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Minutes of Executive Board Meeting 89/140

10:00 a.m., November 6, 1989

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
F. Cassell	
C. S. Clark	
	Shao Z., Temporary
	B. S. Newman, Temporary
	J. Prader
E. T. El Kogali	
	S.-W. Kwon
	C. Y. Legg, Temporary
E. V. Feldman	
L. Filardo	M. A. Fernández Ordóñez
	C. Schioppa, Temporary
	A. M. Othman
M. Fogelholm	
M. R. Ghasimi	O. Kabbaj
	B. Goos
J. E. Ismael	
B. Jalan	
A. Kafka	
J.-P. Landau	J.-F. Cirelli
Mawakani Samba	C. V. Santos
Y. A. Nimatallah	M. Al-Jasser
G. A. Posthumus	
	N. Adachi, Temporary

L. Van Houtven, Secretary and Counsellor
M. Primorac, Assistant

Also Present

African Department: R. O. Carstens. Asian Department: D. A. Citrin, K. Saito. European Department: M. Guitián, Deputy Director; T. A. Bayoumi, R. Cippa, G. Hacche. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; P. A. Acquah, G. R. Kincaid, K. M. Meesook. External Relations Department: G. Bhatt, A. Mountford. Fiscal Affairs Department: V. Tanzi, Director. Legal Department: J. K. Oh. Research Department: J. A. Frenkel, Economic Counsellor and Director; M. Goldstein, Deputy Director; B. B. Aghevli, J. M. Boughton, Y. Harada, M. Khan, P. R. Masson, D. J. Mathieson, P. J. Montiel, M. Schulze-Ghattas, D. Villanueva, P. Wickham, M. A. Wattleworth, I. Zaidi. Secretary's Department: C. Brachet, Deputy Secretary; A. Tahari. Bureau of Statistics: V. Galbis. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: J. O. Aderibigbe, M. B. Chatah, M. Eran, A. Gronn, S. M. Hassan, Z. Iqbal, J. M. Jones, J.-L. Menda, A. Napky, P. Péterfalvy, A. Raza, R. Wenzel. Assistants to Executive Directors: H. E. Codrington, E. C. Demaestri, S. K. Fayyad, M. A. Hammoudi, A. Hashim, J. Heywood, Hon C.-W., K. Ichikawa, L. I. Jácome, K. Kpetigo, R. Marino, N. Morshed, J. A. K. Munthali.

1. <u>EXECUTIVE DIRECTOR</u>

The Chairman welcomed Mr. Landau, Executive Director, to the Executive Board.

2. <u>NATIONAL SAVING - ROLE IN WORLD ECONOMY - RECENT TRENDS AND PROSPECTS</u>

The Executive Directors considered a staff paper on recent trends in and prospects for the role of national saving in the world economy (SM/89/172, 8/11/89), together with a paper containing background material on the same subject (SM/89/172, Sup. 1, 8/14/89).

Mr. Mawakani made the following statement:

> At the Board's consideration of the staff paper on saving in developing countries (EBM/89/173, 6/9/89), it was made clear that the discussion was preliminary and would cover only a part of the staff's ongoing work on savings. I therefore welcome this substantive and informative staff paper, which attempts to address the complex and diverse theoretical and analytical issues of saving behavior in both developed and developing countries. The paper reflects the views of both the Interim and Development Committees on the vital importance of saving behavior for macroeconomic stability, economic growth, and external balance, as well as the policy measures that are needed to foster saving formation conducive to sustained economic expansion. I find the selection of the main topics that have been suggested for consideration to be judicious; the subjects are wide ranging and their discussion should help us to comprehend the complexity of saving behavior in both industrial and developing countries.
>
> The issues that are broadly relevant to national savings in developing countries differ substantially from those in industrial countries, in particular because of the structural dissimilarities in their respective economies. The attempt that has been made by the staff to raise these issues is commendable, given the paucity of data and the problems associated with estimating and measuring savings, consumption, and investment in most developing countries, as well as the central issue of the large global current account discrepancy, as discussed in Appendix I and Appendix II of SM/89/172. I would encourage the staff to continue work in these areas.
>
> The trends in national saving rates have shown differences across industrial countries, especially between the major ones, with high saving rates recorded in Japan and Germany and relatively low rates in the United States. Since the 1970s, there has been a general decline in saving rates, which can generally be traced to government dissaving. While private saving rates

also tended to decline, they did so at a reduced pace compared with the decline in government saving rates. There is a close correlation between national saving rates and levels of investment, which have weakened in recent years compared with the 1960s and 1970s.

I would agree with the staff assessment that, in view of the demographics of the industrial countries, the medium-term prospects for changes in these countries' saving and investment behavior do not appear bright. It is therefore important for them to formulate and implement appropriate fiscal policies aimed at lowering government consumption patterns to enhance public savings, rather than increasing taxes.

The analysis of the saving and investment process in developing countries is well done. I welcome the classification of groups of these countries to include the various categories, such as high and low savers, as well as those experiencing debt-servicing difficulties. This has helped to improve the analytical framework and to shed more light on the saving and investment experience of developing countries in recent years. The general observation is that these countries have similarly experienced sharp reductions in national savings and, since 1982, significant declines have been recorded in Africa and the Middle East, while Asian and East European countries have exhibited little or no change in their saving rates. A more significant observation is that the sharpest declines have been recorded in countries that experienced debt-servicing problems, while those without such problems were able to stabilize their saving rates. As far as the national saving rates of these countries in relation to domestic investment is concerned, the wide variations in experience indicated in Part C, Section I, Table 2 of SM/89/172--in particular for countries with debt-servicing problems--point to the unfavorable effects that factors such as high international interest rates and adverse terms of trade have had on the level of their national incomes, thereby constraining their capacity to save and to invest.

In the examination of the various factors that have caused the unfavorable saving and investment experience of developing countries in recent years, the staff paper, with the support of the econometric analysis of Appendix III, asserts that savings in developing countries may be affected by the relatively low levels of per capita income, short life expectancy, and the uncertainties surrounding the macroeconomic environment. While I agree that these factors have certainly influenced saving behavior, there are other factors that appear to have been overlooked. These include the impact of the deterioration in the terms of trade of developing countries on government and private saving rates; the general weakness in data on income and saving; the limited coverage by or nonexistence of social security or pension schemes; the partial monetization of these economies; and the geographically limited banking and financial networks. In some countries, these factors, including financial repression, have led to the development of private informal savings schemes that are becoming important sources of funds for private investment. Innovative approaches for mobilizing savings in these countries should take into account ways in which the operation of these informal savings schemes could be encouraged and strengthened.

While the motives for savings do not differ significantly from those in industrial countries, it should be stressed that household decisions to save in developing countries are made in a different environment. From this perspective, it has been suggested that the importance of extended family arrangements may contribute positively to household saving in developing countries. Indeed, intergenerational links may be one way in which cultural factors could have significant effects on household saving behavior across countries. But as far as sub-Saharan African countries are concerned, one would have thought that extended family arrangements, which comprise a much wider circle of members than the word suggests in Europe or North America, would rather contribute negatively to saving behavior, since household preferences involving the needs of several dependent members would lead to high rates of consumption, and not saving. Moreover, the existence of strong intergenerational links that constitute a substitute for social security in these countries tend to contribute to lower saving rates. I would suggest that more empirical work be undertaken on some of these factors that influence saving behavior in the developing world.

The emergence and persistence of large external imbalances among the major industrial countries since the early 1980s have heightened international concerns about the highly skewed saving patterns among these countries and have led to the conclusion that these imbalances constitute a problem for international economic adjustment that must be addressed. Unfortunately, the studies cited in the staff paper on this issue are not unanimous on whether or not the correlation between domestic savings and investment has weakened with the high degree of international capital mobility. As stated by the staff, one body of evidence provided by Feldstein and Horioka suggests that the internationally open financial markets of the early 1970s, involving some limited capital mobility, did not lead to a reduction in the high correlation between savings and investment in industrial countries. It may be argued that the correlation remained so strong because of the limited mobility of capital and rigidities in the financial markets in high-saver countries. This is borne out by the other body of evidence, including the more recent research by Frankel, Feldstein, and Bachetta (1989).

The conclusions drawn from this latter research are threefold: first, saving and investment may be correlated, given the similarity of their reaction or responsiveness to certain types of external shocks. Second, fiscal policy in the 1960s and 1970s was probably aimed at limiting the magnitude of current account imbalances in response to shifts in the net balance of private saving and investment through offsetting shifts in public sector saving during that period. Third, the weakening in the national saving and investment relationship that emerged in the 1980s was the result of financial reforms in some high-saving countries such as Japan and Germany. These reforms permitted significant amounts of savings to be funneled into the world capital markets and from there to some of the low-saving countries, such as the United States, that had been running substantial budget deficits. The result was the emergence and persistence of the large current account imbalances among the major industrial countries, which have become a matter of international concern. While one cannot argue that, per se, these current account imbalances constitute a problem, in the current international environment, characterized by low saving rates in both industrial and developing countries, they are bound to cause difficulties.

When developments in the external current accounts of these major industrial countries create conditions that appear inconsistent with the stance of domestic policies, the imbalances become a problem to be corrected because of the high costs that they impose on the rest of the world, especially when adjustment is unduly delayed. Indeed, the financing of large budget and current account deficits contribute to higher interest rates than would be warranted, thereby exacerbating the debt problems of developing countries. Such financing leads to the crowding out of developing countries, particularly the middle-income ones in need of finance. Finally, there is the increased vulnerability of the world economy to disturbances in the international financial markets. In this connection, it is important that the Fund in its surveillance exercises continue to encourage these major industrial countries to undertake the necessary economic and structural adjustment measures that would help to smooth out their external imbalances. Such measures should aim at strengthening the saving performance in those countries where saving rates are relatively low.

The staff paper has provided evidence that, as in industrial countries, there is in developing countries a close association among saving, investment, and growth. However, there is no clear evidence of the causes of the changes in saving, investment, and growth variables, because the interactions among them appear complex. Regarding the saving and investment relationship indicated in Table 4 of Part C, Section III of the paper, it is significant that the levels of national saving and domestic investment show a close relationship in the predebt and postdebt crisis period for all country groupings, and becomes stronger in the postdebt crisis period for most of the groups. After 1982, the relationship shows a weakness only among the country groups in Asia that had relatively favorable access to international capital markets, as well as in countries that avoided debt-servicing problems. As far as growth in the developing countries is concerned, Table 2 of Part C, Section III of the paper shows that there was a slowdown in economic growth. Sharply lower growth was recorded in countries that experienced debt-servicing difficulties, while those that did not encounter such problems exhibited some growth in output.

The common factor in the relationships described above relates to the debt crisis, whose onset not only curtailed the flow of foreign savings from the industrial countries to the developing ones, but also made it necessary for developing countries to rely more on national savings for domestic investment in order to enhance the growth prospects of their economies. As is now well known, the national saving rates in most developing countries have not compensated for the decline in the inflow of foreign savings to help promote domestic investment. Given the high level of investment required to sustain economic growth in these countries, I am of the view that every effort should be made by the authorities to raise national savings. However, it is clear that foreign saving will continue to be needed to complement domestic efforts. Therefore, measures to encourage the reflow of foreign savings to these countries would be appropriate.

As stressed in the staff paper, the causes of the changes in the variables in the perceived close connection among saving, investment, and growth, are not quite clear. The complexity of assessing how these variables act on each other calls for great caution in recommending to countries that are implementing growth-oriented programs, policies to raise both public and private savings and investment. A greater understanding of the related socioeconomic environment in which saving decisions are made is necessary before venturing into any policy recommendations, however appropriate they may seem.

In general, the array of policy options available to developing countries, as outlined in Part C, Section IV of the paper, is well known. Although these policies can provide some incentives for mobilizing savings, they have to be combined with imaginative approaches that take into account the existing weaknesses in the financial system and the informal private arrangements for mobilizing savings.

On fiscal policies, in particular, attempts to achieve rapid fiscal balances at the expense of productive activities should be avoided. Indeed, massive and unpredictable revenue-raising measures on a narrowing tax base are more likely to threaten private sector savings than to encourage them, and thereby reduce confidence in the economy. Emphasis should, therefore, be placed on a reasonable time frame of adjustment, the efficiency of tax administration, and the broadening of the tax base.

On exchange rate policy, while there may be cases in which the exchange rate can help to speed the adjustment process, it could be argued that the expectation of frequent changes creates conditions for inflationary pressures, disincentives to save, and, ultimately, capital flight.

Irrespective of the options chosen, it is essential that governments try to establish a stable macroeconomic environment including strong institutional arrangements for providing adequate incentives to save and invest. Such macroeconomic stability could be enhanced through the maintenance of a favorable international environment, a process in which the industrial countries are expected to play an important role.

What we learn from these staff studies on saving, investment, and growth and where we go from here will be a reflection of industrial countries' willingness to cooperate in solving the problem that has been posed by the declining levels of national savings. I would encourage the staff to continue its work on this important issue and, in particular, on the determinants of saving behavior in developing countries.

Mr. Prader made the following statement:

The staff paper offers several original insights into the economies of saving which should be duly taken into account in future world economic outlook discussions and in bilateral consultations. I shall briefly comment on those issues that I found most relevant: on industrial countries--the role of public revenues in the mobilization of national savings, the impact of tax distortions and financial liberalization on savings and the international distribution of savings and investment; and on developing countries--the causality between savings and investment and the relevance of income distribution for the mobilization of savings.

On public revenues and savings mobilization, on the occasion of the last world economic outlook discussion, our chair already referred to the importance of the conclusion on page 28 of the staff paper, where it is proposed that under certain conditions an increase in taxation may have a more positive influence on national savings than a reduction in public expenditures. This proposition is supported by the evidence that the public savings effect of a tax increase is not necessarily offset by a reduction in private savings and, even more important, by the analytical conclusions emerging from endogenous growth models. In short, these models propose that the long-term externalities of investment may not always be adequately captured by a market-based return on investment and saving, so that a sufficient share of resources needs to be allocated to the public sector for investment in social infrastructure. A prolonged reduction in the financial burdens imposed by excessive public sector expenditures has to take place first, before such propositions can be introduced successfully into countries' fiscal strategies. As the fiscal adjustment programs that have been implemented by many industrial countries since the beginning of the 1980s are reaching or are close to their original objectives, the need to reformulate policies in a new medium-term perspective clearly arises. One key element in the reformulation of these policies should be the appropriate distribution between private savings and public savings. I would strongly recommend that the Fund take a leading role in this process by assisting countries with appropriate policy advice as it has done until now in promoting the unilateral realignments in public deficits and spending patterns which had to be achieved first.

More specifically, I would suggest that the Fund focus its consultations with member countries on public savings policies on the following type of questions: how can the financial room created by the budgetary realignments of the last decade be best allocated between a reduction in taxation and a rehabilitation of public investment infrastructure? What role could a more active industrial policy play in capturing the externalities associated with the investment process, and should such a policy be funded from tax revenues or from other sources of savings mobilization? Should the role of government in the savings/investment process be more explicitly visualized so that it can be more easily protected against erosion? This issue can be of particular importance in a climate in which the general emphasis and public opinion's expectations continue to be predominantly oriented toward tax decreases. A clear perception of the role of government in long-term savings and investment decisions in turn could favorably influence the behavior of households by encouraging them to adopt similar strategies of their own. Such a causality relationship would run counter to the more conventional assumption, presented in the staff paper, that an expansion of the social services network would always discourage private savings.

Another set of questions refers to the situation of those countries for which budgetary stabilization has not yet been achieved: how can investments in social infrastructure be better protected during a period of prolonged fiscal adjustment? Should we insist more strongly on the need for rapid fiscal adjustment in periods of high income growth in order to protect infrastructure expenditures against future adverse income shocks? Can a more optimal pattern of national savings be obtained from the relocation of certain public functions to the private sector rather than from across the board cuts in public dissavings?

Finally, the trade-off between tax reduction and government capital formation also has international implications: can an appropriate degree of government revenue be ensured in an environment in which governments compete internationally for the location of savings and investments through the systematic reduction of their taxation levels? In other words, the intense competition for private savings may very well result in a depression of public savings and ultimately in a decline and a deterioration of savings at the aggregate level. Coordination of tax policies, though urgently needed, may be difficult to achieve in such a competitive environment.

Turning to the impact of tax distortions and financial liberalization, a preliminary question arises from the notion on page 29 of the paper that income taxes tend to distort private savings decisions because they drive a wedge between the savings return and the investment return. What is the most efficient way to reduce this distortion: should savings be submitted to a specific tax regime, or alternatively, should income taxation be gradually reduced in general? For equity as well as efficiency reasons, the second course of action, which aims at protecting the convergence between the tax rate on labor income and on capital income, seems preferable. While this is also the Fund's preferred advice according to a recent working paper of Mr. A. A. Tait (WP/89/87, 10/23/89), international developments may now impose the first course of action because the competition for the location of savings amplifies the pressures for a zero taxation of capital income.

I fully agree with the staff that the liberalization of financial markets increases the need for a systematic elimination of tax distortions on saving and borrowing. Another important implication, though only marginally addressed in the staff paper, is the need to protect the stability and reliability of the savings industry throughout the process of liberalization. Savings institutions that enjoy a high degree of confidence from the public and savings instruments that are characterized by a high degree of transparency and reliability may be important factors in supporting the savings tradition of a country. Unless these characteristics are protected by an appropriate organization of the savings sector at the government level, the process of liberalization may result in savings that are better allocated and remunerated but are smaller in total volume.

Since the issue of international distribution of saving and investment is at the center of our world economic outlook discussions, I shall limit myself to two short comments on the analysis on pages 26 and 27 of the paper.

First, the distinction between saving/investment discrepancies that result either from sound private initiatives or from policy distortions is attractive in theory, but may often be of little relevance in practice. Indeed, there is little or no evidence at all that the markets are acting in consistency with such a distinction. The failure to impose a timely adjustment on external imbalances created by unsustainable policies in the early 1980s and the inconsistency of the present exchange rate pressures with the adjustment are cases in point and suggest that the markets might as well be unwilling to finance imbalances which are caused by sound savings and investment decisions. More consistent market reactions could, in my view, only be expected in a system of more stable exchange rate relationships where rate decisions are made on the basis of policy rather than market pressures. The European Monetary System experience shows that under a system of stable exchange rate relationships, payments imbalances may be financed during a prolonged period of time without upsetting the markets provided they reflect sound business decisions such as the import of capital goods to restore the private investment level. Such a system does not exist among the largest countries, so that their current account imbalances are likely to remain a source of instability, regardless of their origin.

Second, the notion that current account positions would not be a source of concern in themselves, also seriously weakens--in particular on behalf of surplus countries--the justification for policy actions aimed specifically at the correction of large imbalances. In the framework of the policy coordination process, Germany and Japan have both taken substantial measures to increase the level of domestic demand; these measures were directly aimed at bringing about a needed correction in external imbalances and would have been difficult to justify only on the basis of distortions in domestic savings and investment incentives.

Regarding the causality between savings and investment, on page 50, the staff introduces the important notion that for the indebted countries the weakness of investment performance may be at the origin of their domestic savings shortfalls or at least of the relocation of domestic savings to foreign assets. The implications of such inverse investment/saving causality in my view merit further study because they may provide additional insight into the resource problems of developing countries in general. In view of the scarcity of private savings in most developing countries, public investments, though important for infrastructural purposes, are likely to produce strong crowding-out effects on private investment. This crowding-out effect may even be further amplified to the extent that the contraction of the private investment sector in turn discourages private savings even more, thereby further aggravating the scarcity of available resources. To minimize the risk of such crowding-out reactions, a delicate balance between the resources allocated for public investment and those released for private investment will have to be established. At the time of our last consultation with Thailand, I suggested that a possible solution to this problem may consist in that country's strategy to let the private sector first make its investment decisions and then to support these decisions by means of necessary investments in public facilities.

Future work on the role and determinants of national saving should give more explicit consideration to the relevance of income distribution patterns for the savings performance of developing countries. In this connection, the following questions come to mind: can the difficulty of many countries to collect a sufficient amount of savings for investing them in public infrastructure rehabilitation be ascribed to weaknesses in the distribution of incomes? Is the problem of capital flight, from which many heavily indebted countries are suffering, compounded by the excessive concentration of wealth among small groups of the population, because this concentration is a source of social tension which fuels the fear that capital, if not expatriated, will be expropriated through taxation? More generally, to what extent can the differences in savings and investment performance between the heavily indebted countries and several successful Asian countries, on which recent world economic outlook studies have concentrated, be explained by the fact that the latter have adjusted their economies under conditions of much less distorted income distribution?

At a time when the Fund is asked by its members to address the problems of countries' debt overhangs and foreign asset overhangs more directly, such considerations can, in my view, no longer be omitted from the province of Fund recommendations on adjustment policies.

Extending his remarks, Mr. Prader considered that the fiscal adjustment programs that had been implemented by many industrial countries since the beginning of the 1980s with the help of strict expenditure control had reached or were close to their original objectives. It was open to question whether the industrial countries could now concentrate less on expenditure cuts and consider how the room for maneuver created by fiscal restraint could best be used; that depended on each country's specific circumstances. In that context, he had, in his statement, differentiated between those countries that had already achieved their fiscal stabilization objectives and those that had not.

The proposition of the staff that under certain conditions, an increase in taxation might have a more positive effect on national savings than would a reduction in public expenditures was a very important point, Mr. Prader continued, particularly in a climate in which fiscal issues tended to become very ideological and the positive impact of the role of government on the functioning of the economy tended to be understated. It had been demonstrated by growth models that the public sector had to take care of a number of long-term externalities of investment caused by market imperfections. To do that, the public sector would need adequate resources to undertake the necessary investments in social infrastructure.

He would turn next, Mr. Prader said, to the international implications of the trade-off between tax reduction and government capital formation, or in other words, the competition of governments for the allocation of savings and investments through the reduction of their taxation levels. More specifically, during the Article IV consultation with Germany, Mr. Grosche had informed the Board that some net tax relief was to be provided to enterprises. It was difficult to see the rationale for such tax relief against the background of booming business profits and the well-known concerns of the German authorities about the budget deficit. If the German authorities were indeed planning such a move in the context of the completion of the unified European market, then the fact that the strongest and most competitive exporter in Europe was resorting to such measures would force other smaller European countries to also participate in competitive tax relief actions. Perhaps Mr. Goos could comment.

With respect to the determinants of saving in developing countries, Mr. Mawakani had mentioned a number of factors in addition to the role of income distribution that had a major impact on the savings level, Mr. Prader noted. In view of the possible implications of those determinants for the Fund's adjustment policy recommendations, it would be important to have empirical and quantitative estimates of the magnitudes of all those factors. Perhaps the staff could elaborate more on those variables, and do some further research in that area.

Mr. Goos observed that the Board had lately been stressing the need for structural adjustment. Germany had one of the highest rates of corporate taxation, which it had tried to reduce by providing net tax relief to enterprises. High taxation of enterprises tended to hamper the willingness of enterprises to invest, so that a reduction in taxation would encourage investment. That stimulation of domestic absorption in turn would reduce Germany's current account surplus and help to improve domestic efficiency.

Mr. Prader remarked that he would welcome an objective comparison of German tax levels with those in the rest of Europe, as well as some comment from other European Directors.

Mr. Nimatallah made the following statement:

> The object of today's discussion is to search for ways and means to sustain noninflationary growth worldwide in the medium term. One should remember that, in the end, every country wants to continuously improve the standard of living of its people. Certain countries make a conscious decision to postpone this improvement in the standard of living and instead keep consumption down, save more, and invest in faster capital formation. They use tax and price-setting means to reduce consumption and they direct the saved resources to the public sector. Whether the public sector uses those resources efficiently is another matter.
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> The matter of saving ratios is essentially a supply-side issue. I am heartened that the Fund has come to focus more on ensuring adequate supplies of savings to secure growth of productive investment at lower real interest rates in the future. I hope that the next step will be for the Board to focus on the issue of how to secure the channeling of savings to more productive investment. I also hope that the Fund will next turn its attention to the questions of employment, labor training for better skills, and the average acceptable rate of unemployment as workers enjoy more leisure time. I am aware that the World Bank gives enough attention to the questions of energy, land utilization, and cleaner water supplies. All these are supply-side matters that, in addition to demand management, deserve greater attention from now on.
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> I am favorably impressed by the staff paper, which stimulated my curiosity on a wide range of issues, and I will now try to respond to the issues proposed for discussion by the staff.
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> I have often felt that public sector nonproductive expenditure has led to lower national savings in many countries. In the United States, in particular, this started with the declaration by President Johnson in the 1960s that he could have both guns and butter at the same time, when he announced his dream of a greater society as he was financing the war in Vietnam. The cold war, the armament race, and local wars, in addition to insistence on achieving targeted real rates of growth, have led to waste and nonproductive expenditure in most countries.

It is hoped that with relaxed tensions, less nonproductive expenditure will be needed and governments will be able to reduce deficits and save more. Speaking of increased saving by governments, I would like the staff to look into what happens to budget surpluses and government savings. Will they be used to partly repay debt? Also, what is the relationship between national savings, national debt, and national wealth? Would retiring government debt lead to less household savings and more corporate productive investment?

I have often doubted the impact of interest rate changes on medium-term efforts to generate more savings, especially in developing countries in general, and those of the Islamic faith and less monetized economies in particular. Now, the staff confirm my views that, although interest rates can help in the allocation and possibly short-term mobilization of savings, interest rates do not seem to have much impact on saving behavior in either industrial or developing countries.

I am not sure that all countries' rates of saving are low, especially when compared with their rates of domestic investment. However, what is important is that there should be a much narrower differential between the rates of the high and low savers. This would help greatly in policy coordination among the G-7 countries, as would lower differentials between inflation, interest, and growth rates. My question is whether it is possible to narrow the saving rate differential. Or is it that some peoples are naturally more frugal than others? I am hoping that an important factor in the differential is the active decision that countries like Japan have taken to postpone a higher standard of living at this stage, and to improve gradually the standard of living of their people, after which they will begin saving at a lower rate. At the same time, countries like the United States and Sweden should adopt some measures to slow down the improvement in their standards of living and encourage more saving.

This brings me to some specific recommendations for industrial countries. I recommend to the United States, Sweden, and countries like them, which are generous to borrowers, to adopt measures to minimize tax deductions that encourage borrowing, whether for expenditure on consumption or leveraged buy-out purposes.

It is to be hoped that in the medium term, as a result of financial market liberalization, tax distortions will be eliminated through general tax reform. Needless to say, such tax reform should be coordinated among trading partners in order to share the burden and the benefits of saving and investment rate improvements, not to mention the further improvement in policy coordination.

I strongly suggest that governments with large unsustainable deficits start seriously reducing nonproductive consumption, particularly on military institutions, but continue expenditure on improving infrastructure and supply-side factors, including better trained human capital. As I have often insisted, governments should not increase taxes, but rather, should achieve more savings by reducing nonproductive expenditure--simply because governments are already large, and history has proven that governments are less efficient than the private sector when it comes to productive investment.

On developing countries, income distribution is of vital importance in the determination of saving rate. I invite the staff to look more into this issue, and in particular, how inflation, indirect taxes, and subsidies can be used to redistribute income and increase or reduce public sector savings. Income distribution matters are gaining more importance now, in light of efforts to eliminate poverty in developing countries. It is a well-known generality that poorer sections of society tend to have a higher propensity to consume. At this stage, however, I am mostly concerned with the impact of fluctuations in the terms of trade of developing countries, which often lead to serious fluctuations and disruptions in savings and investment rates. I recommend that the countries concerned concentrate on diversifying their economies. Industrial countries can help in this process by reducing discrimination against processed or manufactured exports from developing countries.

The other matter that concerns me at this point is capital repatriation. I recommend to the concerned countries to adopt the appropriate policies to create a hospitable environment to both repatriated capital and foreign capital.

Finally, I am not alarmed by the current account deficits of the large industrial countries, as I see little connection between those deficits and efforts to increase saving rate. It is to be hoped, however, that reducing fiscal budgets will eventually lead to narrower and sustainable current account deficits, which would certainly help in improving policy coordination and sustaining growth without inflation.

Mr. Kafka made the following statement:

The two staff papers offer useful suggestions regarding studies that should be undertaken or sponsored by our staff. But even before these further studies are completed, helpful inferences regarding program design can be drawn from the papers before us.

Let us first deal with the industrial countries. The basic development stressed by the papers is the decline in saving rates, both gross and net. There have been offsetting developments in the behavior of household and corporate savings, and the decline in national saving rate is clearly associated with the decline in government savings. It is also noteworthy that national saving rates are expected to decline further in the absence of policy action. The discussion of the determinants of saving has as its principal conclusion the uncertain and, in any case, weak effect of interest rates on saving in this group of countries.

The section on the adequacy of saving appears to suggest that saving may be inadequate or at least is more likely to be inadequate than the reverse from the welfare point of view. This conclusion satisfies me emotionally, but it is not really demonstrated nor--as we all know--demonstrable. There is no objective criterion of welfare. The weighting of benefits to different members--including different cohorts--of the community is entirely subjective. The Pareto criterion--which attempts to circumvent this subjectivity--is an illusion. It does not show what effect on welfare, as measured by the Pareto criterion, a policy action will have. It shows only what effect a policy action would have if certain things, which cannot be assumed, could be assumed--for example, that an increase in output will actually be distributed so that no member of the community would lose real income.

The discussions, first, of the effect of saving on endogenous technical progress and of the latter on growth, inter alia, and second, of the international distribution of saving and investment are particularly commendable.

What are the conclusions for policy options in industrial countries? If industrial countries wish to raise their saving rates, they have to do it essentially through budget policy and tax policy. To some extent, they have already done this. It is also important to stress, as the paper does, that raising the saving rate will be helpful from a worldwide point of view only if there is an improved, even a much improved, coordination of income tax policies in order to bring social and private returns on investment worldwide into closer correlation.

On the other hand, I find the paper's treatment of the choice between income and consumption taxation somewhat disappointing. It is not only a question of income distribution that is involved here; that could even be circumvented by replacing consumption with expenditure taxation, along the lines suggested by the late Lord Kaldor. (I am, of course, aware of the political consequences that his ideas have tended to produce.) But consumption taxation, like expenditure taxation, is also more likely to have an impact on inflation than is income taxation. This should be kept in mind.

Certainly, one conclusion to be drawn is that, from the point of view of a peaceful and well-functioning world economy, the increase in national saving in the rich countries, if it can be shared with the poor countries, has a great deal to contribute. We should remind ourselves of this on all appropriate occasions.

Turning now to the developing countries, first, there is here also a strong declining trend in national saving, owing of course to developments in the highly indebted countries. In Table 2 of the paper, it would have been interesting to show the change in interest remittances after 1981 or 1982 as a percentage of national income. It would also be interesting to show consumption not only as a percentage of national income but also in real terms, which would give us a better perspective on the impact of recent developments on current as well as future absorption.

As in the case of industrial countries, it is again public saving that has been most closely associated with the decline in national saving. The discussion of the relationship between saving, investment, and growth is formulated in appropriately cautious terms. Since the debt crisis, so many difficulties have been created for the highly indebted countries that to discern a particular direction of causation would indeed be difficult.

In the discussion of the determinants of saving, it is somewhat curious that monetary and interest rate policies are discussed separately. The paper concludes that, as in industrial countries, the effect of interest rates on saving in developing countries is likely to be uncertain as well as small. The paper, nevertheless, lists a series of reasons why things could be different, which seems rather contrived. The paper also states that interest rates may have a major impact on investment efficiency. With one exception, however, no empirical proof is offered, nor even any literature quoted. One could, of course, always appeal to the general principles of economics--but that would not teach us much. The one exception is that interest rate policy does have an empirically visible effect on capital flight.

The fact that interest rate policy appears to have an influence on private financial saving is interesting, but would bear further reflection. In this connection, the warning on page 52 against precipitate financial liberalization is intriguing.

Also interesting is the theoretical analysis of the effect of exchange rate devaluation on saving, but it does not seem to go very far. How far should one confiscate wealth through devaluation in order to stimulate saving?

Now, some very tentative conclusions: which further studies are suggested by the paper? Certainly, more work should be done on the effect on saving of interest rates. Equally, much more work is needed on the effect of interest rates on the structure and efficiency of investment. On program design, we should be much more careful in recommending changes in interest rate policy in order to raise saving. Perhaps this is only a problem of formulation, since interest rate policy is certainly relevant to the problem of capital flight. I certainly hope that the apparent effect of devaluation on saving will not strengthen the propensity to recommend devaluation of which our staff is, unjustly in recent times, sometimes accused.

The possibility of the Fund sponsoring certain studies is worth considering, because our research staff is overworked and because it would be interesting to have members of the Research Department participate more and more in mission work.

Mr. Jalan recalled that the Board had had a brief discussion on savings in June, at which time he had expressed some disappointment with the analytical framework of the related staff paper. He was happy to say that the current papers more than made up for that. As the main paper rightly recognized, economic science was not very far advanced in its understanding of either the mechanism of, or policies related to, savings. However, the analytical part of the paper had raised some interesting issues.

Saving rates in industrial countries in the 1980s had been lower than in the 1970s, Mr. Jalan noted; that seemed to be true of industrial countries as a group as well as of most of the countries taken individually. Yet, the growth performance of industrial countries as a group and of most of the countries individually in the 1980s had strengthened. The inflation performance in industrial countries had also improved, and since 1983, the inflation rate had been almost half the average of the 1970s. The combination of those patterns raised some interesting issues. For example, could it be argued that some countries were more efficient savers and some countries were more efficient investors, and that intercountry allocation was currently better than before? Or could it be that competition for low savings was leading to better allocation within countries? The experience of the 1980s had to be examined not only in relation to savings, but also in terms of the impact of those savings on growth rates. On the surface, there were some paradoxes that needed to be resolved.

A second related issue was the relationship between the distribution of savings and that of current account surpluses and deficits, Mr. Jalan continued. A point that had been raised by the former Chancellor of the Exchequer, Mr. Lawson, and by Mr. Prader was that in a world of capital liberalization, current surpluses and deficits were not unusual or destabilizing. To some extent, the staff paper also shared the view that current account imbalances need not necessarily be a cause for concern. However, a scientific answer to the question of that relationship was important, and the Fund should have a view on which surpluses and which deficits among those that currently existed were benign and which were unhealthy.

The staff paper was necessarily tentative on policies for increasing household savings, Mr. Jalan remarked. Particular policies, including *interest rate policy, could affect savings either way. However, it might* be useful to re-examine the paragraphs on tax policies on pages 29 and 30 of the paper. The paper started out by boldly stating that an important distortion in the industrial countries was the income tax, and for a few lines, the staff seemed to favor a consumption tax. But then the staff went on to say that the effects of a consumption tax on savings were also uncertain. What then was the view of the Fund staff? Assuming that government expenditure was necessary, what should be the tax policies in relation to individual taxation? Further work was necessary on that issue.

With respect to savings in the developing countries, Mr. Jalan considered that the paper raised the right issues and provided more or less the correct analytical answers to them. However, there were some points that seemed relevant for the design of the Fund programs, to which he would like to draw attention. As pointed out by Mr. Kafka, the paper dealt with the impact of interest changes on savings in both developed and developing countries. The empirical evidence in the industrial countries seemed to indicate that the impact of real interest changes on aggregate savings was likely to be small. That also seemed to be true of econometric evidence in developing countries. Yet, in Article IV consultation discussions, the Fund routinely assumed a strong positive relationship between increasing the real interest rates and private savings. For example, the correct policy in respect to interest rate had been a point of difference between the Fund staff and the authorities during the 1988 Article IV consultation discussion on China. He personally felt that positive real interest rates were essential, and that in the long run, a country that did not have positive real interest rates was not likely to have satisfactory financial savings. However, in an unstable situation of high inflation, which the authorities were seeking to control by fiscal policy and a very tight monetary policy, it had to be clarified whether positive real interest rates had to be achieved day by day and week by week.

The paper's conclusion in regard to financial liberalization was also of interest, Mr. Jalan commented. As pointed out in the paper, a stable macroeconomic environment was the key factor in the success of financial liberalization. Yet, several Fund-supported programs recommended financial liberalization during a period when macroeconomic environment was unstable. Once again, a clear position on this issue was necessary in the context of program design under conditions of instability and high inflation. His own view was that stabilization should be given priority in Fund-supported programs, and that structural policies such as financial liberalization should be followed only after the economy had been stabilized.

Mr. Nimatallah remarked that Mr. Jalan's request of the staff to adopt a firm view on the question of income tax versus consumption tax was a tall order, for two reasons. First, the Fund had tended to keep itself at arm's length from issues of equity and redistribution of income, preferring to leave decisions of that sort to governments. Second, governments did take deliberate decisions concerning the speed of improving the standard of living of their people. While some emphasized the use of consumption taxes at early stages in order to divert resources for government savings, others favored income taxes because they wanted those sections of the society with a higher propensity to consume to receive more benefits and consume more, which meant that they saved less. Any judgment that the Fund passed on the adequacy of the consumption/income tax choice should be made on a case-by-case basis, keeping in mind that even within each case the situation varied with the changing emphasis on the improvement in living standards.

Mr. Jalan agreed with Mr. Nimatallah that the decision should be made by the country concerned. He had only been making the analytical point that the Fund should refrain from passing judgment on either form of taxation.

Mr. Landau made the following statement:

This meeting gives us the opportunity to consider the role and the recent trend of national saving. During Article IV consultation discussions, we try to analyze the policies pursued by different countries, and very often we offer an opinion on the role of national savings in the macroeconomic equilibrium, but always in a specific context. Today, however, we have the opportunity to synthesize our thoughts and to present them in a more general framework.

Principally, I will raise some major issues affecting the role of savings in industrial countries, before turning briefly to the situation in developing countries.

First, what are the factors responsible for the changes that have taken place in national savings rates? As no simple answer exists and as I broadly endorse the staff appraisal, I will just stress a few points. The most important single component of the decline in national saving rate has been the drop in government savings in a number of countries, and the most direct way to raise national savings is to increase government savings. As far as household savings are concerned, we agree that we must keep in mind, before formulating a definitive opinion on the trend, that current saving is generally as high as that of the late 1960s and early 1970s, which does not mean, however, that the present situation is satisfactory everywhere.

As for the role of financial liberalization and innovation, the staff paper and the first detailed study in the background paper show the difficulties in assessing the consequences of financial liberalization and innovation on the level of savings. I agree that we must view such studies with caution, as the consequences for the level of savings are definitely not clear. But at least the innovation and liberalization processes have increased the efficiency of savings in the sense that a given amount of savings can be transferred into a more productive set of investments than before.

Second, what is the "desirable" level of savings in industrial countries? This is certainly not an easy question, but traditional analyses of the links between savings and growth, when applied to industrial countries, do not exclude the possibility that the level of savings is today, on the whole, insufficient.

We also note with great interest that the more recent growth models show the importance of the savings rate as a crucial factor for long-term growth, which is in accord with our own views. Furthermore, the paper rightly points out that this assumption, together with the assumption of international financial and human capital mobility, leads to the need for policy coordination in support of savings.

Third, what is the significance of current payment imbalances among major countries? The approach whereby these imbalances are viewed as reflecting an optimum allocation of world savings is stimulating and represents a break with concepts widely held today. Its merit lies particularly in stressing the importance of the freedom of capital movements as a condition for the sound allocation of savings. Such an approach would be irrefutable in a world of perfect information and perfect foresight without any distortions or rigidities; but it is farfetched to draw from it the conclusion that the external balance should not constitute today an economic policy objective--namely, that for a given level of investment, countries should not be concerned with the level of domestic savings.

Indeed, current payment imbalances could reflect an unsound allocation of international savings, first, because information is not always correct. For example, if the economic agents overestimate disposable wealth, in the future they may tend to save less than would be necessary to allow them to eventually achieve the level of consumption they expect. External imbalances may reflect such a tendency, which it is up to the government to try to correct.

Moreover, the savings rate chosen by the agents may pose a problem of fairness between generations, as underlined in the staff paper. Excessive consumption may now entail insufficient income for future generations. There is no doubt that economic policies should take this fairness issue into account. Here again, this could mean attempting to overcome external imbalances.

In addition, the present distortions--in particular, the differences between countries in the taxation of income from savings--may render savings allocation among countries as reflected in current balances much less efficient than would ideally be the case, that is, if there were no distortions or rigidities. Thus, on the one hand, we should try to remove these rigidities and distortions. On the other hand, as long as they persist, we should not lose sight of the objective of achieving some degree of payments balance to avoid a deterioration in the quality of the allocation of international savings. In these circumstances, asserting that an external balance should no longer be an economic policy objective could make it more difficult for countries to achieve the rate of domestic savings that they consider appropriate.

Finally, an unsound allocation of savings could also proceed from exchange rate expectations not in line with fundamentals. Perhaps the staff could examine this problem in future studies. Is there scope for further studies on this matter?

Current payments imbalances--whatever their cause--may be a problem if they are too large. They run the risk of abrupt reactions on the financial and exchange markets. Thus, they introduce an element of uncertainty in the economic environment, which, along with other factors such as inflation, tend to discourage investment.

For these reasons, we cannot consider the current payments imbalances between major industrial countries as unimportant. These imbalances should be seen in light of their causes, and in this we concur with the view expressed in the staff paper. From this twofold standpoint, the imbalances currently held by the United States, Japan, and Germany are clearly excessive and dangerous to the world economy. The deficits of the United Kingdom and Italy seem equally worrisome. Therefore, in our view, external balances should remain at least an intermediate economic policy objective.

Fourth, what are the policies needed to promote an appropriate level of domestic savings? The choice among the different instruments will depend on each country's particular situation. As long as the Ricardian equivalence is nil or weak, as the econometric studies on the subject would seem to indicate, action through public savings must play an important role. Thus, a reduction in public dissavings or an increase in public savings is, in our view, a fundamental instrument for re-establishing external balance in countries with deficits. In this respect, the staff paper suggests that a reduction in public consumption would be more efficient than a tax increase. One may ask whether this assumption, which does not seem to have been demonstrated in the United States, has not been drawn on terms that are too general, which could lead to unwarranted recommendations regarding the role of government. Indeed, the paper rightly notes that a reduction in public expenditure could damage the social infrastructure, and this damage could abate growth, which in turn could affect the saving rate.

Tax policy is also an important element in ensuring a good level of public savings. As far as private saving is concerned, it must specifically contribute to improving the efficiency of savings allocation. This is particularly necessary with the increasing mobility of international capital, and we fully endorse the point made in the staff appraisal that savings derived from a coordinated tax policy will provide an efficient allocation of the world's capital stock.

Turning now briefly to developing countries,as regards the analysis of factors that determine savings, the study of the links among savings, inflation, and devaluation seems particularly important. Savings are greater in developing countries with low inflation, which confirms the fact that a stable currency and economic environment promote savings in general and private savings in particular. It would be interesting to know whether more detailed comparisons have been made in specific geographical areas--in particular, in Africa--between private savings in low- and high-inflation countries.

However, the assessment of the effect of devaluation on savings does not seem entirely consistent with the finding that low inflation promotes savings. A clarification of this relationship would be desirable, through a study of the links between savings and currency stability in the various categories of developing countries.

As for the links between savings, investment, and growth, we share the staff's cautious position on this point, but the importance of "human investment" approached from the standpoint of public expenditure on education appears in the study as an interesting hypothesis to explain growth in lower-income countries. This point deserves further exploration.

As to the means of increasing the level of domestic savings, the fact that a case cannot be made for Ricardian equivalence in the developing countries suggests that it should be considered fundamental to reduce negative public savings, particularly by increasing the taxes actually collected.

Mr. Goos said that he was in broad agreement with the staff's analysis and its conclusions, although he would later raise some questions concerning a few points. His general agreement extended, in particular, to the findings concerning the strategic role of government consumption in determining national saving and for the external current account balance. That finding was essential for financial and economic stability, and hence for sustained growth. It therefore would indeed be appropriate for countries with unsustainable external deficits to focus their adjustment efforts prominently on fiscal consolidation.

At the same time, the staff's analysis rightly indicated that it would be in nobody's interest if surplus countries were to reduce their national savings, Mr. Goos noted. In addition to the arguments presented in the paper in support of that view, two further aspects suggested that savings were rather too low on both a national and international level. First, while the widespread underutilization of labor--one important production factor--could perhaps be alleviated by a more efficient allocation of resources, it appeared that in many instances its solution could be substantially facilitated by an increase in the capital stock. Second, the need for industrial countries to support economic advancement in the developing countries through the generation and transfer of savings necessitated the accumulation of current account surpluses by industrial countries as a group.

It therefore followed that he also shared the view that current account imbalances per se were no reason for concern, Mr. Goos continued. What mattered was the sustainability of the underlying saving and investment performance, which would indeed give rise to questions in cases where that performance reflected inefficient domestic policies. However, even in the absence of such inefficiencies, including artificial incentives and tax distortions affecting saving, borrowing, and investment, governments could not adopt an attitude of benign neglect vis-à-vis external current account developments. There would still remain a crucial role for stabilization policies to counter unexpected exogenous shocks that may adversely affect domestic saving and investment. There was also a role for stabilization policy to correct market imperfections.

Against the background of the staff's analysis, it generally appeared that the efforts undertaken since the early 1980s by many industrial, but also some developing, countries--to curtail the role of the public sector through redressing government consumption and budget deficits combined with structural reforms aimed at more directly strengthening private sector initiatives--boded well for the future, Mr. Goos said. But such achievements were no reason for complacency, particularly not in those countries with continued low saving rates that were giving rise to balance of payments concerns. Those countries should enlist all instruments available to strengthen national saving in a comprehensive and balanced fashion. While in most cases that would require a resolute attack on inefficient public sector consumption and investment, he was somewhat reluctant to share the staff's skepticism over the relevance of interest rates and inflation to savings performance. He recognized, of course, that that skepticism was based on a substantial body of theoretical empirical work, but it seemed to be at odds with quite a number of conceptual and factual considerations.

First, on conceptual grounds, Mr. Goos considered it somewhat peculiar that while apparently minimizing the relevance of interest rates, the staff seemed to be so concerned with the provision of tax incentives for borrowing. He wondered whether that differing emphasis was consistent with the assumption of rational behavior; given that the granting of tax deductions for borrowing costs was in effect equivalent to lowering the effective rate of interest, why not expect the same adverse effect on savings from low or negative real interest rates?

Another conceptual inconsistency arose from the general observation that the saving rate tended to be higher for low-inflation countries and that countries that had consistently maintained positive real interest rates also showed relatively low rates of inflation, Mr. Goos went on. If one combined those two observations, one had to conclude that interest rates actually did have a bearing on national savings.

That conclusion also seemed to be borne out by recent empirical work undertaken by the Asian Development Bank and J. J. Polak, Mr. Goos added. Polak's major policy conclusion had been that in order to promote savings and growth, countries should not keep real interest rates artificially low, and he even recommended that the setting of real interest rates at sufficiently positive levels should be among the top priorities in both Fund and Bank conditionality. No less straightforward was the 1989 Asian Development Outlook of the Asian Development Bank citing the level and nature of incentives to save--notably, real interest rates--among the determinants of domestic saving. Similarly, the joint Fund-Bank staff paper for the most recent Development Committee meeting concerning the external environment and financing requirements for growth-oriented adjustment, stated that a stable macroeconomic environment--which he presumed would include a low inflation rate--that provided incentives for efficient production and offered positive real returns on saving was an essential part of the strategy to raise savings, investment, and growth.

Accordingly, Mr. Goos hoped that the inconclusive evidence emerging from the staff paper would not lead the staff in its country work to ignore interest rates or de-emphasize price stability. While that did not seem to be the staff's intention, it did appear that the staff planned to monitor those factors for other purposes than to raise domestic savings, namely, to improve factor allocation and to reduce capital flight, inter alia. In addition, if the staff did disregard interest rates and inflation in industrial countries, which was the impression one received from the paper's sections on industrial countries, that would be somewhat inconsistent with the conclusions reached in the course of the Article IV consultation discussions with the United Kingdom and with Australia--that a restrictive monetary policy, including a high interest rate policy, was a reasonable approach to stabilizing the external accounts.

For all those reasons, Mr. Goos considered that efforts to maintain positive real interest rates should be redoubled, not only in the design of Fund-supported adjustment programs, but also in the context of Fund surveillance over both developing and industrial countries' financial economic policies. In that context, the structuring of the discussion in the staff paper into two separate country sections conveyed the impression that the industrial countries and developing countries were faced with fundamentally different issues in their saving performances. While that might be true in regard to institutional and cultural factors affecting the level of saving, in general, such country-specific factors were less likely to play significant roles in changing saving behavior in individual countries over time, which was the more relevant issue from a policy perspective. In other words, country-specific factors affected the level of savings, rather than the response of the saving rate to certain incentives.

With respect to the level of savings, Mr. Goos added that he was doubtful in particular about the appropriateness of differentiating the discussion according to countries' level of income. The general proposition that low-income countries had only a limited saving capacity at first glance might appear quite reasonable, but there were many indications that such countries were actually able to save. The issue was less whether they could generate savings than how those savings could be mobilized. The question then arose of which problem came first: the low-income level leading to a low savings ratio, or the savings actually generated not being properly mobilized and channeled into productive investment, thus leading to low income. One should not forget that all countries had at some point started out with a low income, and that some of them had succeeded in generating high savings while others had not.

In the context of the Board's presentation of the issues to the Interim Committee, Mr. Goos said that he would prefer a more integrated discussion of the policy instruments for stimulating savings than the one in the staff paper. Such a presentation could also be somewhat more comprehensive than that in the paper, which had little to say on the importance of money or credit control for national saving--surprisingly little considering that the control of monetary aggregates was at the very center of the Fund's program design.

Finally, Mr. Goos commented that the paper's discussion of the relevance of exchange rate policy was somewhat on the short side and not quite commensurate with the many questions and concerns surrounding that policy instrument. He concurred with the staff's concluding observation in the developing country section, which stressed that the avoidance of periodic real exchange rate overvaluation could make an important contribution to fostering a macroeconomic climate conducive to investment, although he would have added that such a climate was also conducive to domestic savings. He understood that that matter would be further pursued in the context of the staff's work on the design of the Fund's policy advice, and was looking forward to a more substantive analysis of the issue, including in particular of the role of exchange rate expectations and their interaction with relative price developments and on the adequacy of interest rate levels.

Mrs. Filardo commented that she had not perceived the paper as recommending low interest rates. Rather, the paper had made the point that interest rates changed the composition of saving but did not have a meaningful effect on the level of saving. Regarding Mr. Goos's doubts whether saving was related to a country's level of income, it seemed clear that those who lived at a minimum level of subsistence could not react to a rise in interest rates by increasing their savings. Finally, on the grouping of countries in the staff's analysis, she considered it very important to present to the Interim Committee the differences between industrial countries and developing countries, as well as those between low and highly indebted countries within the group of developing countries.

Mr. Nimatallah said that, as he saw it, the paper had made the point that the net effect of changes in interest rates was not clear. That was supported by the case of the United Kingdom. When the interest rate had been increased sharply for the purpose of reducing domestic demand, those who earned interest might have increased their consumption expenditure, while those who paid interest most likely had reduced their consumption. The question was which group had more impact on the net change in demand. Savings could be affected by the overall level of interest rates, but not so clearly by changes in those rates. When a country embarked on a Fund-supported program, it could not change its consumption habits over the short period of time for which the program was in place. It might be that changes in the interest rate did have a net effect over the medium term in the direction that the Fund and the country concerned wanted, but it was not clear that they had an immediate impact in the desired direction.

Mr. Goos remarked that Mr. Nimatallah's comments seemed to support the effectiveness of interest rate policy. He himself agreed that changes in interest rates might have an ambiguous effect in the short term, but as Mr. Nimatallah had said, the level of interest rates was certainly relevant. If a country had negative real interest rates, it was generally appropriate to advise that country to aim toward a positive level of interest rate. There was of course also the point that in the short term, particularly in an unstable macroeconomic environment, interest rates could not always be set to be positive on a day-to-day basis.

Based on the theoretical and empirical evidence gathered in the paper, it was premature to say that interest rates could be ignored in the future, Mr. Goos concluded. The paper had deemed the interest rate instrument as still being useful, even though primarily for allocative purposes and in repatriating flight capital.

As to the ability to save, Mr. Goos repeated that he had difficulties with the proposition that low-income countries could not save and were therefore dependent on foreign capital inflows. Of course their prospects for development would improve if they received external resources, but if one examined the actual consumption behavior in low-income countries, there was clear evidence of saving, ranging from farmers not consuming their whole harvest, to parents of girls who had to put aside the resources for hosting expensive wedding feasts, to the poorest of countries building monuments that were clearly not financed by external resources. Those instances were each clear evidence that the problem was not so much one of generating savings as one of mobilizing those savings and channeling them into the right uses.

With respect to the question of country classification, Mr. Goos considered that since many, if not most, savings instruments could be expected to influence savings decisions in exactly the same way, whether they were applied in a developing country or an industrial country, it made sense to summarize those instruments and discuss their effect in a joint chapter, rather than repeating the same conclusions in each country section.

Mr. Jalan remarked that Mr. Goos's point that low savers tended to have high inflation rates and that high inflation countries tended to have lower growth rates was very interesting. The explanation was that, from a long-term perspective, a positive interest rate policy was always good: negative interest rates led to increased demand for funds and reduced supply, with the resulting gap usually being met by credit expansion leading to high inflation. It was a given fact that a country with a higher interest rate would necessarily have a higher rate of saving vis-à-vis other countries with lower interest rates, but that was not the issue. For a particular country, the effect of negative interest rates would be that the saving rate would probably not increase, credit expansion would take place, and the rate of inflation would rise. In addition, there was substantial evidence, including from his own country, that negative interest rates discouraged financial savings and encouraged savings in nonproductive forms, which again drove up inflation.

Mr. Cassell remarked that in examining the relationship between savings and growth, one had to consider the stock of capital as well as the flow. The impact of an acceleration in inflation on the real value of the stock of capital would have some implications for saving behavior over the medium term.

Turning first to the industrial countries, the staff had rightly focused on the clear downward trend in national saving rate since the early 1970s, Mr. Cassell observed. It was worth noting, however, that that broad picture concealed two distinct phases. The first, covering the ten years after the first oil price shock, saw a marked decline in government saving combined with broadly constant or even rising private sector saving. The second phase, since the early 1980s, had seen a steady improvement in government saving, offset in many countries by a sharp fall in household saving.

Even that more detailed breakdown failed to capture an important aspect of the movement from year to year in aggregate government saving, Mr. Cassell continued. It seemed quite clear that the supposed secular decline in public saving in the period 1973-83 was substantially accounted for by the two recessionary episodes associated with the 1973 and 1979 oil shocks. During those recessionary periods, governments had allowed their deficits to rise significantly. In contrast, public sector saving had recovered strongly between 1975 and 1979 as the level of activity picked up, and there had been a similar strengthening in government finances since 1983, with one or two notable exceptions.

That pattern suggested that many governments had continued to regard fiscal policy as an important instrument of countercyclical policy, Mr. Cassell went on. It also indicated that there might perhaps be a cyclical explanation for the observed fall in public saving. For example, the relatively low level of aggregate government saving seen in the later stages of the current upswing might be linked to the persistence of widespread unemployment in many countries. High unemployment would tend to reduce government saving both directly, by increasing welfare spending and reducing tax collections, and indirectly, by imparting an expansionary bias to macroeconomic policy, notwithstanding the structural nature of unemployment in many European countries. He would be interested in staff comments on that interpretation of trends in government saving.

A central message of the staff analysis was that fiscal policy had a key role to play in ensuring that national saving was kept at an appropriate level, Mr. Cassell noted. That implied that fiscal policy should be set in a medium-term rather than a short-term context. In addition, it intimated that governments should have some view of what constituted an optimal level of public saving.

The staff paper might have benefited from a discussion of the factors that could be taken into account in determining that optimal level, Mr. Cassell remarked. The latter would not be independent of the saving and investment plans of the private sector, and it would depend, among other things, on the structure of the public sector itself in terms of how much of the capital formation in the economy was publicly owned. However, in most countries, the required direction of change was clear. As far as the United Kingdom was concerned, the Government's objective was to minimize the burden on the private sector--in terms of both taxation and debt interest--by maintaining a broad balance in the fiscal position over the medium term. Where there were adverse demographic trends or unfunded state pension schemes, there might be a need for larger government saving to ameliorate the burden on future taxpayers.

The need to increase government saving rested on the assumption that the current level of national saving was "too low" from the point of view of intertemporal optimization, Mr. Cassell stated. Perhaps the clearest evidence for that could be found in the path of real interest rates. Since 1980, real short-term rates had averaged between 4 percent and 5 percent, significantly higher than in the 1960s and early 1970s--when indeed they had often been negative. Although real interest rates were influenced by a host of factors other than saving and investment, that secular increase did suggest that there had been an insufficiency of saving relative to investment in recent years. As Mr. Lawson had reminded the gathering at the recent Annual Meetings: "One Keynesian legacy has been a preoccupation with an incipient shortage of demand, whereas it is an incipient shortage of capital that is emerging as the real problem...."

The staff paper fully recognized the wider implications of increased international capital mobility, Mr. Cassell noted. One of the most important of those implications was that the increasing integration of world capital markets appeared to be leading to a gradual decoupling of domestic investment and saving rates, which should enhance international welfare over the longer term.

The counterpart to that development might be seen in the increasing size of external imbalances in the industrial world, Mr. Cassell pointed out. As the staff noted, to the extent that such imbalances reflected the optimizing decision of private agents, they should not be seen as a problem, but simply as the consequence of different national resource endowments and preferences. In some cases, of course, current account imbalances might reflect underlying market distortions, structural rigidities, or, in the case of deficit countries, an excessive level of government dissavings. Nevertheless, in assessing the origins and, hence, the sustainability of the current external imbalances, one should certainly not underestimate the significance of capital market liberalization in the 1980s and, in particular, the impact of the removal of exchange controls. In some respects, there seemed to have been a return to the pattern seen in the classical, pre-1914 gold standard. Between 1880 and 1913, six of the eight economies for which data were available recorded an average current account surplus or deficit of over 2.5 percent of GDP.

In practice, it might be extremely difficult to establish whether in particular cases an observed external deficit or surplus was in some sense benign, partly because the determinants were still not fully understood, Mr. Cassell noted. The staff devoted considerable space to the impact of tax policy on saving, but it was not clear that the level of saving--as opposed to its allocation--was significantly affected by the tax structure. The worldwide trend over recent years had been toward lower marginal income tax rates, which had been associated with a falling private sector saving ratio in many countries. That perhaps reflected the fact that the elasticity of saving with respect to the effective, or post-tax, rate of return appeared to be rather low.

Nevertheless, Mr. Cassell said, he would certainly not dissent from the general proposition that tax policy should be formulated so as to minimize tax wedges between pre-tax and post-tax rates of return on saving and investment. That was in fact the test of the exchange between Mr. Prader and Mr. Goos; if Germany was indeed starting with a large wedge between the pre-tax and post-tax rate of return on investment, then it was probably true that cutting taxes would stimulate greater domestic absorption and thus reduce the current account surplus.

Turning to the staff analysis of saving in developing countries, Mr. Cassell indicated that he could be brief since the Board had discussed the subject several times recently. The staff raised the issue of the impact of extended family arrangements on saving in developing countries. He would welcome elaboration on that. In particular, the staff suggested that the main effect of extended family arrangements might be to extend the effective planning horizons over which households made their consumption decisions--an argument that might suggest, rather improbably, that Ricardian equivalence might be more prevalent in developing societies. It seemed that there was an even simpler explanation, that the main impact of extended family traditions was to reduce the working population's need and ability to save for retirement. In short, he was more attracted to Mr. Mawakani's conclusions.

He had not been convinced by the staff's argument that an exchange rate devaluation would tend to increase national saving by reducing the real value of financial assets, Mr. Cassell commented. While that effect might indeed be relevant, in many cases it might be dominated by the impact of the devaluation on the cost to consumers of purchasing a minimum basket of essential goods. That again was an important issue worth further study, given the conventional assumption that an exchange rate devaluation should in the medium term induce an improvement in a country's current account, and hence, an increase in its net national saving rate.

One conclusion that came out of the staff's econometric analysis on the determinants of growth in developing countries was that the level of investment in human capital had a key role to play in increasing growth, particularly in low-income countries, Mr. Cassell noted. That in turn suggested that the design of Fund programs should focus not only on the level of government saving, but also on the distribution of government spending.

He endorsed the staff's concluding remarks, Mr. Cassell said. For many developing countries with little or no access to international capital markets, domestic savings had to be the main source of investment finance, and that might become more true as time went on. Therefore, low savings resulted in low investment and growth. In those circumstances, the challenge was to pursue a tight fiscal policy, backed by positive real interest rates, by financial sector reform, and by the establishment of a realistic exchange rate. That policy mix was at the heart of Fund-supported adjustment programs.

Mr. Clark made the following statement:

The staff has prepared a very comprehensive study of the factors that may be affecting national savings. This is a timely and useful review, given the concerns about growing fiscal imbalances and the decline in national saving rate that have been expressed by many Executive Directors during Board discussions. While no strong conclusions can be drawn, the paper nevertheless does raise some important questions. In view of the breadth of the study, I will keep my comments brief.

Let me now turn first to the determinants of saving. With respect to industrial countries, the paper identifies government dissaving as the major reason for the decline in national saving rate. We agree with this finding and note that a recent OECD working paper on national savings reached the same conclusion. One element in government dissaving in many countries has been the failure to limit increases in government expenditures given relatively high and, in some cases, rising interest rates. This is, of course, extremely difficult to do but we agree with the staff that the impact of budgetary policy has to be one of the key issues in looking at savings and investment. Factors other than government policies also help to explain saving behavior, but they cannot account for the sharp decline in saving rate in the last decade. Demographic factors, for example, would be expected to come into play over a much longer horizon. But even here, it is not clear that savings will fall with the aging of a population. Recent studies done in Canada have thrown some doubt on this proposition.

I will now turn to the most contentious issue in the paper, that is, the question of whether the current level of national saving is too low. As the paper correctly points out, there are good reasons to question the traditional neoclassical model of economic growth in which growth is related to technological changes and the saving rate is not a factor. There appears to be a positive relation between saving rates and growth rates that contradicts the predictions of the traditional model. Work on a new theoretical approach, in which the rate of technological progress is endogenous and linked to the rate of investment, is at an early stage and the evidence is not clear, although the arguments do have a strong intuitive appeal.

In the paper, it is argued that there are positive externalities associated with saving and investment that cause the social rate of return to diverge from the private rate. In such a situation, myopic behavior on the part of the present generation can lead to excessive current consumption, which will make the next generation worse off. However, in addressing this issue, it has to be appreciated that private saving reflects intertemporal choices regarding consumption and saving. To the extent that saving rates indicate rates of time preference, it cannot be concluded that present low rates are necessarily inappropriate.

Nevertheless, I agree that it is important to consider the accumulation, not only of physical and financial assets, but also of human capital, research and development expenditures, the protection of the environment, and other nonconsumption expenditures that enhance the quality of life and future productivity. But the staff itself agrees that there are practical difficulties in identifying these externalities and determining whether there is indeed a significant wedge between social and private rates of return, which clearly remains an issue for further research. Although the evidence is at best mixed, I do not believe that we can be complacent about present levels of savings. It may well be that from a longer-term perspective, in particular if one takes into account environmental and other social concerns, saving rates may be too low.

Quite apart from the longer-term issue of the adequacy of savings is the more immediate concern of the large domestic and external imbalances in savings and investment among major industrial countries. As was discussed in the last World Economic Outlook, while it can be argued that the large external imbalances may reflect differing saving/investment preferences, those imbalances can lead to macroeconomic instability and threaten international trade by creating a favorable environment for protectionist trade measures. Exchange rate movements will eventually eliminate these external imbalances, but possibly not before a period of extreme instability. For these reasons, measures to correct domestic imbalances should be taken sooner rather than later.

This brings me to the issue of policy options. We agree that the most appropriate way to correct the saving/investment imbalance is by fiscal consolidation that stresses a mixture of tax reforms and spending cuts. But in this exercise, governments must be aware that private decisions on saving are made within the context of government policy. Governments should therefore ensure that tax and regulatory measures do not distort private saving and investment decisions. In this regard, I can support the recommendation for governments to re-examine the tax treatment of consumption and saving and specifically to eliminate, or at least reduce the number of, provisions in the tax code that encourage borrowing. To this end, we endorse shifting the tax burden from direct to indirect sources. We would, however, caution against measures that in effect substitute one distortion for another, such as incentives to promote savings.

I will now make a few observations on savings in developing countries, which, since I essentially agree with most of the points in the paper, will be by way of brief amplification. For example, it could be emphasized that the underdevelopment of financial markets is an important reason for low levels of saving in developing countries. In many countries, there is neither a wide choice of financial instruments nor intermediaries, and the flow of financial information does not allow for rational savings behavior; for instance, it is often the case that interest rates are not well known.

As is the case in industrial countries, government dissaving is a major contributor to low national saving rate and must be the focus of any policy action to address the problem. The paper has rightly identified public enterprises as the origin of much of the difficulty and there is no doubt that the operations of such enterprises could be made more cost effective and, in some cases, privatized without any serious reduction in the perceived social benefits that led to their establishment. Moreover, although low per capita incomes make it difficult to raise revenue, especially in the poorest countries, one can agree that there is potential for revenue enhancement through improved tax administration.

Finally, given the reduced availability of foreign savings, the importance of policies in developing countries that provide incentives for private savings, discourage capital flight, and promote efficient investment must be stressed. This points to the need for ensuring that subsidized or negative interest rates, credit allocation, and other regulations do not provide the wrong savings and investment signals.

Mr. Fogelholm made the following statement:

The staff papers provide a comprehensive review of the issues concerning savings and investment and their relationship to macroeconomic stability, growth, and external balance. I will limit my remarks to three points.

First, I will comment on the decline in savings in the industrial countries, including the Nordic experience in this regard. Without reiterating the various theories and factors put forward to explain the downward trend in savings in the last decade, the staff papers adeptly illustrate that the reasons for this change in saving behavior are numerous and complex, and often very country specific. It is interesting to note that the largest part of the decrease in savings is a result of developments in the public sector. Furthermore, the analysis gives support to the view that a change in public sector savings would not be totally offset by an increase in private sector savings. Although the generation of private savings is important, the need to increase national savings in several countries has clear implications for the future formulation of fiscal policies, including in the Fund's programs.

From a Nordic perspective, it is interesting to observe that while in most industrial countries the decrease in public sector savings has been the main factor behind the downward trend in national savings, it is principally private savings that have decreased in the Nordic countries. But even in such a homogenous group, there are substantial differences in savings developments. In the 1980s, some countries experienced a much larger decline in private savings and a corresponding consumption boom than did others. This can be ascribed, inter alia, to differences in economic policies, and also to the fact that fiscal and financial policy changes that affected savings took place at different stages of economic development in these countries. Also, generally speaking, I believe that we will find in studies that the level of economic development will have a significant influence on savings as will, of course, the income level, which was taken up in the discussion between Mr. Goos and Mrs. Filardo. I think that they are both on the same track actually: one talked about the change in saving rate, while the other talked about the level.

In some of the Nordic countries, liberalization of the domestic credit markets has had a substantial negative impact upon savings. The effect has been heightened because high marginal tax rates and deductibility of interest payments have led to low, or even negative, after-tax real interest rates. In recent years, however, tax reforms lowering marginal tax rates and expanding the tax base with the specific goal of increasing household savings have been on the economic policy agenda. Positive income expectations and an increase in wealth, mainly owing to rising prices of housing, are other important factors that have influenced the savings behavior in the Nordic countries. It is also believed that the increasingly comprehensive and publicly financed pensions systems in the Nordic countries have contributed to the fall in the level of household savings.

The staff paper concludes that economic theory and empirical studies give no clear-cut answers as to the effects of interest rates on private savings. Nevertheless, I dare to assert that at least the experience in my countries--as documented in studies over the last 20 years--indicates a positive correlation between real interest rates and savings. There also seems to be a tendency for the effects of real interest rates on savings to increase when financial markets are liberalized. In this connection, it is easy to agree that real interest rates are necessary for the efficient allocation of financial savings. It would, however, be interesting to know if studies have shown whether an increase in real interest rates has led to an improved allocation of savings. We can always say that we need real interest rates to maintain proper allocation, but are there studies that show that a higher real interest would actually have improved allocation?

Second, I will comment on the issue of the adequacy of total savings. Globally, reduced saving has necessarily been accompanied by lower investment. In that sense, one can say that savings have been sufficient--at least in the short run. But this raises, of course, the question of whether the present level of savings and investment is sufficient to sustain adequate growth in the long run. In the interesting review of endogenous growth theories, the staff concludes--notwithstanding the early stage of empirical work on such models--that positive side effects of savings suggest that the level of savings in industrial countries may indeed be on the low side. With continued, relatively high unemployment in many countries, it can also be argued that there is a need to increase investment in order to expand the capital stock, and thereby enhance employment opportunities in the long run.

At the same time, there is the general issue of the improvement in the quality of investments through the application of more sophisticated technology and the accumulation of human capital. Since expenditures on research and development and on education are treated as consumption instead of investment in the System of National Accounts, it could be claimed that presently both savings and investments are underestimated in the national accounts. This phenomenon distorts the overall picture, particularly in countries that allocate a substantial amount of public expenditure to education.

Third, on external imbalances, what weight should be given to current account surpluses and deficits when focusing on developments in savings and investments? Is there a case to be made that the lack of current account equilibria between major areas does not necessarily constitute a problem? The liberalization of cross-border capital transactions implies that countries can maintain high investment rates without having correspondingly high saving rates. There is nothing wrong with that, at least not in the short run, if the allocation of savings between countries is not distorted and reflects the search for the most productive investment opportunities.

However, in the long term, regardless of the absence of distortions, imbalances are certainly not sustainable when expectations change and the perception of a growing foreign exchange rate risk increases.

It is also clear that the potential for volatility, in particular if underlying real imbalances are regarded as unsustainable, has increased as commercial transactions following the liberalization of financial markets now constitute only a small portion of the total foreign exchange transactions. Consequently, this chair has repeatedly stressed that large and persistent current account imbalances carry an inherent risk of generating abrupt and unexpected capital movements, ultimately resulting in exchange rate instability.

Finally, in judging the appropriateness of the distribution of savings between countries, it is essential that the framework in which this distribution has emerged be taken into account. Liberalized capital markets have made current account deficits easy to finance, if a country is creditworthy. Differences in tax regimes may, however, influence capital movements significantly, and thereby contribute to the emergence of inappropriate savings and investment imbalances. Increased international coordination of economic policies--both monetary and fiscal--is therefore called for, in order to promote the allocation of resources to investments where the returns are highest. From this, one may conclude that the Fund's surveillance task is definitely not over.

Mrs. Filardo made the following statement:

The request from the Interim Committee to our Board during the 1989 spring meeting was "to undertake a study on national saving and on the policy measures needed to foster saving formation conducive to sustain economic expansion." For today's discussion, the staff has presented two papers with an insightful analysis of the world's national saving situation and policy recommendations for both industrial and developing countries to correct their deficiencies.

The staff first explores the factors that are responsible for changes in national saving rates. There is a general consensus that national saving has declined during the last few years, primarily as a result of government dissaving, so that the best solution is to reduce expenditure and eliminate tax distortions. Nevertheless, the validity of this recommendation seems to depend on the relative social values of the foregone private and government expenditure; the definition of saving that is being used; and the growth model that is relevant.

In this regard, a relevant question is whether it is appropriate to measure saving in the same way in both industrial and developing countries. The currently accepted form of measurement, while convenient for international comparisons, presents serious constraints for a more accurate analysis, and its deficiencies would seem to affect the level of saving, policy implications and, ultimately, its effect on economic growth. Appendices I, II, and III of the staff paper are very illustrative in this respect. Of the main difficulties encountered in the definition of saving for industrial countries, it would seem that the most important ones are the discrepancy of accounting systems between the United States and other industrial countries, and the conceptual problem of defining income and saving, including the classification of capital gains and losses, adjustments for inflation, consumer durables, research and development, and human capital. Although the paper emphasizes that these issues are difficult to resolve at either a theoretical or empirical level, perhaps one could select a group of the most important ones in order to enhance the indicators, improve the analysis and, therefore, the policy recommendations. In the redefinition of saving, a case could be made that saving is considered as an alternative among other financial assets by a portfolio manager, who also evaluates consumer time preference, risk, and return after taxes. Thus, even if interest rates are high, their effect on saving is not significant in that international financial integration might offer a more profitable investment alternative.

In developing countries, there are serious constraints on the availability of data. Among the most important findings are, first, that the measurement of private saving in the form of foreign assets is virtually impossible. Data on private capital flows in the balance of payments account are weak. Also, it has been found that the impact of the real interest rate is not significant and that capital outflows, especially in highly indebted countries, are motivated by fears of potential capital losses arising from expropriation or possible tax increases. In Appendix III, on the econometric analysis of saving, it is demonstrated that the debt overhang has a significant impact on saving. In this regard, one needs to be cautious about including capital repatriation in Fund programs for the purpose of filling the financing gap, if there is no accurate methodology to do so. Otherwise we could run the risk of underfinanced programs if capital repatriation does not take place. Could the staff comment on how data and the definition of saving could be improved both in industrial and developing countries?

In relation to the adequacy of saving, the paper analyzes the intertemporal relationship between saving and economic welfare, first in the context of a traditional model of economic growth, in which technological advance is determined exogenously; and second, by using more recent models of economic growth, where technological advance is endogenously determined. The main difference is whether we can argue that the social rate of return from saving and investment is higher than the private return, in which case we can conclude that saving is low. Since the main implication of the traditional model is that the long-term rate of growth is unaffected by the saving rate, while the endogenous model assumes that the accumulation of human capital is the means by which labor productivity grows over time, an increase in saving leads to a permanent increase of both capital and effective labor, and thus it has a sustained impact on growth. While, according to the staff, the empirical evidence of these theories is in infancy, it seems logical that any discussion of trends in national saving rates would have to take into consideration the accumulation of human capital research and development expenditure and other expenditures that enhance productivity. Furthermore, in an open economy and in many developing countries undertaking strong adjustment programs, the distinction between saving and investment is fundamental, since policies to stimulate saving may have little effect on growth if the factors promoting growth are associated primarily with domestic investment. As I mentioned before, this becomes more important in the context of capital mobility.

While the staff has indicated that any political prescriptions made on the basis of endogenous models will require accurate empirical information about the forces determining growth, in our view the Fund is the perfect place to develop such investigation, not only because we have very important data on industrial and developing countries, but also because we have the responsibility of surveillance and the obligation to enhance program design and policy recommendations for the countries that use Fund resources. As the relevant research would fall in the category of program design, we consider that the Research Department should develop a set of recommendations for the continuation of this investigation.

Regarding the international distribution of saving, one of the main questions raised by the staff is whether it is necessary to determine the origin of the current account imbalance before assessing whether the imbalance is undesirable and, if so, how to correct it. If one accepts the premise that the most important source of decline in national saving has been government dissaving, mainly in industrial countries--which have a major responsibility within the international financial system--perhaps this has also been the main reason for maintaining high real interest rates. While this could not have a significant impact on saving, the way governments of low-saving industrial countries finance their deficits through the issuance of treasury bills and bonds, the international financial integration between those countries, and the sophistication of their domestic markets compared with others have permitted these countries to have permanent access to capital markets to finance their internal and external imbalances and to delay adjustment. These actions have obviously implied a tremendous cost for those highly indebted developing countries that previously had access to financial markets but whose access at present has been curtailed through distortions created by tax, accountancy, and financial regulations in industrial countries. Thus, while in the last few years we have observed continuous internal and external disequilibria in the major industrial countries, and from time to time sharp movements in exchange and interest rates and stock market crises, this situation might not be sustainable without undermining the world financial system, mainly affecting the most vulnerable countries whose liquidity is squeezed through reduced access to financial markets, high real interest rates, and exchange rate volatility.

On the effectiveness and viability of policy options to increase saving, if we assume that growth models and the definition of saving have to be reassessed, policy prescriptions to promote saving have to be cautiously evaluated in both industrial and developing countries. In industrial countries, while the paper concludes that government dissaving is the main reason for the decline in national saving and presents a set of policies to reduce government expenditure and tax reforms, it also indicates that there are few possibilities of tax reforms being undertaken, since most industrial countries have already recently implemented reforms. The staff then suggests that the elimination of tax incentives that encourage borrowing and tax harmonization could be a good alternative to promote saving. I concur with the staff that tax harmonization has to be stimulated, but I wonder whether there is sufficient empirical evidence to suggest that the elimination of tax incentives to borrow could contribute significantly to an increase in saving of the magnitude that seems to be required by the governments of industrial countries. Given the constraints on the tax side, it would seem crucial to reassess the composition of government expenditure in order to determine the most efficient role of the state in the economy and its priorities. I wonder, for instance, what classification is given to defense expenditure and its impact on economic growth, especially in those countries that have fundamental responsibilities in this respect.

In the case of developing countries, the level of saving depends, among other factors, on the level and distribution of income and, ultimately, on the burden of debt. The staff has made a useful analysis of the factors determining saving in these countries; the interaction between public and private saving; and the relationship between saving, investment, and growth, and in particular, the direction of causation. The conclusions reached by the staff clearly reflect the different saving behavior of each group of countries. The staff considers that endogenous growth models might be as relevant to developing countries as they are to industrial countries, but I would say that they are even more important, given the degree of development and, in many cases, the level of poverty in the developing countries. For instance, those countries with a subsistence level income and those with a debt overhang can hardly react to interest rates in order to increase saving. While macroeconomic stability is a prerequisite for economic growth, policy prescriptions have to be cautiously assessed depending on the economic circumstances of each country. As the staff has rightly stressed, "for a given level of foreign saving an attempt to increase national saving could result in excessive contraction of demand, reducing domestic income and leading to lower values of both national saving and domestic investment." In this regard, the Brady initiative has to be strongly enforced, so that it might promote debt and debt-service reduction. Otherwise, we will continue to have failing economic programs because our policy advice is not consistent with specific country circumstances.

Mr. Feldman made the following statement:

The issues under consideration today are complex, particularly those related to policy recommendations. The current papers will, I hope, serve as a basis for further research and for a more detailed study on Fund policies to promote savings. Like Mr. Jalan, I would very much like to see how the issues under discussion are translated into operational terms.

On the question of the international distribution of saving and investment in industrial countries, according to the staff, current account imbalances could be benign to the extent that they reflect the optimization of decisions relating to saving and investment made in the absence of significant distortions or rigidities in the system. We understand the stylized arguments presented by the staff to support this view, which underline the difficulties in evaluating the conditions under which current account imbalances could be considered benign. There are considerable uncertainties in evaluating whether balance of payments imbalances reflect private or public sector behavior; whether the private sector is assessing risk-adjusted returns appropriately; whether or not rigidities and distortions in the system are significant; and whether some policies implemented by the authorities can be considered distortions in themselves.

Perhaps the staff could comment on these uncertainties and difficulties and on how they affect the process of determining the benignancy or malignancy of current account imbalances.

I strongly endorse the staff's views that it is necessary to know the origin of a current account imbalance before assessing its desirability; that the financial ability of external imbalances may allow a country to delay a needed adjustment by prolonging its nonoptimal behavior; and that delayed adjustment inflicts unfair costs on other countries which in turn need to overadjust to absorb abrupt external shocks. Having said all this, I tend to believe that the concept of a benign current account imbalance is rather questionable.

Let me turn now to the discussion of saving issues related to developing countries. The effects of an increase in international interest rates on the debt crisis, on the generation of public savings, and, more generally, on saving, investment, and growth have not been sufficiently stressed in the staff papers. Specifically, not much emphasis is given to the magnitude of the external transfer of resources; to the impact of interest payments on fiscal expenditures, and hence, on the deficit of indebted countries; and to the additional fiscal efforts required to compensate for the increase in interest payments. This in turn has weakened the policy recommendations offered by the paper; in particular, there is not enough emphasis on the need for debt and debt-service reductions. Such reductions are essential to reduce the heavy burden of external debt on developing countries and to promote an orderly process of saving, investment, and growth in these countries. I will not elaborate on our position on this point at this time, as we have presented it during the debt strategy discussions. The Research Department, by means of several papers, has also elaborated on the need for and advantages of debt reduction operations to reduce the debt burden and the debt overhang. We hope that this issue will be further analyzed in greater detail as part of future research on the role of savings in developing countries. In some cases, untimely reforms to liberalize financial markets--for example, those adopted alongside strong fiscal imbalances--have been traced to the collapse of unstable financial markets.

Implementation of fiscal adjustment policies geared to eliminate high inflation rates has had rather ambiguous effects on total domestic savings. In our view, where fiscal adjustment is the key to reducing inflation, the role of the inflation tax has had an impact upon these ambiguous developments.

The implementation of some stabilization programs has been based on strong fiscal adjustment, particularly on the revenue side. In implementing these programs, inflation taxes have actually been substituted for explicit taxes, at least during the first stage of program implementation. This substitution, while permitting an increase in the level of public savings, has also led to a decline in overall private savings. In our view, this decline can be attributed to distributive effects within the private sector. This situation could have occurred because most of the burden of the inflation tax was on people with high marginal propensities to consume, while explicit new taxes included in the adjustment programs fell mostly on people with relatively lower marginal propensities to consume. Important lessons can be extracted from these experiences, especially in the area of policy design and implementation. We would appreciate some comments from the staff and would also encourage more in-depth analysis of this issue in future work.

Mr. Ghasimi made the following statement:

The staff is to be commended for producing a set of highly informative, comprehensive, and timely reports on the causes and consequences of the recent dismal performance of national saving rates. I recommend publication of these documents in order to benefit a wider audience. The papers have rightly emphasized that since the early 1970s, national saving rates have displayed a general downward trend, and while private and public saving rates have both declined in recent years, the fall in government saving has been much steeper and by far the more dominant of the two. It is also evident that over the same period, national investment rates have been characterized by a similar downward trend, albeit at a slower pace. In such circumstances, the inadequacy of domestic savings to underwrite domestic investment has naturally implied growing reliance on foreign savings, and hence the emergence of substantial current account imbalances.

We agree with the most important recommendation of the paper, which is the adoption of tighter fiscal policy measures mainly through reduced public expenditures. Other recommendations made by the staff--in particular, removing tax disincentives, correcting price distortions, liberalizing financial markets, and rationalizing exchange rate regimes--are also cardinal in reversing prevailing trends in national saving rate. On the whole, we find ourselves in full agreement with the analysis in the papers before us, and wish to make only a few brief comments.

Although many issues related to the measurement of saving in industrial countries are discussed in Appendix I to the main paper, greater emphasis placed on the correct measurement of saving and investment would have been very appropriate. The work of Robert Eisner and his associates on the U.S. budget deficit could be very useful in this respect. Although it may be true that spending on education has declined in some industrial countries, Eisner, in his presidential address in American Economic Association, 1989, has shown that by regarding public expenditures on education, health, and other social services as investment, saving rates for government are sharply boosted. No doubt, his point is equally relevant for private expenditures.

At any rate, while I accept the declining trends in saving rates, the emphasis placed on the role of such contributing factors as credit availability, wealth revaluation, and age structure need more elaboration. On the one hand, as Barry Bosworth has observed in Challenge, August 1989, marginal propensities to borrow and wealth income ratios have been normal by historical standards, and on the other hand, saving rates have been notoriously insensitive to changes in age structure. The basic fact remains that the drop in saving rates still constitutes a puzzle that is hard to resolve. Perhaps the solution might be in fundamental changes in attitudes toward thrift and fiscal responsibility, or maybe in changes in the income and wealth distribution in society. If so, there is a good chance that such tendencies may eventually and automatically be reversed.

For developing countries, however, one additional factor may have been at work--the disinflationary policies pursued by industrial countries in recent years and the adverse effects they have had on the global economy in general, and on developing countries in particular.

Apart from naming a few incentives for private savers, the staff paper wisely sidesteps the issue of private saving and focuses on a recommendation to raise public saving or, at least, to reduce public dissaving. Specifically, the paper makes a two-stage proposal based on reducing public expenditures on the one hand, and adopting revenue-neutral tax overhauls aimed at creating incentives for savers and investors, on the other.

This brings me to my final comments. First, we agree that the most effective way to enhance national saving is to reduce public deficits through increases in taxes and a reduction in public spending. However, the impact of an increase in taxes on private saving has generated considerable controversy. The impact of an increase in future tax liabilities on present disposable income, consumption, and saving depends very much on the discount rates applicable to future tax liabilities. Many economists believe that these discount rates are sufficiently large to render the final impact on private saving negligible. In fact, recent studies have shown that the proposition that a reduction in government deficit has no impact on national saving--namely, the Ricardian effect--is only partially supported by empirical studies conducted on ten industrial countries.

Second, the choice between expenditure reduction and tax augmentation is also a political one and could be persuasively argued either way.

Third, the contractionary effects on the world economy of tighter fiscal policies, especially in large industrial countries, should be more carefully assessed. Perhaps the burden of budgetary adjustment needs to be shared with major surplus countries.

Finally, in an age of takeovers and leveraged buyouts (in developed countries) and investments and showcase projects (in developing countries), the staff paper could have made a somewhat stronger plea for the more efficient use of savings, in addition to lamenting their inadequacy.

Mr. Posthumus made the following statement:

One of the interesting conclusions of the paper on the role of national saving in the world economy is that saving is an important and additional indicator of developments in the world economy. Quite often in the history of economics, saving has been considered a necessary evil. Even today, general statements that deficit and surplus countries alike should take corrective measures, with the implication that surplus countries should consume more and thus save less, point in this direction. The paper provides a rehabilitation of saving as a necessary activity for investment and future growth.

I think that it is indeed a fair conclusion that current account imbalances are not necessarily a problem and that the origin of the imbalance in specific countries has to be analyzed before assessing whether it is undesirable. It is also interesting that there are no indications that saving in any of the major industrial countries is too high; the conclusion is presumably the same for most other countries. Thus, in most countries, raising savings is in itself an important goal to ensure more growth and sustainable growth.

Still, I support the conclusion that some or part of current account imbalances need not present a problem. But this conclusion cannot lead to benign neglect; it has to be qualified by adding that the imbalances must be considered sustainable. They are not sustainable if there is a risk that these imbalances would be misinterpreted and lead governments or international investors to make choices that would destabilize otherwise stable markets where the underlying competitive relations are not the problem. Governments might decide to increase the level of protection, or the opposite: they might decide to abruptly change macropolicies to prevent an increase of protection.

Investors may lose their confidence in the ability of heavily indebted countries to service their debts, even if there is a favorable rate of return on their investments. Investors might exert upward pressure on the exchange rate in countries that have a deficit on the current account. Such perverse exchange rate movements have occurred, while in countries with stable exchange rate regimes the result of investors' lack of confidence has been problems for monetary policy.

Some of the tensions in the European Monetary System can be attributed to such perverse exchange rate pressures. A realignment of exchange rates in such a situation may create the expectation of further realignments. It would be a step backward in a process of convergence, while what in fact is needed is an adjustment in other policies, in particular fiscal policies. These examples seem to indicate that large and persistent current account imbalances--and it must be added even in situations that seem sustainable from the economic point of view--should indeed be prevented. Government dissaving in deficit countries therefore has to be corrected, certainly in view of low saving in the world as a whole.

It is in our view important to analyze the consequences of increased international mobility of capital, as I have indicated before. It appears that the analysis of the role of national saving in the world economy is very helpful in identifying problems and the solutions that might be sought. I found this staff paper quite important, and I consider the fact that the Board discussion was postponed not a good measure of the importance of the paper. Actually, the Board should use the analysis of the paper as an additional tool in implementing the Fund's surveillance role. I support Mr. Ghasimi's proposal to publish the papers.

Mr. Newman made the following statement:

I will focus my remarks today on the role of national savings in developed countries with particular emphasis on developments in the United States. This should not be construed as a lack of interest with regard to savings in developing countries, but rather as a way to avoid repeating much of the discussion that has occurred today as well as in the staff paper. It also reflects my impression that many speakers around this table view developments in the United States as particularly critical. I would therefore like to focus on what we are trying to do about national savings.

Before proceeding, however, I would respond to Mrs. Filardo's question to my chair regarding defense expenditures. Defense expenditures are clearly an integral part of the overall budget and budget deficit, and efforts to reduce the budget deficit focus equally on defense expenditures as on other government spending. Indeed, the current sequester arrangements require absolute cuts on both sides, and therefore larger percentage cuts on defense than on domestic expenditures. I should also point out that these sequesters affect foreign assistance as well.

The decline in the U.S. saving rate, especially since the mid-1970s, has become a matter of increasing national concern because of the potential implications for growth and the emergence of a significant domestic savings/investment imbalance reflected in the large current account deficit. A comprehensive review is now under way of possible measures to improve national savings, and a report is shortly to be presented to the President. The analysis in the staff paper for today's discussion is broadly consistent with our own studies, as well as with similar work recently undertaken by the OECD.

The decline in the U.S. saving rate reflects both a reduction in public saving with the emergence of the large federal budget deficit and a smaller deterioration in private savings. As a result, net national saving as a share of net national income has declined steadily and is now well below the average for the post-war period. While the saving rate has improved recently, it still remains relatively low both historically and in relation to other industrial countries. Despite the decline in national savings, however, domestic investment has held up owing to large capital inflows, which are the counterpart of the current account deficit.

The United States recognizes that the key to improved national savings is a significant reduction in the federal budget deficit. We have made progress on the deficit, reducing its size as a share of GNP from 6.3 percent in 1983 to 3.0 percent in fiscal year 1989. Achievement of the Gramm-Rudman-Hollings target this year will bring that percentage down to 1.8 percent. On a general government basis, the public sector deficit as a share of GNP would be about 1 percent, which is lower than in most industrial countries.

This decrease has been achieved primarily by reducing the rate of increase in federal spending while increasing revenues through economic growth. As you all know, it is never easy to cut spending in the face of competing and compelling national needs. However, the Administration remains committed to meeting the deficit reduction targets set in law.

I have been struck by the differing interpretations given to the staff's conclusion on page 28 on ways to improve government savings. I find myself agreeing with those emphasizing expenditure reduction over higher taxes. In particular, the experience in the United States has been that increased taxes are likely to raise public spending and, combined with reduced private savings, result in a much smaller improvement in national savings than would occur with spending cuts. Furthermore, given the close relationship between public activities and private consumption and savings, we continue to believe that a unified budget provides the most accurate measure of the impact of public spending and taxation on the private sector. In this connection, we would be interested in knowing from the staff whether other countries have "pay as you go" public pension systems and whether those pension systems are included in the overall government accounts.

The reasons for the decline in personal savings over the last 15 years are difficult to sort out. While demographic factors such as the maturing of the "baby boomers" would have suggested increased savings, there appears to have been a decline in the saving rate across generational lines. This may reflect attitudinal changes, particularly as memories of the Great Depression fade, or a shift in timing toward saving later in life. The prolonged economic expansion and the effects of increased wealth, particularly in housing, may also have played a part in reducing household savings. Recently, there has been some improvement in private saving rates. However, it is still too early to say what are the causes of this upturn and whether it represents a fundamental change in behavior. While some have suggested that the 1986 tax reform may be having an effect, some provisions in the law encouraged savings but others worked in the opposite direction.

The domestic debate on possible measures to improve private U.S. savings has been constrained by the need to avoid revenue losses that would increase the budget deficit. At present, the debate is focused on the Administration's proposals for a reduction in the capital gains tax as a means of promoting savings and investment. Consideration is also being given to reducing the double taxation of corporate dividends in order to eliminate the bias toward debt financing, although the revenue costs of such action may make it impractical at this time. With regard to personal savings, there have been several proposals for expanding individual retirement accounts (IRAs), in particular, measures that would not involve substantial revenue losses up front. These include permitting withdrawals at retirement to be tax free but not allowing tax deductions for contributions, and easing the constraints on the use of IRA funds. Proposals for a consumption tax and eliminating the tax deduction for mortgage interest, while potentially important as a means of encouraging savings, pose serious equity and political problems, which make them impractical options at this point in time.

The breakdown of the correlation between domestic saving and investment and the corresponding emergence of large external imbalances in the 1980s have major implications for the world economy. There is, however, no unique relationship between the specific components of national savings and investment and the external position. Moreover, the relationship between public policies and private savings and investment decisions is so close that it is neither possible nor desirable to separate their impact on the external position. Whether an external imbalance is benign or undesirable rests largely on its sustainability and whether adjustment can be achieved in an orderly manner.

The staff's continued focus on the decline in government saving as the cause of external imbalances and the need for measures to reduce budget deficits as the sole cure is myopic. Clearly, deficit countries, especially the United States, need to improve national savings both in the short run and over the long haul. However, exclusive reliance on such an approach ignores the fact that global imbalances also reflect a fall in investment in surplus countries that exceeded their decline in national savings. A prescription that focuses excessively on increasing public savings in deficit countries will have important implications for global growth, unless fully offset by changes in interest rates. However, the effects of changes in interest rates on output may be much smaller than the income effects of government spending and taxes. In these circumstances, a more prudent course for the global economy would be a balanced approach whereby surplus countries also contribute to adjustment by improving domestic investment.

Mr. Ismael made the following statement:

On the adequacy of national saving in industrial countries, I share the view that the saving rate has not reached an optimal level, as the returns on private savings have not fully captured the social returns of investment. Besides the argument that there is economic merit in raising the saving rate, there is also the important global consideration that an increased saving rate for the industrial countries would enable these countries' savings to once again become the source of foreign savings for the development of the developing countries, in particular the very poor ones. In this connection, I am pleased to note the favorable medium-term prospects of a strengthening in government saving of the industrial countries.

On the promotion of household savings, I agree that significant scope remains for measures to further induce an increase of such savings, particularly in the areas of granting tax incentives for private savings and reducing or eliminating tax encouragement for consumer borrowings.

Enhanced capital mobility has been efficiently redistributing savings among industrial countries, so much so that the financing of the persistent imbalance in the current accounts of these countries has not become a major problem. However, I share the view that international capital movement has served to delay needed adjustments in certain countries to raise government savings and to remove distortions in the tax system for the growth of private savings. At the same time, I agree with the staff that it is necessary to investigate the origins of the imbalance in the current account before reaching any conclusions, and that the account itself is not an intrinsic policy objective.

I note the progress achieved so far on the international coordination of tax policies, and would like to encourage the industrial countries to maintain the momentum toward harmonization in this area.

The staff has also rightly pointed out the importance of the demographic factor in the long-term evolution of the saving rate. I urge the staff to highlight the potential problems in this area during Article IV consultations with the relevant countries, so that corrective measures could be undertaken at an early stage of the problem.

I am of the view that a better understanding of the topic of national saving by developing countries could be achieved through an examination of empirical evidence rather than by trying to draw general conclusions from the diverse groups of developing countries. As a matter of fact, the lack of data or the poor quality of available data would have negated the usefulness of the result of sophisticated econometric analysis applied to such data. Furthermore, the macroeconomic framework that was developed with the experience of the industrial countries is hardly suitable for the economic and financial analysis of the very poor developing countries.

The staff has pointed out the vast difference in the saving rate pictures in low and high inflation countries, in countries with and without debt-servicing problem, and in low and relatively higher per capita income countries. While this lack of homogeneity has prevented the drawing of a general conclusion, it has nevertheless highlighted the necessary priorities for policy actions. In the very poor developing countries, the immediate issue is not to try fruitlessly to raise national saving, but rather how to increase both the absorptive capacity for investment and the injection of foreign saving in order to lead these countries to the take-off stage. For the heavily indebted middle-income countries, the immediate issue is how to reduce the debt overhang. Similarly, for the high inflation countries, the priority would be to bring the inflation rate down whereby the saving rate would then rise in its wake. In this context, I fully share Mr. Jalan's view that a certain degree of economic stability should be pursued first, to be followed by structural adjustment measures, leading to positive interest rates in order to ultimately achieve increased savings.

I see the benefit of summarizing the experience of lessons of those developing countries that have been successful in raising their national saving. Observations and conclusions derived from such studies would be more relevant for other developing countries.

Mr. Legg made the following statement:

The large amount of work done by the staff over the last year or so on the subject of saving is clearly justified in view of the importance of improving savings performance--not only for individual countries, but also in view of the systemic and longer-term ramifications of recent trends. I concur here with many of the comments of previous speakers.

It is difficult, however, to avoid the overriding impression that, at best, the current state of economic theory is ambiguous on the question of what factors affect savings, while the available empirical evidence is inconclusive. The papers offer little guidance or comfort, therefore, for policymakers. Nevertheless, the widespread and significant deterioration since the early 1970s in net and gross savings should, at least in part, give rise to some practical policy implications.

In general, the conclusion has been--rightly, I believe--that public savings should be increased, offering an unambiguous means of enhancing total national savings. The Australian experience is, I believe, relevant here, and I will return to this in a moment. Certainly, I am not persuaded by the suggestion of former U.K. Chancellor Lawson that there is no role for the public sector to seek to compensate for private sector savings/investment imbalances.

Nevertheless, there are clearly limits to this approach. Experience suggests that the public sector is unlikely, in practice, to have any better insight into the correct rate of social time preference, while merely aiming for a recurrent surplus, year in year out, is likely to become increasingly untenable politically. Also, there is a limit to the extent that recurrent expenditure can be progressively contained without undermining other important social and economic policy objectives. Over the longer term, an approach based solely on bolstering public sector savings would have significant implications for the structure of ownership and the pattern of economic activity within an economy, not to mention for the operation of monetary policy.

Given the pre-eminence of the U.S. situation in much of the literature, and its relevance to the rest of the world, I will have some comments to offer on the current domestic U.S. policy debate later. I will refrain from commenting on the domestic policy issues facing developing countries, as I have little to add to the comments of earlier speakers, in particular, Mr. Goos and Mr. Mawakani.

I thought it might be useful to focus, however, on the Australian experience, where I have marginally more expertise, and because talking about a specific example helps to keep the discussion on a more concrete basis. Table 1 of the main staff paper highlights Australia as the worst performer among industrial countries in terms of net savings during 1980-87. The rankings are considerably different if one looks at gross savings, although I do not want to dwell on the technical issues relating to treatment of depreciation in this forum. However, the average figures presented in the paper mask important developments--and improvements--in recent years. In particular, total gross national savings, after declining from a peak of over 26 percent of GDP in the mid-1970s to about 17 percent in 1982/83, have since recovered to about 23 percent in 1988/89.

The single most dominant influence has clearly been swings in the level of public sector savings, with the significant improvement in the fiscal position since the early 1980s being almost solely responsible for the recovery in national savings noted above. But there appears, nevertheless, to have been an underlying long-term declining trend in private savings. The factors underpinning the lower rates of private saving compared with those of the 1960s and 1970s are far harder to disentangle.

First, a major factor could be, quite simply, the reluctance of households to adjust consumption in line with the fall in income experienced in the last few years--an example of the overriding optimism of Australians in general. Second, demographic influences have tended to offset one another--a declining youth dependency rate has been masked by an increase in the proportion of the population over 65--although longer-term demographic trends in prospect pose a significant challenge for policymakers. Third, it has not been possible to identify much of a connection over the longer term between movements in savings and after-tax rates of return, which of course include far more than merely financial market interest rates, while financial deregulation and increased access to consumer credit are relatively recent phenomena. However, I agree with Mr. Fogelholm that one would expect the relationship between savings and rates of return to improve as a result of financial deregulation. Fourth, inflation would appear to have had a major influence, but only on savings as measured by the national accounts. The impact of higher nominal interest income clearly increased measured savings during the peak inflation years of the mid-1970s, largely because offsetting capital losses are not captured in the national accounts estimates. But if nominal household savings are adjusted for the measurement impact of inflation, the underlying saving rate is far less responsive to inflation, and far less volatile over the last 30 years. This suggests that we may need to look to other longer-term factors, such as the impact on savings behavior of greater public sector involvement in social welfare activities, and associated changes in income distribution and spending patterns to explain the longer-term downward trend. I emphasize longer-term because I agree fully with Mr. Goos that tight monetary policy, low inflation, and high real interest rates are very important in dealing with short- and medium-term savings/investment imbalances.

A notable feature of Australia's recent savings performance has been the increase in corporate savings associated with increased profitability, and the much larger increase in business investment. Among other things, this--and the resulting widening of the current account deficit--serves to underscore the essential openness of the Australian economy, and the fact that Australia is likely to remain partially dependent on external savings for the foreseeable future, irrespective of improvements in domestic savings. Recognition of this fact has informed much of the Australian approach to tackling the savings issue. This openness implies, for example, that there is limited scope to take policy actions, for example in the tax area, that are significantly out of line with practice in other countries; certainly, it curtails the ability to adjust the post-tax rate of return on investment. Efforts to do so can, of course, increase the investment flows between countries or, indeed, between particular activities within countries (it is changes in the flow that equalize post-tax rates of return), but the implication is that one is introducing allocative inefficiencies, without any necessary impact on the level of domestic savings.

For these reasons, our focus has been on reducing domestic distortions, rather than seeking to add new ones. Of course, many of the policy measures adopted have had a broader structural focus than lifting domestic savings performance. In particular, they relate to the broader issue--arguably more pressing for a small open economy--of ensuring that scarce savings, whether domestic or external, are efficiently utilized. Increased investment is clearly not in itself a cause for concern, even if it means a temporary widening in the current account deficit. It is essential, however, to be confident that this investment is being productively utilized, and it seems from our experience that many of the efforts aimed at enhancing savings really impinge on investment. This is perhaps an aspect of the problem that could be given more explicit emphasis in the staff's future work.

As already emphasized, Australia has achieved a significant improvement in the level of public savings, with, moreover, little or no apparent offsetting movement in private savings. However, recent indications that the emergence of the public sector as a net lender may have been matched, very recently, by the household sector becoming a net borrower provide a moment for pause; of course, many factors may be at work here.

We have also focused on reducing the overall size of the public sector and on measures aimed at substantially improving public sector enterprise efficiency. Financial market deregulation has substantially improved the efficiency of the intermediation process. As noted by the staff, any negative implications of deregulation for private savings performance is likely to have resulted from continuing distortions elsewhere in the economy, rather than from financial deregulation per se.

Significant and far-reaching reform of the tax system has also been achieved, in the interests of "leveling the playing field"--including with regard to alternative forms of saving, while broadening the tax base and reducing marginal tax rates. This has involved the introduction of a capital gains tax and a fringe benefits tax. Inter alia, the latter should discourage employers from offering remuneration in the form of consumption of goods and services. Elimination of double taxation of dividends has removed a major bias in favor of debt financing.

Finally, in view of the longer-term demographic challenges facing Australia, we have also undertaken a number of significant reforms designed to strengthen attitudes favoring personal saving for retirement, while reinforcing the trend away from reliance on the publicly provided old-age pension. Rather than provide a short-term fillip to domestic savings, however, our aim has been to establish a workable system of privately sourced retirement income that will serve Australia well for generations to come.

There are four specific areas of tax policy that I would like to highlight. First, on the question of a broad-based consumption tax, I was particularly interested to note the refreshing equivocation in the staff paper on the issue of whether a switch from taxing income to taxing expenditure would achieve a net increase in private savings, particularly as it has become something of an article of faith in some circles in Australia that a consumption tax would have an unambiguously positive impact on savings--a view also put forward by staff in the recent Article IV consultation discussions.

Second, there is a large body of academic opinion that favors taxing income, especially interest income, in real rather than nominal terms, a view that has recently been given some currency in Australia. But we have chosen not to go down this path for two basic reasons: first, because it is seriously doubtful whether the significant technical difficulties involved in fully indexing the tax system can be satisfactorily overcome, while any partial indexation would merely once again distort the allocation of savings; and second, and perhaps most important, because, as I noted earlier, small open economies cannot afford to pursue tax policies that run significantly counter to practice elsewhere. This only serves to underline the importance of our forthcoming discussion on the international coordination of tax policies.

Third, on the issue of the politically sensitive area of tax treatment of owner-occupied homes, as the staff notes, almost all countries offer some form of preferential treatment in this area. Australia, for example, does not tax implicit rental income. Neither, however, does it offer a deduction for mortgage interest costs. This would seem to be a preferable approach to, say, offering a tax deduction on the liability side without any offsetting tax treatment of the flow of services produced by the asset.

Fourth, there is the question of whether one should provide preferential treatment for corporate retained earnings on the basis that the corporate sector has a greater propensity to save. I emphasize that it is the relative incentive for retaining, rather than distributing, corporate savings that matters, and not the overall corporate tax rate. There is, I think, room for further work by the staff on this issue, but we have tended to doubt the worth of offering this sort of incentive. Inter alia, it tends to encourage firms to lock up savings and therefore reinforces rigidities in corporate ownership and management--which, I suspect, makes these firms more likely targets for leveraged buyouts.

If I might offer one last observation on the general question of tax reform and its relationship to encouraging savings, we need to be wary of academic literature that somehow assumes policymakers are starting with a clean slate. Tax reform always starts with an existing, albeit imperfect, system in place and the virtue of moving from that to a "first best" model always needs to be weighed against the administrative and transition costs involved.

Before closing, let me offer some brief comments on the current U.S. debate. First, there is no doubt that in the United States, the limits of action to improve public sector saving have not yet been tested. However, the staff's argument, during the recent Article IV discussion, that the U.S. authorities should aim for annual surpluses of about 3 percent of GDP to offset the distortionary impact of taxation and social security on savings seems to dismiss too easily the prospects for directly tackling these distortions. I doubt that surpluses of this order will be any easier to achieve, politically, than correction of the distortions. Moreover, such distortions do more than just reduce savings, they also distort the pattern of investment. In this regard, I can only concur with the staff that cutting fiscal expenditures offers the dual benefit of removing distortions and reducing the deficit. There is a February 1989 Working Paper on this subject that is particularly illuminating. (See WP/89/14, 2/7/89)

I fear, therefore, that the continuing emphasis on expanding savings incentives in much of the recent debate is unfortunate. The proposal from some sources--although, I note, not necessarily from the Administration--for extension of existing tax exemptions for IRAs is a case in point. Reliance on any spin-off effects for a savings mentality is, I fancy, little more than an article of faith and I seriously doubt that the likely gain in savings will offset the likely revenue loss. I am therefore encouraged by Mr. Newman's comments, although I am not certain whether the distinction between taking revenue losses now or at some point in the future is a very meaningful one. I harbor similar doubts with regard to proposed changes for the capital gains tax.

Finally, I would like to endorse Mr. Ghasimi's suggestion that some thought be given to publication of these papers.

The Executive Directors agreed to continue their discussion on the role of national saving in the world economy in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/89/139 (10/30/89) and EBM/89/140 (11/6/89).

3. DEBT REDUCTION AND ECONOMIC ACTIVITY - PUBLICATION

The Executive Board approves the proposal to publish, in the Occasional Paper series, an edited version of the staff paper on analytical issues in debt (EBS/89/129), as set forth in EBD/89/324 (10/17/89).

Adopted October 31, 1989

4. PENSION COMMITTEE - NOMINATION

The Executive Board approves the election of the Executive Director nominated to serve as a member of the Pension Committee for the term ending October 31, 1990, as set forth in EBAP/89/252, Supplement 1 (11/1/89).

Adopted November 2, 1989

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 89/45 and 89/46 are approved. (EBD/89/339, 10/26/89)

Adopted November 1, 1989

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/89/206, Supplement 1 (10/30/89), EBAP/89/246, Supplement 1 (11/1/89), and EBAP/89/254 (10/31/89) and by an Assistant to Executive Director as set forth in EBAP/89/253 (10/31/89) is approved.

APPROVED: June 29, 1990

JOSEPH W. LANG, JR.
Acting Secretary