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Minutes of Executive Board Meeting 89/141

3:00 p.m., November 6, 1989

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

Executive Directors	Alternate Executive Directors
F. Cassell	
	G. C. Noonan
	Shao Z., Temporary
	B. S. Newman, Temporary
	J. Prader
E. T. El Kogali	
	M. J. Shaffrey, Temporary
E. V. Feldman	
	M. A. Fernández Ordóñez
	C. Schioppa, Temporary
	A. M. Othman
M. Fogelholm	
M. R. Ghasimi	
	B. Goos
J. E. Ismael	
B. Jalan	
A. Kafka	
	J.-F. Cirelli
	C. V. Santos
	M. Al-Jasser
G. A. Posthumus	
	N. Adachi, Temporary

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

Also Present

African Department: R. O. Carstens. Asian Department: D. A. Citrin, J. Saito. European Department: T. A. Bayoumi, R. Cippa. Exchange and Trade Relations Department: K. M. Meesook. External Relations Department: G. Bhatt. Fiscal Affairs Department: V. Tanzi, Director. Research Department: J. A. Frenkel, Economic Counsellor and Director; M. Goldstein, Deputy Director; A. A. Aghevli, J. M. Boughton, Y. Harada, M. Khan, P. R. Masson, D. J. Mathieson, P. J. Montiel, D. Villanueva, P. Wickham, M. A. Wattleworth, I. Zaidi. Bureau of Statistics: V. Galbis. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: M. Eran, A. Gronn, J. M. Jones, B. A. Sarr, R. Wenzel. Assistants to Executive Directors: H. E. Codrington, E. C. Demaestri, S. Gurumurthi, J. Heywood, L. I. Jácome, C. Y. Legg, R. Marino, N. Morshed.

1. NATIONAL SAVING - ROLE IN WORLD ECONOMY - RECENT TRENDS AND PROSPECTS

The Executive Directors resumed from the previous meeting their consideration of 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. Adachi made the following statement:

I would like to join other Directors in welcoming this opportunity to discuss the role of national saving in the world economy, as it comes at a time when the Fund's surveillance activities have increasingly focused upon the role of saving.

I will organize my intervention along the lines of the staff paper, taking up first the issue of the adequacy of savings, which should be assessed both on the demand side and the supply side of an economy. Customary Keynesian theory, which focuses on the demand side, inherently stresses the importance of consumption, not saving. Thus, it is not surprising that until a decade ago, people were concerned about excess savings rather than inadequate savings. Today, we are expected to focus on the role of national saving on the supply side of the economy, but we should not ignore the effect of saving on the demand side of the economy. We may recommend that a country of full capacity save, but it would not be wise to recommend that a country at full capacity dissave.

Turning to the implication of saving for the supply side of the economy, it would be difficult to assess what level of savings is adequate. Even under growth models with exogenous technological changes, it is possible that the saving rate is less than optimal; however, it would be impractical to evaluate how low the savings rate is, since we cannot assess important factors such as time preference. I also wonder whether the golden rule, or the modified golden rule, could be achieved in the case of dynamic inconsistency, where the time preference changes without additional information. Market imperfections also might hinder the achievement of a steady state where the golden rule prevails or could be attained.

In a similar vein, in the growth model with endogenous technical progress, it would not be easy to quantify the externalities of the investment process. Therefore, we should be cautious about judging the adequacy of savings and should rely on judgmental analysis.

In that we deal with the intertemporal maximization problem of utility function, which depends only on consumption, what we are interested in is not savings but investment, which increases output capacity. The savings are important in the sense that they affect investment.

This brings me to the issue of the international distribution of savings and investment, on which Section IV of the background paper was quite helpful. However, I am rather dubious about the policy function type of approach. The decision-making process in government policy is a complex one. While it is certain that we can develop ex-post policy functions, I wonder how much we can simplify the decision-making process into a model.

In passing judgment on the implications of a current account imbalance in the medium term, we should take into consideration various factors in addition to savings/investment imbalances--for example, whether the country in question is a surplus country or a deficit country, a net debtor or creditor, a key currency country or not. The United Kingdom once ran a balance of payments surplus for an extended period, and the United States also ran a surplus for many years. I wonder to what extent we can attribute these phenomena to savings and investment imbalances. As the staff emphasizes, judgmental analysis would be essential in analyzing the current account imbalance. Thus, it should be underscored that policy option recommendations ought to be based upon a full understanding of the limitation of analytical techniques.

When we come to the stage of implementing policies, prudence is essential, since policy measures might incur additional structural rigidities in the economy. The saving rate is not an appropriate target, because it is difficult to quantify the adequacy of savings. In this connection, the statistical issue presented in Appendix I of the staff paper should be noted. The structural background of an economy, which varies significantly from one country to another, is also important. Some of the differences in saving rates among countries might be attributable to differences in their structural and historical background. Furthermore, any measures aimed at increasing savings should eventually lead to increased investment, since our primary objective is not the increased savings themselves but the rise in investment. Therefore, we should focus on the transformation process from saving to investment as well, including in particular the role of financial intermediaries.

The role of national saving in the world economy is important and should be studied further. However, much remains for further research. In the meantime, we must rely on prudent judgmental analysis in considering this subject.

On the role of saving in developing countries, I share Mr. Goos's views on the dichotomy between developing and industrial countries. In developing countries, which do not have access to the market, national saving should play an important role in increasing investment. Moreover, it is essential for developing countries to establish credibility in order to mobilize external resources. To this end, the implementation of policy measures aimed at domestic saving is instrumental to establish such credibility.

Turning to program design, the program should always be tailored to the needs of the member concerned. Therefore, if in the country concerned a higher real interest rate increases national savings--a theoretically possible situation, I do not see any reason for hesitating to increase the real interest rate. In any case, growth theory tells us that real interest rates must be positive in the long run, although several assumptions have to hold in this case.

Finally, let me respond to Mr. Newman's inquiry about budgetary systems of member countries. The Board may recall that this chair has stressed the need to pay due attention to the differences in members' budgetary systems. We firmly believe that in Japan's budgetary setting, the appropriate indicator of the budgetary balance is not the general government balance.

Mr. Shao made the following statement:

I welcome today's discussion on the role of national saving in the world economy. Over time, national saving has been recognized more and more as an important factor in sustaining domestic growth and, therefore, as a way to ensure sustained growth in the world economy. This was also emphasized in the last Interim Committee report in the context of "the vital importance of saving behavior for macroeconomic stability, economic growth, and external balances." Since we all face an increasingly integrated global economy, the role of national saving has become the object of international attention.

The world economy has been expanding for the last seven years and it is still growing. Adequate resources must be ensured in order to sustain longer-term growth. However, declining savings rates present a worrying sign for future growth. According to the staff, over the last two decades the trend has been a decline in national saving throughout the world as a whole. The reasons are very complicated and result mainly from socioeconomic factors. Since the staff has explored the situation fairly thoroughly, I will make just two brief observations concerning the potential danger in government dissaving and the role of national saving in external imbalances. However, I would like to ask the staff whether there is any evidence that the decline in national saving has already to some extent made a negative contribution to recent world economic expansion.

I agree with the staff's findings that the decline in national saving is reflected mainly in government dissaving, which is a common phenomenon in industrial and developing countries alike. Excessive government dissaving would push up interest rates, which would discourage investment on the one hand, and directly crowd out private investment on the other, thus affecting long-run developments. Although excessive dissaving would have a direct impact on those countries that have difficulties with external financing, it would also create problems for others because, eventually, no country would be able to obtain finance freely in world markets. Such countries would soon find themselves in a position of the market not having confidence in their ability to repay and they would then run into problems of solvency. By then, adjustments would be costly and abrupt. Therefore, budget policies should be treated head-on in order to correct the present decline in national saving.

Promotion of national saving would not only secure sustained growth with an expansion of utility capacity through investment, but it would also help to reduce the external imbalance among the major industrial countries. As analyzed by the staff, some countries find it easy to finance via international financial markets and they are therefore able to delay their domestic adjustment. Easy access should be considered as a temporary, and not always reliable, solution. We have already discussed extensively the urgency of correcting external imbalances among industrial countries through those countries' macroeconomic adjustment policies, and the encouragement of national saving is yet another way to help correct those imbalances.

I share the view that we need to encourage national saving in order to promote and secure greater investment and, thereby, attain sustained world growth. I would like to join those Directors who suggested publication of these important studies.

Mr. Othman made the following statement:

While some of the details included in the main paper might perhaps have been more appropriately organized as background information, the papers together present an analysis of a number of complex interrelated issues in a clear and precise manner, and have successfully identified some important questions for the Board to reflect upon. However, the importance of such research needs to be evaluated on the extent to which its results contribute to the improvement of program design and the quality of advice rendered. It is also important that such advice be based on empirical rather than theoretical studies.

Savings performance must, to be understood in its proper context, be analyzed as part of a broader macroeconomic framework together with investment and growth. Section II of the background paper is particularly useful, as it underlines the considerable uncertainty about the causalities of the statistical relationships between savings rates and growth. Recent research on endogenous growth models seems to provide some analytical justification for certain types of government expenditure and subsidies, such as those relating to education and research and development. It therefore becomes increasingly important to look at not only the level of savings, but also its distribution, a point that has already been made by other speakers this morning.

Furthermore, while it is possible to make generalizations on savings performance across countries, factors influencing savings behavior and economic growth differ markedly among countries. Perhaps a further classification of developing countries according to the stage of development and level of debt outstanding would have been analytically useful in discussing the policy options facing governments, particularly because the determinants of growth vary among countries at different per capita income levels.

It is difficult to challenge the contention that there is a need for increased world savings. In addition to available evidence that savings rates for major industrial countries are not too high, possible arguments that they are too low have been advanced by the staff. The endogenous growth models that I have alread referred to could also lead one to a similar conclusion.

The persistence of trade imbalances among major industrial countries, together with the collapse of private sector lending to many developing countries, indicates that there is a problem in the present global distribution of savings and investment. Developing countries are at a stage of development where one would expect the transfer of resources to be in the reverse direction to that which is taking place. The root causes of an improper distribution may, however, be varied. For industrial countries, increased economic policy coordination, harmonization of tax systems, and removal of policy induced distortions could serve to improve the distribution of saving. For developing countries, it is necessary to focus on the causes and consequences of capital flight and of the debt crisis, together with the many structural problems that may exist.

While each country has to strive to arrive at an appropriate balance of policy measures designed to promote savings that are suitable to its own circumstances, it is possible to draw some general inferences. The importance of raising government savings through the budgetary process should be emphasized, as should the need to remove fiscal incentives which encourage borrowing. Credibility and perceived stability of economic policies are also generally recognized as being necessary to encourage savings accumulation. Coordination of incentives that emanate from policies pursued by major industrial countries is another area on which industrial country governments could focus.

On the other hand, interest rates have been shown to have relatively little bearing on savings decisions. For industrial countries, the staff paper concludes that the weight of empirical evidence supports the view that correlation of interest rates with savings is small. For developing countries, the paper acknowledges that theoretical predictions on the impact of interest rates are ambiguous, and the evidence, which is mixed, points to a small positive effect on private saving. I would underline the importance of advice on interest rate policy rendered by the Fund being based upon empirical research rather than theoretical arguments. Indeed, it should be recognized that, particularly in societies where high interest rates are perceived by a large segment of the population to be socially unacceptable, the efficacy of such an instrument could be called into question.

The specific example of the theory of second best provided in the paper--that the gains from financial liberalization can be largely dissipated through tax distortions, which results in excessive borrowing and inefficient investment--is thought-provoking. In practice, particularly in developing countries where market distortions, poor information flows, and a weak institutional framework may increase the possibility for the theory to be applicable, financial liberalization needs to be promoted with the utmost of caution. Financial liberalization is likely to be workable only in a stable macroeconomic environment, and the dangers of abrupt liberalization, which have already been elaborated upon, must be guarded against.

I would like to focus briefly on a number of factors that may be of particular relevance to developing countries. Income distribution in developing countries needs to be evaluated not only from the perspective of the marginal propensity to save, but also from the perspective of the marginal propensity of the more well-off segments of society to engage in capital flight and tax evasion, both of which may affect national savings. Furthermore, the adverse demonstration effect of a wealthy subclass of society on national savings (when such lifestyles are projected by powerful media influences) needs to be evaluated. Taxes on consumption of luxury goods may have important consequences for the promotion of savings in such an environment. The extent to which devaluations would promote savings in developing countries would vary with country circumstances. In some cases, expectations of devaluation may cause capital flight or deter investment, while in other cases devaluations may be a necessary response to an unsustainable balance of payments situation. Like other Directors, I found the discussion in the staff paper on this subject to be brief. I would also like to support Mr. Ghasimi's proposal to publish these papers.

Mr. El Kogali made the following statement:

The papers before the Board show that the issues are complex and that policy makers must seek as much empirical information as possible, especially where the link between instrument and target is theoretically ambiguous. I will make a few remarks on the distribution of saving among industrial countries and on the implications for macroeconomic policies before going into some detail about developing countries.

Apart from the fact that savings rates in most industrial countries have dropped sharply in the last decade, the available pool of saving has tended to be unevenly distributed, despite progress toward financial liberalization that has permitted the easy flow of savings across boundaries. One of the explanations given in the staff paper is that the widening budget deficits in a number of low-saving countries, in particular, the United States, have created excess demand for saving that has been attracted to these countries through higher interest rates. This is one of the reasons for the large and persistent current account imbalances between the United States, on the one hand, and Japan and Germany, on the other.

These imbalances suggest the need for a change in domestic policies in the low-saving countries, and a most effective place to start would be with efforts aimed at improving fiscal performance. I might note at this juncture that this chair has been among those who have called attention to the impact of high interest rates in major countries in contributing to the debt problem of developing countries. The staff paper shows that our concerns are indeed justified. The Fund, therefore, must continue to keep the issue of domestic policy reform in low-saving industrial countries on the front burner through its surveillance exercise.

Turning to some issues raised in the context of developing countries, evidence confirms the importance of the level of income as a determinant of the saving rate in developing countries, but it is ambiguous with respect to the role of interest rates. On the first observation, it may be pertinent to ask how far low-income countries that have faced slow or negative growth for a protracted period can succeed in raising the level of domestic saving to finance the increase in investment required to restore adequate levels of economic growth. Needless to say, these countries must intensify their efforts toward domestic resource mobilization--self-help must be the cornerstone of their development effort--and the public sector in particular must rationalize its spending priorities. However, it cannot be denied that the liquidity constraints on investment would be eased, thereby helping the growth process, if domestic saving efforts were supplemented in a substantial way by foreign capital inflows. In this connection, the suggestion on page 34 of SM/89/192--that developing countries in the present international economic environment would have to rely on national saving to finance domestic investment needed to revive growth--implies that poor countries are unlikely to see much difference in their growth prospects despite much talk about adjustment with growth.

A related subject is the urgency of solving the present debt crisis. First, countries with debt-servicing difficulties have experienced a sharp decline in saving rates. Second, the debt problem has severely curtailed the flow of foreign saving to such countries. This is another reason why many countries have not benefited fully from the easy flow of saving across boundaries. Donor countries and international institutions such as the Fund must help to redress the situation. In this regard, the catalytic role of the Fund must be emphasized in the sense that Fund-supported programs should provide enough financing to encourage donor countries to provide funds for members that have limited resource bases and are at low levels of development.

On the ambiguity of the correlation between savings rates and interest rates, the clear message is that generalizations must be used with caution. I am aware that some studies, such as Professor Fry's study on the Turkish experience between 1950 and 1977, have concluded that financial repression has a negative impact on saving and the efficiency of investment. However, I am also familiar with other studies that have placed less emphasis on the importance of interest rates, focusing more on other mechanisms to integrate capital markets in developing countries and thereby raise the saving rate.

Professor Bhatt, for instance, in stressing the creative adaptation of banking technology to suit local conditions, cites the role of the leading banks in India in expanding a network of branches with a view to mobilizing deposits as well as providing credit for agriculture and small enterprises. He also notes the role of the syndicate bank, which was able to reduce transaction costs while concentrating on the rural areas. In Jamaica, credit unions have been important; and the system known as "susu" (a group of persons agreeing to contribute a fixed sum of money at regular intervals, the total contribution being given in turn to each member of the group) has made positive contributions to saving in some countries in Africa. The establishment of cooperatives is also seen as a way to spread the banking habit and stimulate increased saving. All of these involve institutional reforms that deserve further research, perhaps in joint studies with the World Bank. As for Africa in particular, the experience has been that the capital cities are "overbanked," while the rural areas are severely "underbanked."

In a larger sense, increasing the saving rate in developing countries will require efforts to raise real incomes in the agricultural sector, given the importance of real income in the saving process. In Africa, for example, the bulk of the population works in agriculture at the subsistence level, and the crucial issue is to raise the level of investment in this sector. Evidently, remunerative prices for agricultural commodities, together with extension support in the areas of production and marketing, must be the focus of economic policy. There should also be credit schemes that are designed to meet the needs of the agricultural sector.

Table 6 of the staff paper provides some interesting information on the relative role of savings and investment in determining growth in low-income countries. The impact of the domestic saving rate is negligible, while investment in human capital and the growth rate of exports are the dominant factors, suggesting that low-income countries should emphasize policies that operate directly on investment, including attracting private foreign investment. Section III of the supplementary paper supports this view when it concludes that "...policies aimed at investment, rather than at saving, would appear to be more reliable avenues for attaining higher growth." One can infer from this observation--and in fact relate it to my earlier comment about the role of external resources--that given the liquidity constraint in low-income countries, increased inflows of external resources should be acknowledged to have a pivotal role in these countries in a short- to medium-term framework.

The indication that investment in human capital is an important mechanism to enhance growth in low-income countries serves to focus attention on this and other means of improving productivity in these economies. Some researchers have suggested that investment in human capital has played an important role in improving labor quality and thus in raising productivity in some of the more successful developing countries. It has been argued, for instance, that low capital coefficients in

Taiwan and Korea between 1965-70 were due in part to large increases in productivity during the same period, when output per worker rose 42 percent in Korea and 31 percent in Taiwan. Of course, one must be mindful of the brain drain problem that developing countries face. Each country would have to find solutions to this problem based on its own situation. The point to be made is that it is a problem that cannot and should not be ignored.

Lastly, I will comment briefly on the exchange rate question. Without getting into a debate on the relevance of exchange rate changes in the adjustment process, questions can be raised about the contribution that devaluations--especially if they are frequent and substantial--can make to increasing the level of saving and investment. The discussion on exchange rate policies on page 53 of the staff paper is highly theoretical. In this context, it should be noted that many countries in Africa have implemented massive devaluations in recent years, with little direct impact on saving or investment. In fact, frequent devaluations can become a source of instability in the economy, fueling inflation, which in turn creates uncertainty. This generates additional pressure for capital flight. Such issues deserve further research, because there are many who feel that the lesson of experience, at least in the low-income countries of Africa, does not support the theoretical conclusions.

The Economic Counsellor and Director of the Research Department remarked that the subject of the role of national saving in the world economy would continue to be discussed in the Board. Indeed, the staff paper had been prepared as a background paper for the world economic outlook discussion, and the Board discussed on an ongoing basis the key issues in the world economy, so that the issues mentioned by Directors at the current meeting would once again be brought up, for example, during the November 20 discussion of exchange rate developments.

Saving should be viewed in a dynamic, medium-term, supply-side framework, and not as a vehicle for short-term demand management, the Economic Counsellor began. In that context, the relationship between the public sector and the private sector had to be considered because the response of the private sector to public sector policy measures could offset the original intent of such measures. Some Directors had indeed raised the question of whether or not government spending was productive, since that would determine very much how the private sector responded to such spending.

The Ricardian equivalence theorem, to which a number of Directors had referred, implied that budget deficits were irrelevant in that the private sector saw through changes in the public sector's accounts, so that any increase in the deficit, for example, would cause the private sector to cut down its spending in anticipation of an increase in future tax liabilities, the Economic Counsellor said. For that theorem to hold true, however, a number of assumptions had to be made. First, the private sector's planning horizon had to be sufficiently long. Second, the government deficit should not be distortionary. Typically, however, a government deficit in and of itself, quite apart from the tax structure, introduced distortions into the economy, as was currently being clear from discussions of the U.S. budget deficit. Given that perspective, the Ricardian equivalence theorem should be viewed not as an empirical reality but rather as a conceptual aid that helped to focus ideas.

There was no perfect way of grouping countries for analysis, the Economic Counsellor remarked. Either one looked at individual countries, as was the case in the Article IV discussions, when one could be perfectly accurate, or one could attempt to group different countries and hope that this aggregation of data across countries would shed some light on the discussion. Indeed, in the staff's previous paper on saving, Directors had proposed alternative groupings--a request to which the current paper had responded.

Another general comment that he had before responding to Directors' more specific questions concerned the importance of the difference between correlation and causality: if two variables moved together in a positive or negative manner, this did not necessarily mean that one variable caused the other; both variables might be responding to a third whose role was not immediately evident, the Economic Counsellor cautioned.

A number of Executive Directors had pointed to the complexity of the impact of interest rates on saving, the Economic Counsellor noted. Positive real interest rates were essential because of their contribution to the proper allocation of resources; their sole rationale was not to promote domestic saving. There was strong evidence that high domestic interest rates attracted capital and reduced capital flight. However, evidence on the influence of interest rates on capital flows and saving had to be considered in the context of the somewhat limited reliability of econometric estimates. The quality of the data provided to the staff by some of the countries was very poor. For example, in developing countries interest rate data frequently referred to administered interest rates instead of the effective interest rates that in fact governed behavior. In such cases, it was not surprising that interest rates did not appear to have an impact on saving.

Mr. Jalan had raised the point that while saving had declined in the 1980s, growth had been relatively high, and asked how that could be explained, the Economic Counsellor recalled. First, much of the developments of the past few years could be attributed to reforms, including substantial changes in policies on the supply side and removal of distortions. Second, as was implied in the question, it was not enough just to look at an aggregate called saving; the composition and quality of that aggregate was also important.

Despite the argument of Eisner and others that what was generally viewed as a deficit might not actually be a deficit because government spending on some activities should be viewed not as consumption but as investment, the Economic Counsellor said, such manipulations of accounting did not change the basic fact that in practice and as an economic matter, the United States did have a significant budget deficit.

On the question of whether short periods of negative real interest rates could be tolerated, the Economic Counsellor and Director of the Research Department remarked that no program should be based in advance on periods of negative real interest rates, since in practice that would tend to result in a long period of negative real interest rates, and could also threaten the government's credibility. However, if a medium-term economic program were introduced, in the transition period a short period of negative real interest rates might be expected. Indeed, it was inevitable that there would usually be very short periods of negative real interest rates, as the market could not immediately adjust to each and every inflationary development. He did not see great danger in such an event, provided on average real rates of interest were positive.

The quality of positive real interest rates was as important as their absolute value, the Economic Counsellor stressed. For example, the achievement of high positive real interest rates in the context of very high inflation could lead to disastrous outcomes--as illustrated in various Latin American cases. On the other hand, they could be achieved in the context of price stability and solid macroeconomic policy packages, as had been the case in several Southeast Asian economies.

The fact that positive real interest rates were necessary to encourage saving did not imply that the higher the positive real interest rate, the better it was for allocation, the Economic Counsellor remarked. The goal was to reach the optimal real interest rate; deviations on the positive side were as costly as deviations on the negative side. If interest rates were too high, the goals of increased investment and growth could be thwarted. There was also a danger in excessive fine tuning. The market had to be allowed to indicate the optimum level of interest rates, and if lower interest rates were desired, that goal had to be supported by stable and credible policies.

On the issue of sequencing when a country was experiencing both high and variable inflation and a weak financial market, the Economic Counsellor said that his own instinct would be to work first toward stabilization. Then, once the economic system had adjusted itself and relative prices were more meaningful, financial liberalization should take place to facilitate capital flows.

The staff would never conclude that negative real interest rates were a good thing, the Economic Counsellor assured the Board; he was simply cautioning against promoting positive rates only on the banner of the promotion of saving. There were many other good reasons to bring about positive real interest rates.

The question of which external deficits were harmful and which were benign involved a good deal of judgment, the Economic Counsellor commented. Clearly, some deficits were worse than others. In general, it was fair to say that if the public sector was the prime source of the external deficit, the deficit was harmful. However, one should not then conclude that every private sector deficit was therefore of the good variety; that would only be the case if all private sector decisions were being taken in an environment of appropriate policies. He would term the imbalances of the United States, Japan, and Germany as being large enough to cause concern, because they increased dangers of protectionism, sharp policy changes, impatience of portfolio holders, instability in financial markets, and calls for "sand in the wheels" to stop capital flows. The key question was whether these imbalances were sustainable.

On the question raised by Mr. Kafka of how far one should sacrifice wealth to stimulate saving in the context of exchange rate devaluation, the Economic Counsellor said that the staff did not necessarily view the exchange rate as a demand management instrument, but rather as a price that helped to determine the allocation of resources among sectors. From that viewpoint, perhaps the wealth effects of exchange rate changes were not of prime importance. As the Board was aware, a new Interdepartmental Working Group on Fund Policy Advice had been formed, and one of its first projects was to study the nature of Fund policy advice in the exchange rate sector.

Mr. Jalan had asked why the staff paper seemed to advocate a consumption tax, but later concluded that such a tax would not have a major effect on saving, the Economic Counsellor recalled. It was indeed true that the effect on saving of a consumption tax was not as pronounced as one might expect. In addition, however, a decision on which sort of tax should be used depended on what was the optimal way to pay for government expenditure, or what was the optimal tax structure. That in turn begged the question of whether the quality of government expenditures was sufficiently high for those paying the tax to be willing to continue doing so.

On how to correct a fiscal deficit, Mr. Newman and the staff had both suggested that expenditure changes were the most effective solution, the Economic Counsellor recalled. However, Mr. Landau had raised the valid point that if for some reason a government's expenditures were paralyzed, it should not rule out other ways of cutting the deficit; rather, it should consider raising taxes, which was the second-best solution. The problem was that the greatest enemy of the second best might well be the first best.

An upcoming staff paper by the Fiscal Affairs Department would deal with such issues as the coordination of tax policies, the Economic Counsellor and Director of the Research Department noted, so he would not respond to questions raised in that area.

The staff representative from the Research Department said that there was no doubt that positive real interest rates would bring about a shift in savings from nonfinancial to financial assets. But there was neither conceptually nor empirically a very strong relationship between real interest rates and the aggregate level of savings. Be that as it may, one could not conclude that real positive interest rates were not an effective policy instrument; the validity of that statement depended on what the instrument was being used for.

It was very difficult to assess the benefits of improved resource allocation directly, the staff representative remarked. Nevertheless, studies that had tried to measure such benefits indirectly had all found a linkage between positive real interest rates, development of the financial sector, investment, and growth. While the causality links between those variables were not always clear, there was no doubt that countries which had pursued positive real interest rates had attained a better allocation of financial savings into investment, resulting in higher rates of growth.

The ambiguity in the direction of causality arose because of the fact that a high public dissaving was generally associated with a high rate of credit expansion and inflation, the staff representative observed. Consequently, the positive correlation between inflation (and interest rates) and aggregate dissaving did not mean that the high inflation (and low real interest rates) had caused a reduction in private savings. The situation became more complicated when stabilization policies were being implemented in countries with high inflation. In such cases, the definition of real interest rates became an important issue. Defining real interest rates as nominal interest rates minus expected inflation begged the question of how to define expected inflation. If the authorities were confident that inflation would drop as a result of stabilization policies designed to have that effect, they might well choose to set an interest rate that was initially negative in real terms but would become positive as stabilization measures took hold. However, if the determination of the interest rate was based on the inflationary expectations of the public, which might have less faith in the success of the stabilization program, interest rates would have to be much higher initially. In that case, if the inflation rate was indeed brought down, the real interest rates could end up being very high. That, as the Economic Counsellor had pointed out, could be an even worse evil than negative real interest rates.

To the extent that the lower income groups in the society were more likely to have borrowing constraints, a shift of income from higher-income groups to lower-income ones by itself could indeed reduce savings, the staff representative said. However, there were of course other considerations. Countries with a more equitable distribution of income would have a more stable environment, which was likely to help savings. How was an improved income distribution to be accomplished? Was it the pattern of growth itself that generated better income distribution; or was it that income should be redistributed through taxes and subsidies, and if so, what was the effect of such redistribution? If taxes were raised very high, one would have to consider how much potential there was for high income groups to shift their income outside the country, for example.

Some empirical work had been done in that area, but the studies were inconclusive: the literature did not reveal a very strong relationship between income distribution and saving.

The suggestion had been raised by Mr. Nimatallah that perhaps certain cultures were just naturally more frugal than others, the staff representative from the Research Department recalled. That concept had a lot of intuitive appeal. However, the work done by the staff, as illustrated in Appendix III, indicated that not much could be attributed to that factor. For example, dummy variables, which had been introduced for a group of high-saving Asian countries to account for cultural factors, did not improve significantly the explanatory power of the savings equation once all the other factors were taken into account. However, he stressed that it was very difficult to conclude any strong evidence from that study as the data were very weak.

The other staff representative from the Research Department indicated that the staff paper had used the UN System of National Accounts, under which social security was included in the government accounts wherever possible. That was also the procedure used in the world economic outlook when the staff made comparisons across countries. On the other hand, when a table focused on developments in an individual country, the staff tried to follow the practice that was preferred in that country. In that context, of the major industrial countries, in addition to the United States, Italy and the United Kingdom also included social security in the government accounts. The other four--Canada, France, Germany, and Japan--excluded most social security accounts. The staff was trying to develop a clear position as to what was the best way of handling those accounts in the world economic outlook. Since social security, lending programs, and government guarantees all created contingent liabilities for governments, it would be helpful to develop a consistent way of treating those different types of accounts. The staff would of course report to the Board on any conclusions that were eventually reached.

Mr. Jalan said that while he agreed that no taxes were desirable from the point of view of individuals, from the perspective of the com munity as a whole, the counterpart of private taxation was government expenditure. He therefore preferred that direct taxes not be referred to as a distortion.

The Economic Counsellor and Director of the Research Department noted that an optimal tax structure was that which mobilized resources at the lowest cost. There were a number of distortions associated with tax systems. For example, income tax systems were said to distort decisions on work versus leisure, while some taxes on interest income were said to distort decisions on consumption versus saving. As a result, expenditure taxes were generally preferred over income taxes. In addition, one had to keep in mind the costs of administering the tax system. In general, his point had not been that taxes should be avoided, but on the contrary, that hey should be evaluated on the basis of which system provided the necessary resources at the least possible cost--and not on the basis of whether or not the taxes stimulated savings.

Mr. Nimatallah asked the staff to reflect on whether it was possible that as societies tried to improve their standard of living and therefore devoted a growing share of their income to consumption, the savings rate would naturally decline, and that the advancement of technology would allow countries on average to achieve a higher rate of growth with a given level of investment.

The Economic Counsellor and Director of the Research Department, in response to a question from Mrs. Filardo, remarked that it was not necessary to wait until all the relevant statistical issues were resolved before attempting to correct the U.S. deficit.

Mr. Newman said that while deficient savings related to investment in deficit countries did have to be improved, it was equally true that investment in surplus countries had either declined faster than savings or had not changed. Yet the emphasis throughout the staff paper had been on improving the savings in the deficit countries. He acknowledged that the United States had to improve its deficit, but if that were the only source of adjustment, there would be major implications for growth. A more balanced adjustment process seemed preferable.

The Economic Counsellor and Director of the Research Department remarked that the focus on savings in the paper under discussion was only natural since that was the subject of the paper. In the world economic outlook discussion, the staff had emphasized that there were two sides to the concept of reducing imbalances. However, because the world economy had been close to full capacity for a while, with increased inflationary pressures as a result, it was not appropriate to call for a fiscal expansion in the surplus countries to compensate one-for-one for the fiscal contraction that was hopefully forthcoming in the United States. There was certainly not much concern yet that the decline in the U.S. budget deficit was proceeding so rapidly that it would swing the world into a serious recession. However, the staff definitely did not consider it desirable that there should be policy paralysis in the rest of the world while the United States took all the action. In fact, there were numerous structural measures that the surplus countries should be taking at the same time.

The real issue was that there were two ways of filling a saving/ investment gap--either by raising savings in the United States or by lowering savings abroad--and the preferred solution was clear, the Economic Counsellor commented. On the other hand, the staff was not wed to the notion that the world resources were fixed. The size of the pie should be increased, and the way to do this was to stimulate the right structural measures in the surplus countries to increase investment and improve the allocation of resources. To the extent that coordination included an element of peer pressure, whenever the major surplus countries decided it was appropriate to begin such steps was indeed the right time.

In fact, in the current circumstances of good world economic performance, with close to full capacity, the political atmosphere was particularly good for undertaking difficult political structural measures. In any event, the key requirement was that the United States reduce its budget deficit. While the rest of the actors should not be passive, it was also clear that the United States should not wait for the other countries to take the first step.

Mr. Cassell said that he agreed that the elasticity of savings with respect to real interest rates was low. Therefore, the desirable policies were those that would shift the supply schedule of savings outward, but it was difficult to know what those were. He would welcome staff comment on that question.

He had difficulty with the concept of benign imbalances, Mr. Cassell remarked. While there might be a part of any particular deficit or surplus that was benign, there was another part that almost certainly was not. He would definitely describe his own country's deficit in those terms; part of the deficit reflected an overheating of the economy. The point of the former Chancellor of the Exchequer in that context had been that the other part of the deficit reflected an excess of private investment over private savings in the economy, which was likely to be self-correcting by private sector decisions in time, whereas there was no similar self-correcting mechanism for a budget deficit. It was in that sense that one could loosely state that private sector deficits were good and public sector ones were bad.

The Economic Counsellor and Director of the Research Department remarked that essentially he agreed with Mr. Cassell. However, while it was true that the elasticity of saving to changes in interest rates was relatively low, the response to a given change in macroeconomic policies or real interest rates would vary depending on the overall climate of confidence in the persistence of those policy measures. In addition, those countries that tended to have low inflation, positive real interest rates, and stable fiscal management also tended to grow faster than countries without those characteristics, which was certainly a desirable "side effect."

He was not comfortable with terming balances as benign or malignant since, as Mr. Cassell had pointed out, it was difficult to distinguish between different parts of the same imbalance, the Economic Counsellor indicated. But on the notion of a current account surplus being self-correcting in time through capital flows, while that was theoretically conceivable, in practice markets did not react favorably to large persisting imbalances, and regardless of intellectual arguments regarding the benign nature of those imbalances, there immediately developed pressures for protectionism, for "sand in the wheels," and for other distortionary measures.

Mr. Kafka commented that it was in fact more important for the countries with very large deficits to take steps to reduce their imbalances than for those with very large surpluses. If a group of surplus countries did not increase domestic absorption, but made it possible either through appropriate lending policies or through donations for a third group of countries to raise their absorption, that would have exactly the same effect on the deficit countries in terms of helping to eliminate their deficits.

The Economic Counsellor and Director of the Research Department agreed that the surplus countries could reduce their surplus by creating deficit flows, and it was definitely in the interest of a country with a large deficit to correct its imbalance. It so happened that such correction also generated some good for the world as a whole, but the rationale for doing it was purely self-interest.

The Chairman then made the following summing up:

> Executive Directors noted the critical importance of saving for the promotion of economic welfare, including the maintenance of strong and sustainable growth in the world economy, external adjustment in deficit countries, and the amelioration of the debt problem. Saving rates had declined in many countries, industrial as well as developing, and these declines had been associated with lower rates of capital investment. In addition, saving rates had diverged significantly across countries, falling substantially in some countries while remaining stable or even rising elsewhere. This divergence had contributed to the emergence of large current account imbalances, especially among the major industrial countries.
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> Directors called attention to both the similarities and the differences in the issues related to saving as they concern industrial and developing countries. The determinants of saving, as well as the importance of saving for stable growth, were generally seen as being similar in both groups of countries, although the special circumstances of developing countries needed to be emphasized. A few Directors also expressed concern about the implications of the decline in saving rates in the industrial countries for the developing countries. With saving falling below investment in the industrial countries in the 1980s, the aggregate current account balance of those countries had shifted from surplus to deficit. Hence, the net flow of savings, which traditionally had been from industrial to developing countries, had now moved in the other direction.
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> Directors were particularly concerned that medium-term projections did not indicate a significant improvement in saving patterns, and they agreed that ways should be sought to stimulate both private and public saving.
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> Directors found that among the main factors influencing saving, the most important was clearly government policy, which

affected public saving directly and private saving indirectly. The most effective means for reversing recent trends in saving would be for deficit countries to improve the financial position of the public sector, and for all countries to adopt structural policies that would minimize distortions that work against saving or investment.

The decline in private saving rates in the industrial countries was associated with a number of other factors. These factors included the revaluation of the stock of wealth; increases in the relative income position of the older groups in the population; certain shifts in relative prices; financial liberalization; and tax distortions. The rise in the average age of the population was also cited, although the quantitative importance of this factor remained unclear.

Directors underscored that declines in saving rates had been associated partly with developments that had improved economic welfare. For example, financial liberalization had allowed households to smooth their consumption over time by giving them easier access to credit. In some cases, however, the structure of taxes and government transfers had played a role in discouraging private saving. Tax distortions had exerted an even greater impact on the composition of investment in some countries, resulting in overinvestment in certain sectors, in particular, in housing.

In discussing the relationship between saving and external imbalances in industrial countries, Directors returned to some of the themes developed in the earlier discussion of the world economic outlook and Article IV consultations with a number of major countries. While there was a general recognition that current account imbalances, per se, need not be undesirable, many Directors stressed the importance of avoiding large or persistent imbalances. To the extent that open capital markets facilitated the international flow of saving to areas providing productive investment, some imbalances in current account positions were inevitable and, indeed, desirable. But the magnitude of the imbalances that had arisen in recent years was a major problem that had to be corrected. Directors underscored that large and persistent imbalances that were associated with imprudent financial or structural policies would eventually lead to disruptions in the capital and foreign exchange markets, and could provoke protectionist actions. Thus, the emergence of a large current account imbalance indicated that the country's economic policies were in need of attention.

Directors took note of a number of recent studies that had xplored the relationship among saving, investment, and growth. While recognizing the preliminary nature of the studies, Directors were encouraged by the findings, which suggested substantial externalities associated with capital formation, in particular through investment in research and development, in human capital, and in other social infrastructure. These studies served to strengthen the case for promoting saving through tax and other incentives.

Views were mixed regarding the efficacy of policies to stimulate private saving in industrial countries. Several Directors noted the importance of maintaining appropriate tax policies, notably the avoidance of disincentives of saving--such as permitting interest payments to be deducted from taxable income--and of high marginal income tax rates. While some Directors suggested that shifting from income taxes to consumption-based taxes might help stimulate saving, others questioned how effective such a shift might be, and cautioned that consumption taxes tended to be rather more regressive than income taxes, and could contribute, at least temporarily, to inflationary pressures.

A number of Directors were uneasy about the suggestion that inflation and interest rates had relatively small effects on saving, in developing as well as industrial countries. They noted that the maintenance of positive real interest rates in developing countries had been shown to be associated with low inflation, which in turn was associated with high saving rates. Directors underscored the importance for all countries to aim monetary policy at preventing the emergence of inflationary pressures and financial instability. Stable prices and positive real interest rates were regarded as prerequisites for the development of financial sector and efficient allocation of resources. Several Directors suggested that further study on the role of interest rate and other financing policies in promoting saving and growth would be helpful.

Directors took note of the negative effect of the shift in the net flow of foreign saving to the developing countries, which had been exacerbated by the very sharp declines in national saving rates in most groups of developing countries. Factors that were cited as having contributed to the decline in national saving rates in these countries included government dissaving, losses by public enterprises, financial repression, macroeconomic instability, and adverse external shocks or changes in terms of trade. Directors also noted that the decline in saving rates had been particularly evident among countries with debt-servicing difficulties, those with high rates of inflation, and in countries with relatively low levels of per capita income. The reduced flow of foreign resources since the onset of the debt crisis in 1982 suggested that domestic saving bears the brunt of financing the bulk of the increase in domestic investment. Macroeconomic stability, in both industrial and developing countries, would be crucial to stimulate saving and improve the efficiency with which saving was used in developing countries. Several Directors noted the importance of addressing resolutely the problem of debt overhang to re-establish conditions more conducive to promotion of domestic savings.

In this connection, Directors noted also the importance of fiscal restraint, which raised national saving by both increasing public saving and reducing dependence on foreign borrowing. Monetary restraint was equally important in securing financial stability, and thus improving the environment for both saving and investment. Furthermore, exchange rate flexibility and unification of exchange markets were seen to be effective means to promote efficient allocation of saving by channeling resources into the domestic financial system that would otherwise flow abroad or into unproductive assets. To the extent that strong economic growth tended to promote saving, it was noted, the level of saving was indirectly stimulated by these efficiency gains. In any event, Directors were unanimous that the achievement of price stability was key to a successful program of interest rate reform and financial liberalization.

Finally, I would note, as did several Directors, that the papers that the staff prepared for today's meeting would be suitable for publication after benefiting from the comments and suggestions offered by Directors in the course of this discussion.

Mr. Goos asked whether, since the Board had been asked by the Interim Committee to report on its findings on saving, it might not be appropriate to publish the staff paper before the next Interim Committee meeting.

The Chairman noted that the spring meeting of the Interim Committee would be later than usual--on May 7, 1990--so that if publication were postponed until after that meeting, the paper would lose some of its relevance. He was in the hands of the Board, but would remind Directors that before publication, key paragraphs could be revised in light of Directors' comments. The Interim Committee discussion would focus not only on the staff paper, but also on the results of the current Board discussion, possibly enlightened by further discussions. That might justify returning to the question of saving in the context of the next world economic outlook discussion in late March, 1990.

Mr. Posthumus said that he agreed with the Chairman. The paper was essentially an analytical paper, which did not contain specific policy advice to specific countries. Accordingly, even if it was published before the Interim Committee met, it could still be used by the Interim Committee as a basis for its policy advice.

Mrs. Filardo asked how the staff planned to continue research on the relationship between saving, investment, and growth.

The Chairman responded that while no precise topics had been identified on which the staff could focus its research, management would consult with the staff on that question, and keep the Board informed on any new developments.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/89/140 (11/6/89) and EBM/89/141 (11/6/89).

2. EXECUTIVE BOARD COMMITTEES

The Executive Board approves the reconstitution of the membership of the four Executive Board standing committees as proposed by the Managing Director in EBD/89/342 (11/1/89) and Correction 1 (11/2/89).

Adopted November 6, 1989

3. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/89/255 (11/1/89).

Adopted November 6, 1989

APPROVED: June 29, 1990

JOSEPH W. LANG, JR.
Acting Secretary