to pay higher nominal rates of interest when there were favorable prospects for profitable investment. On the other hand, unfavorable external factors tended to bring about the opposite result.

Finally, Mr. Zhang observed, it would have been useful if country materials available for consultation reports had been used more fully on the analytical side of the paper. He hoped that some of the conclusions arising from the discussion would be passed to the area departments of the Fund for their use in evaluating interest rate policies, and for designing stand-by programs with members.

Mr. Coene remarked that the staff had written a clear analysis of the role of interest rates in resource allocation in developing countries. The paper showed that interest rates had indeed a broad and pervasive influence in the economy. As a price, interest rates should equilibrate the supply and demand for funds, and any large departure of the real interest rate from that equilibrium level would inevitably lead to a misallocation of resources, which would negatively affect growth potential. He was not however fully convinced that there was a theoretical justification for the idea that the interest rate equilibrium in all cases had to be at a level where the rate was positive in real terms, as seemed to be implied throughout the paper. Much depended on the particular supply and demand conditions in any given country, and its growth requirements. Large deviations from the equilibrium level, however, could only have negative influences on resource allocation, and correcting the deviation would have a major impact, even on financial savings in low-income countries. In those circumstances, the staff recommendations were quite appropriate. When there was a narrow range of variations in real interest rates around the equilibrium level, the balance of the different forces at work was less clear cut, and the empirical evidence in industrial countries tended to validate that outcome. The conclusion about appropriate interest rate policies should thus be qualified--as the staff had indicated--and they should be dealt with on a country-by-country basis.

The price level had exercised its equilibrating effect and achieved the optimum level only in conditions of competition, Mr. Coene observed. Where there was no competition, there might be some justification for the authorities wishing to control interest rate developments in a flexible way, so as to allow the interest rate to reach its optimum level in the prevailing circumstances. Even if that was a second-best approach, it seemed preferable to a system of market-determined interest rates, which could be very destabilizing in a thin market, particularly in low-income countries where only limited domestic savings were available, and there was no choice of profitable investment opportunities.

In those cases where interest rate reforms were warranted as an element in an adjustment program, Mr. Coene stated, caution should be exercised in undertaking them; otherwise there were likely to be financial problems and bank failures. The short-term effects of such reforms might be destabilizing even if the longer-term effects on savings and investment were positive. The staff had mentioned that while higher financing costs discouraged borrowing for investment in existing firms, the amount needed for working capital tended initially to increase, particularly when firms had a high debt/equity ratio as a result of overborrowing during a long period of high inflation. A significant decrease in the ratio could not be brought about in a short period, and there might be a need for the authorities to soften the impact of the interest rate reform on the industries affected.

When interest rate reforms were introduced, Mr. Coene concluded, they should be supported by a reform of banking and financial practices. In developing countries, the financial sector was mostly oligopolistic, meaning that the banking sector tried to determine interest rates by gentlemen's agreement. Any real reform would thus require the introduction of some competition in the financial markets. Reform could be brought about by a flexible setting of interest rates, by introducing new financial instruments, by regulating the financial markets for the classical central bank instruments, and by carrying out institutional improvements.

Mr. Jaafar commented that the staff had persuasively argued the case for the maintenance of positive real interest rates on two grounds: first, interest rates represented a deserving reward or incentive to savers for forgoing consumption; second, they were an effective means of encouraging productive use of capital. The staff considered that financial savings were responsive to positive real rates of interest and that the countries that maintained positive real rates of interest tended to achieve a higher rate of growth. He had no difficulty with the theoretical argument for maintaining a positive real rate of interest. Interest after all was the price that had to be paid for money or capital. It was rather paradoxical that in many developing countries, where capital was a scarce resource, its price had been deliberately kept low.

The term "developing country" covered a mixed rather than a homogenous group of countries, Mr. Jaafar considered. For the purpose of analyzing interest rate policies in less developed countries it would therefore be appropriate to divide the countries into various subgroups, instead of merely into low-income and higher-income countries. A useful grouping might be: first, Islamic developing countries, which had begun to introduce the concept of Islamic banking, in one form or another. Second, there were the oil-rich countries, where a substantial portion of exports and national income was derived from the sale of oil. In those countries savings and expenditure were the primary function of fiscal policy, government expenditure, and savings, so that interest rates had only a marginal role to play. Third, in centrally planned economies, savings and the allocation of resources were planned by the state. Consequently, interest rates had a limited role to play. There, savings and the allocation of resources were planned by the state, and interest rates had only a limited role to play. There were of course other partly planned economies where the market mechanism was allowed to play some role in the allocation of resources.

Two days previously, Mr. Jaafar recalled, Executive Directors had discussed the economy of Hungary, and had learned that the availability of consumable items, inflationary expectations, and interest rates all influenced the level of savings in that country. The same three factors seemed to be relevant in developing countries. There were of course economies that were essentially free; in them most decisions on savings and expenditures were taken by the private sector. It was to that category of countries that SM/82/213 was particularly addressed. The scope for pursuing independent interest rate policies in countries with an open external sector was rather limited. It could in fact be argued that any interest rate policy in a developing country was bound to be strongly influenced by interest rates in major industrial countries.

No single analysis was appropriate for all less developed countries, Mr. Jaafar believed. What was needed was a different analysis for each of the various subgroups of countries, one that would take into account all the factors influencing savings and investment. One example that he had cited was the Islamic countries, several of which had already introduced alternative methods for sharing profits and losses.

Regarding the empirical evidence given in the staff paper to illustrate the positive relationship between real interest rates and financial savings, and between real interest rates and the rate of real growth of gross domestic product, Mr. Jaafar said that he would like to know whether a similar result would have been obtained by the staff using different sets of data and different sets of less developed countries.

The staff had written on page 21 of SM/82/213 that interest rate action had been specified in 13 extended arrangements approved between 1978 and 1980, and in 11 stand-by arrangements approved in 1980, Mr. Jaafar noted. He wondered what the experience with the use of interest rate policies had been in the 24 countries. In those cases where the interest rate policies had been effective, it would be helpful if the staff could say which complementary factors had helped in the process. In the cases where interest rate policies had not been effective, did the staff have any idea which missing ingredients could have made them so? More information of that sort would help Executive Directors to decide whether the existing interest rate policies in less developed countries were effective or not.

The staff had given a number of reasons why the authorities in less developed countries liked to keep interest rates at a low level, Mr. Jaafar remarked. There were even more reasons than those given by the staff. Attempts to achieve a better distribution of income and employment had often been mentioned. While the arguments for positive real rates of interest were sound, in some less developed countries the reluctance of some authorities to permit interest rates to be determined by the market was based on a lack of financial institutions, which could give rise to a number of imperfections in the financial markets. Other institutional, social, and political constraints in a number of countries had made it difficult for the authorities to increase interest rates to a level consistent with the market rate. It might be helpful if the staff would conduct an in-depth study of the experiences of less-developed countries with interest rate policies.

Mr. Sangare commented that the role of interest rates in developing countries was a topic that continued to claim the attention of both academic economists and policymakers. Much more extensive work was required to provide further insight into the ways in which interest rate policies could be set not only in pursuit of short-term and medium-term stabilization, but also in the light of the longer-term objective of economic development. He hoped that Executive Directors would have the opportunity to return to that aspect at some time in the future.

Making three general observations, Mr. Sangare found that, judged on its own merits, the model adopted by the staff was theoretically consistent, and indeed offered one approach to determining how financial resources were mobilized and allocated in the short term in economies in which the capital market functioned efficiently, and in which the level of income was relatively high. However, the model paid little attention to institutional factors, and thus lost much of its relevance as a basis for development strategy. Second, the sample of countries used in the paper was rather small. Consequently, it was difficult to know how valid it would be to extend the conclusion to other developing countries, many of which differed in important respects from those mentioned by the staff. Third, the paper was short on empirical evidence. It would have been helpful if more quantitative information had been provided, as the basis for evaluating the findings of other empirical work in the field.

Taking up specific issues discussed in the paper, Mr. Sangare commented that the staff seemed to believe that interest rates served as a price incentive to savers. Hence, a rise in interest rates should stimulate savings, particularly during periods of high inflation. In practice, from an operational point of view, such a simple relationship did not hold true in all cases. Empirical studies had shown conflicting results, with some researchers arguing that no useful effects had been obtained by introducing into the savings function an interest rate variable, real or nominal. Consequently, while policymakers should be aware of the potential use of interest rates as a tool for mobilizing domestic savings, the importance to be attached to it should be based on conditions in any given country. One of the conditions that would have to be taken into account in developing countries was the level of real income. If the income of the majority of the population was spent on necessities, it would be a mistake to think that the volume of domestic savings could be increased by merely raising interest rates. In those circumstances, the model would have to take into account the level, distribution, and rate of change of income.

A dynamic analysis would also be concerned with institutional problems, like those associated with the mobilization of savings in the rural sector, Mr. Sangare remarked. In many developing countries, a large proportion of the people had little or no access to financial institutions, and banking operations were concentrated in towns. Such a situation suggested that the potential impact of interest rates on the saving level in less developed countries would be moderate. While the staff was aware of the problem, it had made no suggestions for improving the situation. It had been argued that in Africa, for instance, where the nonmonetized sector was relatively large, monetization could be considered as an important part of savings policy, since it would facilitate the transformation of savings in kind into monetary forms. There was also empirical evidence which suggested that financial intermediation had positive influence on domestic savings in most developing countries.

On the impact of interest rates on investment, Mr. Sangare noted that the staff had expressed concern that in many developing countries the high interest rate could impede investment and hamper economic growth. Their concern was legitimate, as it was in industrial countries, where it was generally agreed that high interest rates had played an important role in keeping the economy stagnant. In industrial countries, the thrust of economic policy was not to adjust interest rates upward to cope with inflation; rather, it was to reduce inflation and by so doing to push interest rates down to reasonable levels. A similar arrangement would surely be an appropriate policy stance for developing countries, at least from a longer-term perspective, if the rate of interest was to bear some relation to the rate of return on investment. In most developing economies, agriculture and small-scale enterprises predominated. Could the expected average rate of return be high enough to induce investors to borrow at high rates of interest, since the returns on agricultural and other small-scale enterprises depended to a great extent on price movements abroad, over which developing countries had no control?

Another important issue was the uses to which the financial resources were put, Mr. Sangare commented. The staff seemed to be saying that resources tended to flow into nonpriority investments when interest rates were below their equilibrium level. A corollary would be that once the distortions had been corrected, the market would allocate resources rationally. In considering that argument, it would surely only be fair to acknowledge that there were difficulties in allocating scarce financial resources through administrative means. It was of course true that what might be considered nonproductive projects did find their way into development plans, or were given priority for credit purposes. However, it remained doubtful whether the removal of interest rate questions would necessarily produce the desired allocation of resources in a given situation. For instance, could policymakers rely upon the rate of interest to channel savings into investment in agriculture, a priority sector in many developing countries? Would the equilibrium level of interest rates guarantee that increased savings would not be used to support the consumption habits of urban dwellers? Clearly, due consideration would have to be given to other variables in conjunction with interest rate policy, if the volume and quality of investment were to be improved in any given country.

The staff had also discussed the influence of interest rate policies on capital flows, indicating that the experience of several countries suggested that such flows were highly responsive to variations in interest rates, Mr. Sangare noted. His view was that institutional arrangements to attract remittances of expatriate workers, such as the possibility of maintaining foreign currency accounts, were essential. Similarly, political stability of the sort that affected public confidence did play an important role in determining the extent of the impact of interest rates on capital flows.

In conclusion, Mr. Sangare observed that the staff paper was an appreciable contribution to the complex question of interest rates in developing countries. More needed to be done to cover the aspects that several Executive Directors had touched upon in their statements. He was therefore looking forward to a future paper in which the staff would take account of the remarks by Executive Directors at the present meeting.

Mr. Prowse commented that SM/82/231 and Correction 1 was a solid exposition of what might be called the received doctrine on the subject. It certainly seemed to be in line with the main stream of academic thought. In adopting the expression "financial repression," the staff was in good company with the academics of the past decade or so. On that point, Executive Directors might be interested to hear a quotation from McKinnon's work entitled Money and Capital in Economic Development. Talking of the role of bankers in less developed countries, McKinnon had written: "But organized banking has a sorry record in penetrating the economic hinterland of less developed countries, in serving rural areas in general, and in serving small borrowers in particular. Bank credit remains a financial appendage of certain enclaves: exclusively licensed import activities, specialized large-scale mineral exports, highly protected manufacturing, large international corporations, and various government agencies, such as coffee marketing boards or publicly controlled utilities. Even ordinary government deficits on current account frequently preempt the limited lending resources of the deposit banks. Financing of the rest of the economy must be met from the meager resources of cooperatives, money lenders, and so on. It is this phenomenon that I call 'financial repression.' An increase in the efficiency of [the banking system] is, therefore, a necessary condition for enlarging the real size of the monetary system and for alleviating the problems which arise with it." The staff's use of the language therefore seemed to be perfectly in order.

In his view, Mr. Prowse continued, the staff had developed a clear case in favor of allowing interest rates to be determined in the market. It was however not necessarily established that the real interest rate should be positive at all times. Nor did he believe that the staff had actually made such a claim. There were market situations in which the rates that were produced would not be positive in real terms, a fact that ought to be recognized by Executive Directors.

It had been rather difficult to discover at first reading that the staff had been discussing the impact of interest rates over different time periods, Mr. Prowse commented. In the longer term, there was surely little doubt that real interest rates should be positive. There was less scope for agreement about the need for positive real interest rates in any given economy in connection with short-term stabilization.

As he understood it, Mr. Prowse went on, the staff had simply been saying that higher rates of interest led to higher rates of saving in many economies, and that the higher supply of savings led to higher real growth; such a conclusion had to be considerably qualified. On the other hand, a number of Directors had tended to overlook a valid point that the staff had been making, namely, that higher rates encouraged higher financial savings, as distinct from savings in other kinds of assets. Consequently, the proportion of the national income that was being saved might not increase as fast as the part that was being saved in financial assets. He would therefore support some of the comments to the effect that there was no need for real interest rates to be positive at all times made by other Executive Directors, not only because of the dichotomy between short-term and long-term considerations but also because of the number of economic groups included in the term developing countries. It did not seem possible to apply the conclusions reached by the staff to all developing countries without qualification; but the staff had not suggested that it would be.

He would have liked to see an appendix surveying the analytical argument, even though the paper was generally consistent with academic thought, Mr. Prowse stated. He would have also liked to be able to examine in greater detail the empirical studies available elsewhere. He would also have found it helpful if the staff had given more recognition to the great diversity of economic forms in developing countries. The staff had for instance mentioned planned economies, Islamic economies, very poor economies, and small poor economies with no financial infrastructure at all. In the latter it seemed clear that raising interest rates would not stimulate saving, since most of the population had no contact with financial institutions. Indeed, one of the countries in his constituency had produced a savings bond with a positive real rate of interest, to which the total subscription in a year had been $12,000. At the other end of the scale, Mr. de Groote had mentioned two days previously that in Hungary the level of savings was not sensitive to the level of interest rates, according to many economists.

Another point that might be worth bearing in mind, Mr. Prowse considered, which he would return to later, was the importance of the external environment in affecting the freedom of the authorities to determine monetary policy within a developing economy.

As to the empirical evidence, Mr. Prowse noted, the staff had made some comment on page 8, where it had written: "The view that interest rates play only a minor part in the determination of saving is supported by empirical tests that reveal only a weak response of savings to interest rates. In evaluating the empirical evidence, however, it must be borne in mind that most studies have focused on industrial countries, which typically show a very narrow range of variation in real interest rates. Applicability of these studies to developing countries is questionable, particularly to those countries where real interest rates are at times substantially negative." But there was surely no a priori reason to expect interest rates to be more effective in the relatively unsophisticated economies of the developing world. Moreover, the staff had relied on an examination of only four somewhat special examples to suggest that savings were more responsive to interest rates in developing countries.

There were also some interesting theoretical excursions; on page 22, Mr. Prowse observed, the staff had written: "The financing of the public sector deficit would be inflationary only to the extent that the resulting rate of monetary expansion exceeds the rate at which the demand for financial assets is increasing." In other words, the public sector deficit would be inflationary only if it exceeded the rate of savings in the economy. He would not agree with such a statement, nor with the following one to the effect that, if the public were offered financial assets at positive real rates, the effect might be net deflation.

The important thing was to recognize, in any particular case, the nature of the economic system the member proposed to adhere to, and its stage of evolution, Mr. Prowse considered. In an appropriate system it would be essential to develop the suitable financial infrastructure if there was to be any prospect of utilizing monetary policy. In passing, the paper did seem to elevate interest rates to the level of a major objective, but even in sophisticated market economies there was a question of whether any particular level of rates was to be sought. The staff might be interpreted to be saying that, where appropriate, authorities, not the market, should determine the rates, which should be positive real rates; but what should they do about monetary aggregates?

The staff had indicated that it recognized that the financial markets could suffer from serious imperfections, Mr. Prowse went on. He wondered whether, in such circumstances, there was a case for offsetting intervention. Mr. Lovato, for instance, had said at the previous session that tackling distortions in parts of the economy on a case-by-case basis might produce a worse net result rather than a better one. He therefore wondered what the attitude of the staff would be to allowing interest rates to become market determined as a goal worth pursuing in an economy that was otherwise structurally distorted because of tariffs, restrictions on capital inflows, and the like.

A further difficult question was how the developing countries should deal with a situation in which high real interest rates were generated in the United States, or in the Eurodollar market, as a result of domestic policies in one of the major countries, Mr. Prowse believed. Should the developing countries allow interest rates at home to follow overseas real interest rates both up and down, or should they try to preserve the objective of having positive real interest rates at all times? Surely, such an attempt would involve constraints on capital flows. In practical management terms, developing countries might have both to protect themselves from capital outflows and to encourage capital inflows. The staff had not given much guidance on how developing countries should balance the pressures on their economies from allowing their monetary policy to be determined by external forces.

Another matter on which the staff had not provided guidance was how to act if external factors generated a sudden increase in external interest rates, Mr. Prowse observed. Should the increase be immediately passed on in the form of a rise in domestic interest rates, to be followed by a fall in rates when world rates changed once again?

Continuing his remarks, Mr. Prowse observed that the received wisdom was that countries would have to adjust quite rapidly to avoid experiencing balance of payments difficulties. But the adjustment would have to be to external factors regardless of the country's long-term objectives. On the other hand, some developing economies had tended to take the approach that interest rates could be negative for some time in particular circumstances, using reductions in the domestic price level to produce real positive rates in the longer term. The outcome might be a more stable situation than would have occurred if interest rates had been adjusted rapidly to external price pressures.

Finally, in developing countries the financial structure was typically not a free market but rather oligopolistic, Mr. Prowse remarked. In those circumstances, he wondered whether it would be suitable for the government to adopt a no-ceiling interest rate policy. Put differently, in a less than perfect market, was there a case for intervening in order to avoid the exploitation of borrowers?

He had found the staff paper interesting and thoughtful, Mr. Prowse stated. Looking at Table 3 on page 40, which the staff had prepared to demonstrate that positive real interest rates had been associated with a strong growth in gross domestic product, he thought that the table might also be said to demonstrate that real growth in gross domestic product was associated with high rates of growth in broad money. If that proportion turned out to be correct, what would be the implication for the Fund's policy prescriptions? The table certainly indicated that the highest rates of growth were associated with the highest rates of expansion of broad money; it would be interesting to follow the deductions that could be made from that discovery.

Mr. Malhotra commented that the staff appeared to advocate a rather simplistic view of the policies that ought to be followed by developing countries in connection with interest rates. He would support the caveats expressed by Mr. Finaish, Mr. Salehkhou, and Mr. de Maulde, with whom he agreed almost entirely.

It would have been most useful, Mr. Malhotra went on, if the staff had noted the limitations of interest rate policies for developing countries in general, and for specific groups of developing countries. As this had not been done; the paper read rather like the defense of a given viewpoint by a few selected examples. The staff dealt with a wide variety of members, particularly developing countries, which had programs supported by the Fund and were subject to conditionality. He was apprehensive that prescriptions based on the rather theoretical approach suggested in the paper could prove impracticable.

The staff also seemed to overlook the wide variety and great economic and social complexity of developing countries, Mr. Malhotra commented. On the question of regulation, while noting that governments typically argued that regulations were necessary because of imperfections in the credit market, the staff had proceeded to demolish the arguments for regulation one by one, and appeared to have concluded that all regulation was either irrelevant or unsuccessful. The staff had not stopped to consider why, in virtually every developing country--and, as Mr. de Maulde had explained, in many developed countries at a previous stage of their development--a need had been felt for some form of regulation. Had the staff done so, it would have issued a more balanced document.

Few would question the broad conclusion that interest rate policy was relevant to savings, to investment, and to exchange rates, Mr. Malhotra remarked. Moreover, if significant out-of-lineness with the inflation rate persisted for a length of time, it would have to be corrected. The staff, however, seemed to be advancing the proposition that member countries should maintain positive real interest rates at all times, and that interest rates should be adjusted flexibly and promptly to inflation rates. That proposition was open to serious question. In India, for instance, a drought had led in 1980/81 to a steep jump in the rate of inflation to about 21 per cent, compared with a previous rate of 3-4 per cent. Interest rates on deposits at that period had been between 8 per cent and 10 per cent. It had then been suggested that interest rates had become totally out of line, and that a major increase was needed in both deposit and lending rates. The Government had however come to the conclusion that, since its intention was to reduce the rate of inflation rather quickly, a major increase in deposit and lending rates would give the wrong signals to the economy.

The situation was bound to recur, Mr. Malhotra considered, in many developing countries where agriculture was a major contributor to the gross domestic product. The impact of weather on most of those economies was well known, and there were great price fluctuations from year to year. It would be most destabilizing if developing countries had to adjust the interest rate rapidly to reflect the rate of inflation. It was beginning to be recognized that rapid changes in exchange rates were destabilizing, and, on the domestic scene, rapid changes in interest rates would have similarly destabilizing effects. A more valid approach would be for each member to decide what its own objective was in connection with inflation, and to fix interest rates in the light of that objective.

It had been his experience, Mr. Malhotra continued, that in some years when inflation had been low and there had been positive real rates of interest, the growth in deposits had been somewhat lower than when the inflation rate had been relatively high. Furthermore, it could be argued that in developing economies there was a closer relationship between the increase in financial savings and growth in gross domestic product, than with movements in interest rates. In any case, developing countries could not afford the luxury of volatile interest rate changes, if they wished to maintain price stability.

The empirical evidence assembled by the staff referred only to a few countries, Mr. Malhotra noted. In most of those countries, rates of inflation had been high, and large differentials had persisted between inflation and interest rates. It would have been useful if a larger number of developing countries could have been examined. Nevertheless, the discussion had been both interesting and productive of agreement, if only on the point that significant differences between the rate of inflation and interest rates were not something to be encouraged. Apart from that general conclusion, however, there was a strong case for adopting a pragmatic approach to the whole question of interest rates.

Returning to the question of regulation, Mr. Malhotra recalled that in many developing countries, including those in South Asia, a large sector of the population consisted of agriculturalists with very small holdings. A large proportion of those agriculturalists tended to be bypassed by the banking sector. Even worse, the general environment was not always helpful to small farmers, artisans, and small manufacturers. While, theoretically, one could talk of the right price of money, in practice it would be wrong to maintain that it should not be mitigated for groups of persons suffering from real handicaps. The staff had pointed out that, when governments allowed concessional interest rates or made more funds available to weaker groups than might otherwise have been the case, economically stronger groups tended to take advantage of the concessions. While it would not be denied that the social structure in a country influenced the effectiveness of efforts to direct benefits to specific groups of the population, the argument did not invalidate such policies.

It was important, Mr. Malhotra commented, that institutions like the Fund should not ignore the social implications of interest rate policy. A stabilization program should not be the be-all and end-all for developing countries. Those countries had to develop in a social environment that made for stability, and stability was brought about to a great extent by governments' being able to show a degree of fairness between various classes of society.

He would however agree with the staff, Mr. Malhotra stated, that there had to be sensible rates of interest over the medium and long term. Subject to the reservations that he had mentioned, the paper did raise a number of important issues, to which it made a valuable contribution. The contribution would however have been much more valuable if the staff had marshaled more evidence, been less selective in choosing examples, and noted the limitations of the use of interest rate mechanism in developing societies.

Mr. Donoso commented that he saw the paper not as an attempt to expand the frontiers of theoretical knowledge on interest rates forward nor as an attempt to set out profound empirical analysis regarding interest rates, but as an interesting attempt to provide evidence supporting long-established and well-accepted conclusions. In that sense, the staff had performed a valuable work; it would be useful to have a series of papers of the same sort to provide a basis for policy decisions.

The present paper, Mr. Donoso went on, was particularly interesting, as a basis for policy definition, especially because it did not apply to any single individual country. Nevertheless, it was incomplete. It lacked some analysis of the determinants of interest rates, and failed to answer such questions as what determined the availability of funds, independent of the rate of interest. It would also be helpful to have more analysis on such matters as exchange rate regimes in the relationship to interest rates. The staff might prepare a study showing the different ways of financing a fiscal deficit in developing countries, indicating whether it thought it important or not whether the deficit was financed by increasing taxes, or by issuing paper, or by raising savings through increases in the interest rate. One reason for tackling such matters would be to provide more credibility for the particular form of analysis that the staff had undertaken. If the intention was to clarify established conclusions regarding such matters as interest rates, and then to use the conclusions to direct policy, it was important to show the many linkages involved. Otherwise, it was difficult to explain why many countries had entirely free interest rates, and nevertheless experienced major interest rate difficulties. A series of papers on the lines he had mentioned would be not only interesting to many members but also a valid contribution to theoretical analysis.

The Deputy Director of the Research Department commented that the staff had been greatly stimulated by the many thoughtful and cogent suggestions made by Executive Directors. It would also take the observations into account in writing any further papers that Executive Directors might request.

Interest rates were a controversial subject, the Deputy Director continued, that elicited responses at all levels from the political and religious to the econometric and technical. In examining the interest rate--one of the two or three most important prices in an economy--an observer was immediately drawn into examining the whole range of economic policy from the standpoint of the interest rate. To have done anything of that sort would have gone far beyond the confines of the present paper. The staff had therefore tried to confine itself to the interest rate alone, realizing that it did of course affect all other aspects of a country's economy.

In selecting topics for inclusion in the paper, the staff had not managed to meet the desires of a number of Executive Directors, the Deputy Director observed. Among the omissions that Executive Directors had wished to have rectified he had noted the distcinction between interest rates in the long term and in the short term. In SM/82/213, the staff had decided to confine itself to longer-term considerations. The staff would not disagree at all with those speakers who had said that it would be wrong to require countries to adjust their interest rate each time that there was a small change in the rate of inflation. Nor had the staff attempted to analyze the effects of interest rates in Fund programs. While that was an interesting topic, it would require an entirely separate study. Moreover, there were many gaps in the literature on interest rates. For certain groups of developing countries, there were few econometric studies of the type that existed on industrial countries. There was little work available on the relations between interest rates and savings and between interest rates and capital movements. The unavailability had limited the reliance on empirical material.

The Executive Directors who had expressed reservations about certain aspects of the paper had disagreed less with the conclusions than with the argumentation, the Deputy Director continued. Perhaps the staff had failed more in its presentation than in its judgment about what was ultimately important in connection with interest rates. It might be worth explaining that the purpose of the paper had been to make the fairly simple point that the interest rate was an extremely important price; indeed, it was one of the key prices, together with the wage rate and the exchange rate. It would therefore be wrong to give the impression that the interest rate was a minor element that could be made subservient to other objectives in the economy without adverse consequences. Policymakers, who would never dream of suggesting that they could hold the exchange rate or the real wage rate to levels that were far from consistent with the course of the economy, would sometimes not hesitate to suggest that the nominal interest rate could be kept at a low level as a matter of convenience, regardless of the consequences for real interest rates.

The staff was not of course concerned with minor variations in the real interest rate--with the question of whether that rate was 3 per cent or 1 per cent, or even minus 1 per cent, the Deputy Director noted. However, the staff paper put forward the idea that in the long run, there was a qualitative difference between positive and negative real interest rates. When real interest rates were minus 50 per cent, which had actually been recorded, there was something clearly wrong with the structure of the economy in question, and corrective action was needed.

Naturally, the Deputy Director remarked, merely raising real interest rates from negative to positive levels would not correct the economic ills of a country, as had been aptly said by a number of Executive Directors. Among many other requirements, it was particularly important to develop a country's financial institutions; but that activity too would be made easier by realistic real interest rates, and it was likely to be hampered by interest rates that were grossly out of line with market values.

Some Executive Directors, the Deputy Director noted, appeared to have understood the staff to be saying that interest rates should always be market determined, and that if they were not, they could not be correct. That was not the intention, and he did not believe that that was what the paper implied. It was of course perfectly correct for governments to counter the many market imperfections that were bound to exist by means of regulation, but, in so doing, governments had to set interest rates with an eye to where they would be if the market were working fairly well and were itself determining the rates.

On the question of the term "financial repression" used in the staff paper, the Deputy Director could refer to the intervention by Mr. Prowse, who had already given a full explanation of the origin of that expression.

As to the coverage of the staff paper, the Deputy Director explained that the omission of an analysis of Islamic banking principles was deliberate. The staff had already issued a paper on that topic entitled "Islamic and Financial Intermediation" by I. Karsten, published in Staff Papers, Volume 29, Number 1, March 1982. Admittedly, the staff had also paid little more than lip service to interest rate matters in centrally planned economies. That subject would not have fitted within the framework of the paper; it was one that warranted a separate study. A question had also been raised about the role of interest rate policy in a country that was politically unstable. It seemed unlikely that a rational economic policy could be implemented in such a country, and interest rate policy, along with other components of economic policy, such as exchange rate policy or wage and salary policy, would likely have to be made subserviant to short-run political considerations.

Reference had also been made to the nonmonetized sector of an economy, the Deputy Director of the Research Department recalled. Naturally, the staff could not but agree with those who felt that interest rate policy was of little relevance in that sector, even if it was a large part of the economy of the country. However, it would surely not be correct to argue that because part of an economy was unaffected by interest rate policy, interest rates elsewhere in the country should deviate from their equilibrium levels. There was also the interesting question of the optimum rate at which the nonmonetized sector should be brought into the monetized economy, and he wondered whether the adoption of realistic interest rates might not play an important appropriate role in that development. Some speakers had remarked that interest rate policy was likely to be ineffective in very small countries or very poor countries. These were, in principle, different cases: if a country was very small, it might well not have the financial institutions that were needed and might have to follow interest rates that were determined elsewhere, so that there would be little scope for an interest rate policy of its own. If a country was very poor, the implication was that the authorities should foster economic development as much as possible, perhaps in part through the kind of realistic interest rate policies described in the staff paper.

The staff representative from the Research Department started by replying to comments regarding apparent bias by the staff in the choice of data. There were in fact severe data problems for many countries, particularly low-income countries. There was some correlation between the degree of development and the quality of the data available. Whatever bias there might be in the choice of data by the staff was due to availability, and not to any other motive.

Regarding the evidence from industrial countries on the relationship between savings and interest rates, the staff representative remarked, much of what was available came from the United States. There were a number of technical problems in the econometric works on the subject, relating inter alia to simultaneous equations bias and multicolinearity. Moreover, over much of the period that was being studied in SM/82/213, interest rates had not varied greatly, and observers were likely to find that they had not had much effect.

In addition, the staff representative continued, there were other variables that also influenced savings strongly, including income, past savings rates, and habits that had become ingrained in the community. Finally, it was possible to find different results, depending upon the observer whose material was being read. The state of the art was such that there was a considerable debate about the impact of interest rates among investigators of equal standing in the profession.

So far as interest rates in developing countries were concerned, the staff representative remarked that there was no reason, on the basis of the little available evidence, to reject the assumption that the substitution effect was at least as great as the wealth effect. The evidence that did exist showed that coefficients on interest rates as a determinant of savings were mostly insignificant but generally positive, which seemed to suggest that the substitution effect was marginally larger than the wealth effect.

There was more evidence of the relationship between interest rates and investment in developing countries, and there were also two countervailing effects, the staff representative indicated. First, there was an effect on the efficiency of investment, as measured by the incremental capital/output ratio. There was also an effect on the volume of investment; if the interest rate rose, the presumption was that fewer investment projects would be desired. Studies that had been undertaken on some Asian countries showed that both the effects were significant: there was a positive effect on the efficiency of investment and a rather adverse effect on desired investment. While one sometimes outweighed the other, it was worth bearing in mind that initially there was a certain amount of unsatisfied demand for investment because interest rates were being held below the equilibrium level. Consequently, although raising the interest rate might decrease the total amount of desired investment, it did not necessarily imply that the actual amount of investment undertaken would be reduced, since initially there was an excess demand for investment.

Another question that had been raised was whether there was any evidence regarding the response of capital flows in developing countries to differences between foreign and domestic interest rates, the staff representative noted. The answer was that there was little evidence on the point; one item was an econometric study on Venezuela by a member of the Fund staff, which showed that the interest differential between U.S. rates and Venezuelan rates had the expected influence on capital inflows and outflows. The other instance, which had been discussed in the recent study by the Fund staff on currency unions, was the West African Monetary Union, where interbank money market rates had been adjusted by the authorities to offset the effects of changes in foreign interest rates on capital outflows. While it was hard to give quantitative evidence, in that respect the developments that had taken place indicated that there was a response to the interest rate differential. However, it was certainly true that more work on the subject would be valuable.

There was a relationship, as Executive Directors had mentioned, between negative real interest rates and the underdevelopment of financial institutions, the staff representative mentioned. The underdevelopment of financial institutions typically led to negative real interest rates because those institutions had as clients a very narrow sector of the economy, to which they were trying to give favorable terms. In a sense, the efforts of the authorities in some countries to hold down interest rates might be considered to be a way of trying to substitute for the lack of development of the institutions. He could therefore agree with many Executive Directors that the development of financial institutions was an important component of achieving a proper interest rate policy. Conversely, a proper interest rate policy was an aid to the proper development of financial institutions.

Referring to Appendix III, which had been mentioned by several Executive Directors, the staff representative from the Research Department explained that it was meant to underline that little was known about the causative effects of interest rates on the growth of financial savings, and the expansion of gross domestic product. What the table reflected was the growth of demand for broad money in relation to the increase in gross domestic product, not the response of the latter to the increase in broad money supply, because it was demand, not supply, that determined the real stock of money. Nevertheless, he could agree with Mr. Zhang that there were questions of the relationship that needed more investigation.

The Chairman then made the following observations:

Executive Directors discussed in seminar a staff paper on interest rate policies in developing countries (SM/82/213, 11/12/82), bearing in mind that in some countries the use of interest rates as a fixed charge on borrowed funds runs counter to strongly held religious or cultural beliefs. Speakers welcomed the format of the staff paper, which analyzed interest rate policies first for their effect on savings and investment, and then for their effects on demand management. Most Directors agreed generally with the staff's conclusions, although some felt that the term "financial repression," drawn from the literature to describe a policy of administered low interest rates, was overly negative.

Some speakers cautioned against making oversimplifications or generalizations in terms of groups of countries. They perceived that the influence of interest rate policies on savings, and on the quality and quantity of investment, depended closely on the type of economy involved. Categorization could include such factors as, inter alia, income level, size, religious orientation, and institutional framework. In each group, the influence of interest rates was seen to be different. In particular, the role of interest rates in countries with large nonmonetized sectors should not be exaggerated. The experience of developed countries with sophisticated financial institutions, or of a number of higher-income developing countries, could not be easily applied to such countries.

The place of interest rate policy was also seen to depend substantially on the development of financial institutions within the varying countries. Speakers pointed out that the degree of sophistication of the financial markets, the range of financial investments, and the extent of the banking network all affected the influence of interest rate policy and caused it to vary from one country to the next. Conversely, speakers stressed that without broadly appropriate interest rates, the institutions that seemed to be needed to enable a country to further its economic growth would not flourish.

A number of Directors considered that the staff had not put forward a great deal of empirical evidence to show that there was a clear correlation between positive interest rates and high-quality investment in developing countries, although the thrust of the staff's argument seemed to be that positive real interest rates were one of the prerequisites for investment-led growth. Speakers emphasized that many other factors could have as much effect on the interest rate and on investment including, inter alia, the importance of the public sector vis-à-vis the private sector, the structure of income distribution, the level of profit, the savings behavior of small, family-based entrepreneurs, and the degree of openness to the outside world, especially the freedom of capital movements.

The relationship between interest rates and savings was not clearcut, several Directors noted. An increase in financial savings might not represent an increase in total savings, but a portfolio shift from real to financial assets. While such a shift might result in a better allocation of financial resources in the economy through the process of intermediation, the development of the financial infrastructure could be as important in that regard.

Directors did agree, however, that interest rates are an important factor in economic policy in developed and developing countries alike. Even those responsible for planned economies, it was generally concluded, were seen to make assumptions regarding the price of capital. Similarly, low-income agricultural economies with little monetization deliberately adopted low interest rates as a means of directing investment and implementing structural planning. Furthermore, the ability of low-income countries to act in the way they desired was observed to depend on their ability either to marshal savings at home or to raise finances abroad. Negative real interest rates, it was concluded, would eventually have to be offset either by higher tax rates in other sectors at home or by a fall in the exchange rate, or by external indebtedness, or inflation.

Many Directors emphasized the short-run problems arising from interest rate reform discussed in the staff paper. They stressed that, in order to avoid intensifying economic difficulties, interest rate policies had to be integrated into an overall adjustment and stabilization program. Particular care had to be taken when political or economic factors affecting internal and external confidence created conditions of disequilibrium.

Some speakers felt that it would have been helpful if the staff had shown the relationship of the interest rate to other economic factors affecting the financial governance of developing countries. Others, however, remarked that the paper could well stand on its own, and that it was beginning to become understood that savings were affected by a number of variables, such as the propensity to consume, of which the interest rate was only one. In the words of one speaker, interest receipts are less the reward of saving than the reward for parting with liquidity for specific periods in return for specific instruments. Thus, interest rates could be considered only one among a diversified set of determinants of policy. Positive interest rates could not of themselves be seen as a substitute for sound economic policy, but negative real interest rates were seen to be associated often with such problems as fiscal deficits, high inflation, and exchange rate instability.

Directors agreed that the staff should provide, in a future paper, more concrete evidence gathered from a wider range of countries, using, among other things, the information gathered by the Fund in the course of conducting programs with individual members.

The Executive Directors adjourned at 6:00 p.m.

LEO VAN HOUTVEN
Secretary