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Economic Commission for Latin America and the Caribbean

"SAVING AND FINANCING" SEMINAR */

SUMMARY AND CONCLUSIONS

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SUMMARY AND CONCLUSIONS

The second seminar on "Saving and financing" was held at ECLAC headquarters from 29 November to 2 December 1989. It was presided over by Gert Rosenthal, Executive Secretary of ECLAC. The seminar analysed four studies on saving and three on the allocation of financial resources, which had been prepared by experts from a number of Latin American countries. These studies are in addition to the 10 case studies examined during the first seminar, held in January 1989. The studies were co-ordinated by the Chilean economist Carlos Massad.

I. STUDIES ON SAVING

The studies on saving were based on the cases of Colombia, Ecuador, Peru and Venezuela. Their chief preliminary conclusions are described below.

1. It is an especially complex task to specify the determinants of domestic saving because of the inadequacy of the statistics which measure changes in the amount of saving. The added domestic saving of the economy is calculated as the difference between capital formation and external saving or current account deficit. A number of measurement difficulties arise from using this method, including the poor quality of statistics on investment and the different units of measurement used for domestic saving (local currency) and external saving (foreign currency).

In preparing statistics on domestic saving broken down according to agent (government, businesses and households), a different methodology from that used for national accounts should be chosen. Moreover, there is not enough information available on depreciation of public assets, which biases the quantification of private saving.

All the above difficulties considerably qualify the conclusions that may be drawn from applying econometrics to aggregate statistics. The more direct the information available on saving by agents (governments, businesses and families) in horizontal or transversal series, the more reliable will be the study of the determinants of saving.

Lastly, aggregate savings series raise problems of identification for purposes of econometric analysis. This is because saving and investment are equal by definition (in the aggregate), and hence it is impossible to identify whether the findings describe the behaviour of saving or that of investment. The direction of causality between the two magnitudes has been the subject of a longstanding debate in macroeconomics, as was pointed out in the previous seminar.

2. The two strongest conclusions suggested as to the determinants of saving are as follows: firstly, permanent income theories, which postulate that saving accommodates temporary variations in income with respect to its trend level, are confirmed. This generally implies a drop in the coefficient of saving during the declining phase of the economic cycle, and vice versa. The second conclusion is that the real interest rate does not influence the formation of real saving; this rate affects the level of the stock of term deposits and other forms of retention of financial resources, but not the behaviour of the annual flow of real savings. The latter conclusion is the same as that reached by the previous seminar.

3. Particularly relevant to the design of economic policy was the evidence presented that the saving of the public sector decreases with the outflow of external saving, i.e., the two forms of saving are substitutive. This finding was rationalized in terms of the political economy of the public sector, an agent that tends to relax its current spending policy when it has access to external financing.

The enormous current burden of external debt and Latin American insistence on reducing the negative transfer of resources abroad-- particularly the transfer of public resources-- make it essential to change the way fiscal policy is conducted in terms of using possible external means of relief in order to increase the saving and investment of the public sector. This policy may be highly complementary to the efforts of private investment, whether public investments are made jointly with private investments, or whether these funds are channeled to private investment projects.

4. Moderate evidence was found that private and public saving crowd each other out to some extent, but not are not entirely substitutive. This implies that an increase in public saving, although it may somewhat reduce private saving, may help expand total saving. This conclusion is the same as that of the previous seminar.

5. Another central concern is to keep the residents' saving inside the country, i.e., to avoid capital flight. This requires real interest rates that offset the risk of devaluation, and exchange, monetary and fiscal policies that provide credibility to the macroeconomic order.

6. The financing of fiscal deficits is another key element. Financial repression, the saturation of capital markets with public debt and rampant inflation have led to a drop in public and private demand for investment and have prevented the formation of saving.

7. In many countries, and in Latin America as a whole, there exists idle installed capacity. If fiscal balances are restored and the balance-of-payments situation is improved (by finding solutions to the external debt problem and applying realistic exchange policies), output can be recovered. If the expansion of consumption is brought under control (and wage policy is the key factor here), a significant increase in saving can

be achieved, as can be seen in the case of Chile. This topic was also brought up at the first seminar.

8. Institutions must be set up to attract saving from the labour force. This would mitigate the potential conflict between growth and distribution, in view of the empirical evidence of lower savings rates in low-income sectors.

9. Finally, evidence was presented that tax increases negatively affect saving by businesses. The effect of these increases on total saving is not clear, however, since there is considerable inertia in fiscal spending, which leads to similar variations in taxes and public saving. Thus, a tax increase would shrink private saving and raise public saving, which would basically imply a transfer of savings rather than a change in their level.

It was recognized, in any case, that there is a need for more research on the private impact of tax measures. It was assumed, as a working hypothesis, that tax incentives to business saving (reinvestment of profits) are more efficient, in terms of generating saving, than incentives to household saving.

II. STUDIES ON FINANCIAL SYSTEMS

The studies that were presented on financial systems covered the cases of Bolivia, Ecuador and Uruguay. The main conclusions drawn from these studies are summarized below.

1. The regulation and judicious supervision of financial institutions play a particularly important role in the prevention of financial crises and in programmes designed to deregulate credit and interest rates. What is essential in regulatory and supervisory systems is the quality of the controls, not their quantity. The primary purposes of these controls are to limit the risk to financial institutions and set standards for reserve and capital requirements that will prevent problems of solvency from arising.

2. Financial liberalization, in the absence of a modification of the framework for regulating and supervising bank solvency, has led to a notable deterioration in the quality of bank portfolios.. Effective regulation and supervision is essential where there is a government guarantee on deposits; even without such a guarantee, however, preventive control is needed, since the State has become involved in the financial crises that are threatening the stability of the financial system.

3. The transparency of financial institutions' equity position is an essential component of an effective regulatory and supervisory system. Transparency allows depositors to take into account the financial institutions' exposure in making decisions about where to save, and encourages those who manage these institutions to take timely steps to

safeguard their financial standing. For these reasons, providing the public with information on the actual solvency position of financial institutions is a partial substitute for controls enforced by a supervisory authority.

4. Financial crises involve equity losses that present difficult economic policy dilemmas. Financial institutions try to deal with losses by providing for greater margins of intermediation, and consequently by raising active interest rates. These rates erode the borrowing capacity of users of credit and encourage the transfer of credit operations abroad. At the same time, losses tend to increase with time, making it advisable to recognize them early. However, financial crises are characterized by depressed asset prices, and so the absorption of losses by a rapid liquidation of assets may augment the State's losses and accentuate the redistributive effects of the adjustment measures.

5. The management and behaviour of interest rates during financial liberalization raise a number of questions.

Firstly, it is important to establish what factors condition or determine interest rates, in what context active rates or passive rates dominate and under what conditions these rates are simultaneously determined.

Secondly, it has been observed that a number of financial decontrol processes have led to high real interest rates even in the presence of significant macroeconomic and relative price adjustments and progress in inflation control, although it is not clear which factors keep the interest rates at these levels. In this respect, it is important to monitor passive interest rates systematically, since the achievement of positive but moderate real interest rates is considered to be a significant sign that the financial system is healthy. In this context, the procedure or method for deregulating interest rates takes on importance, in order to avoid sharp rises in these rates. It is worth analysing whether a certain range should be specified initially, or whether interest rates should be recommended by the authorities.

Lastly, questions arose about continuing to use a system of annual nominal interest rates in countries faced with inflationary pressures and a considerable shortening of the time it takes to conduct financial operations. In some countries, the rigidity of annual nominal interest rates leads to pronounced negative real rates as inflation rises. Recently this system of interest rates has led to substantial positive real interest rates to the extent that inflation has been brought down.

6. Inflation hinders the performance of the financial system by shortening the time available for intermediation operations, shrinking the profitability of financial instruments in local currency (unless procedures are adopted to offset its effects), creating a need for a risk premium in the determination of nominal interest rates because of the uncertainty about future inflation, and in other ways. When inflation is very high, the financial system deviates from its proper role as an

intermediator of funds. If existing regulations so permit, the financial system tends to offer protection against inflation rather than redirecting funds to the production sectors.

STUDY SUMMARIES

I. SAVING

A. "Determinants of saving in Colombia, 1970-1987", prepared by José Antonio Ocampo, Stefano Farne and Catalina Crane.

The study begins with a brief summary of the theoretical literature on the determinants of saving, including especially permanent income hypotheses, the Ricardian theory of equivalence, the impact of the interest rate, external saving and income distribution. It then offers a brief overview of the main findings described in the literature on saving in Colombia. These findings all show an inverse relationship between (better) income distribution and saving, a high propensity to save supplementary income in the public sector and no relationship between saving and the interest rate. As for the permanent income hypothesis, the previous evidence is not conclusive as to the behaviour of the private sector, although it seems to find more support in public sector behaviour. Nor is there any conclusive evidence about the correlation between external and domestic saving, since relations of both complementarity and substitution are found for different periods.

This study provides information on saving by the various agents, i.e., households, businesses, financial institutions, public administration and public enterprises. It should be noted that it is very difficult to find such a fine degree of breakdown in studies of this type, in view of the usual statistical information problems faced by the countries in obtaining statistical data. The study goes on to present new estimates of saving by agents, adding evidence to complement that reported in the first section.

The primary conclusions of this study are as follows: (1) Income distribution is confirmed to have an impact on the determination of private saving, hence the importance of creating institutional arrangements to attract savings, especially from the labour force. (2) The study finds evidence favourable to the permanent income hypothesis, with respect to the behaviour of both private and public sectors. (3) Taxation has a negative impact on private saving and a positive impact on public saving. However, private saving does not seem to respond to changes in the public sector deficit. (4) The interest rate does not influence the formation of saving, although it determines the demand for assets that affect financial intermediation. (5) External saving tends to replace domestic saving, especially at the level of public enterprises.

Finally, the study examines the evolution of resource flows between the surplus and deficit sectors of the Colombian economy. The finding is that households no longer transfer their surpluses directly to enterprises by acquiring ownership rights, and this presents a new challenge to the financial system in terms of its capacity to mobilize saving.

B. "Determinants of saving in Ecuador", prepared by Luis Ignacio Jácome and Alfredo Arízaga

The study begins with a brief discussion of its findings, stressing their macro- rather than micro-economic nature, and pointing out the statistical difficulties encountered in the aggregate quantification of saving.

It then offers a description of the recent evolution of the Ecuadorian economy, noting the impact which the erratic price of oil and natural disasters have had on it.

The third section of the study deals with the relationship between domestic and external saving, attempting to discover whether they are related to each other in a substitutive or complementary way. The fourth section focuses on the link between public sector and private sector saving, in order to test the Ricardian theory of equivalence.

In the fifth section of the study, an effort is made to elucidate the influence of the interest rate on the formation of saving in Ecuador. It points out that statistical difficulties prevent more conclusive evidence from being offered.

Lastly, all the foregoing considerations are brought together and the various hypotheses are verified in multiple regression applications. The main conclusions are as follows: 1) It is possible to augment the total saving of the economy by increasing public sector saving. 2) It is impossible to suggest policies, at this stage of knowledge, that will stimulate private saving with any degree of certainty; thus the hypothesis is raised that the best policies would be those that stimulate private investment. 3) Macroeconomic balances must be restored because of the negative effect of inflation on saving and investment. 4) There is a need to implement both sociopolitical and economic policies to stimulate an environment favourable to investment.

C. "Saving, fiscal imbalances and external indebtedness: Peru 1968-1988", prepared by Héctor Neyra, Renzo Rossini and Oscar Hendrick

This study begins with a brief description of the recent evolution of the Peruvian economy. It then introduces a simple accounting model that presents the three main sources of investment financing, namely, private saving, public sector saving and external saving. Empirical evidence is provided on the evolution of these magnitudes in the past two decades. There is also a methodological discussion on the way in which overdue external debt interest payments should be calculated and the costs of the unpaid servicing of this debt.

The work then turns to a study of the determinants of private saving in terms of the economic cycle, the age structure and the public sector deficit. The public sector deficit is then considered in terms of its influence on total saving. The study concludes with an analysis of external saving and the process of indebtedness of the Peruvian economy.

There are three main conclusions of the work. The first is that external saving has played a strongly substitutive role in public sector saving. This substitutive relationship also appears to extend to private sector saving. The second is related to the effect of the fiscal deficit on private saving. The Ricardian theory of equivalence is not supported, however; the conclusion is rather that public debt is not neutral in the formation of saving. Lastly, an analysis of where external debt goes reveals how these resources were used primarily to finance current and consumer spending, thus hindering the generation of foreign currency needed to pay the debt from which they arose.

D. "Saving in Venezuela (1970-1988)", prepared by Cristina Rodríguez

This study begins with a description of the recent economic evolution of the Venezuelan economy, stressing the dynamics which have resulted from the powerful changes introduced by the enormous variability of the price of oil during the period. The distinctive features pointed out are the slow growth of the product, the high rate of investment and the similarly high, but very unstable, rate of saving. One problem characteristic of this economy is the flight of capital, i.e., the inability to keep the domestic saving generated inside the country.

The study then attempts to establish what the determinants of saving in Venezuela were during the period. Econometric equations are applied to income, interest rates, the relationship between private and public saving and the influence of external saving on the generation of domestic saving. However, the findings are still preliminary and do not support any definite conclusions.

II. FINANCING

A. "Disintermediation and financial liberalization in Bolivia", prepared by Gonzalo Afcha de la Parra

1. De-dollarization in 1982 and hyperinflation in 1984-1985 substantially reduced the size of the financial system. However, high

financial spreads and the effects of inflation motivated the banking system to expand its network of branches and invest in fixed assets. The consequently burdensome administrative expenses and unprofitable assets have caused sizeable problems for the banking system in recent years.

2. From August 1985 onwards, interest rates were deregulated and reserve requirements reduced. These changes were not accompanied by a modification of the system for regulating and supervising the soundness of financial institutions. Deregulation led to high real interest rates, which deteriorated the quality of portfolios. At the same time, the lower reserve requirements facilitated the remonetization of the economy, but it has remained below its levels of the early 1980s. The practice of carrying out a large proportion of transactions in dollars has limited the demand for funds denominated in local currency.

3. The rise of solvency problems in a number of banks in 1987 led to reforms in the system of bank regulation and supervision. These reforms restored control to the Superintendency of Banks, introduced stricter standards for overdue loans and interest payable, reformulated the reserve and minimum capital requirements and proposed that limits on exposure should be set and that the public should be informed about the equity position of financial institutions.

B. "Banking regulations, financial crisis and resulting policies: the case of Uruguay", prepared by Ariel Banda

1. The financial system has undergone financial crises in the context of both closed and open economies, and under highly regulated as well as non-regulated systems. In open economies, macroeconomic variables must be more consistent, since price and quantity shocks may be of a much higher magnitude. The opening up of an economy means that there will be changes in the rules of the game that are not always well received by the economic agents. In particular, many entrepreneurs continue to implement indebtedness programmes that are no longer valid in the presence of positive real interest rates. As for regulation, the determining factor is how effective it is at preventing and controlling the exposure of financial institutions.

2. The recent establishment of a new policy is a recognition of the need to regulate the system, but such regulation must be selective, tending to minimize the main risks without hindering operations. The encouragement of market transparency, appropriately regulated, seems to be an alternative to deposit insurance. Insurance could thus be limited to covering only demand deposits and small-scale savers with higher information costs.

3. In the case of Uruguay, the existing restrictions on the adjustment of the staffing table have favoured the prolongation of financial crises by making the restructuring of financial institutions less flexible.

Moreover, it would seem that the Central Bank does not have all the legal powers it needs to deal with the most recent crises without generating undesirable effects on the system of payments.

C. "Analysis of the Ecuadorian financial system", prepared by Santiago Bayas and Alfredo Arízaga

1. The following factors would help reduce the spread on which the financial system operates: lower legal reserve and capital requirements, greater flexibility in the setting of bank service charges and limitations on the investment of resources from public sources in assets not directly related to business operations, such as in the overexpansion of fixed assets.

2. The financial liberalization initiated in 1984 has contributed to a significant deterioration in the soundness of private banks by not simultaneously modifying the regulatory and supervisory system. The current trend seems to be towards a regulated banking system in which the State would guarantee deposits up to a certain amount (through an insurance fund) and set rules that would correlate risk with capital reserves and requirements. In any case, the introduction of an insurance fund should be postponed until the financial system has been put on a sound footing, since otherwise its resources could be exhausted in the effort to rescue certain financial institutions.

3. The number of banks operating in Ecuador seems to be excessive, and many of them have very high operating costs. Thus it would be useful to increase minimum capital requirements and encourage small financial institutions to merge. The low profitability under which a number of banks are operating makes it difficult to attract additional capital.

4. The system for determining annual interest rates has led to inflexible nominal rates, and hence to real rates which have varied inversely with inflation. The introduction of short-term nominal interest rates, directly linked to the period in which the operations are carried out, would facilitate the adjustment of nominal rates to the inflation rate and thus promote stable, moderate real interest rates.

STUDIES PRESENTED AT THE SEMINAR

- Desintermediación y liberalización financiera en Bolivia (Disintermediation and financial liberalization in Bolivia), Gonzalo Afcha de la Parra

- Determinantes del ahorro en Colombia, 1970-1987 (Determinants of saving in Colombia, 1970-1987), José Antonio Ocampo, Stefano Farne and Catalina Crane

- Análisis del sistema financiero ecuatoriano (Analysis of the Ecuadorian financial system), Santiago Bayas and Alfredo Arízaga

- Determinantes del ahorro en Ecuador (Determinants of saving in Ecuador), Luis Ignacio Jácome and Alfredo Arízaga

- Ahorro, desequilibrios fiscales y el endeudamiento externo: Perú 1968-1988 (Saving, fiscal imbalances and external indebtedness: Peru 1968-1988), Héctor Neyra, Renzo Rossini and Oscar Hendrick

- Regulación bancaria, crisis financiera y políticas consecuentes: el caso uruguayo (Banking regulations, financial crisis and resulting policies: the case of Uruguay), Ariel Banda

- El ahorro en Venezuela (1970-1988) (Saving in Venezuela (1970-1988)), Cristina Rodríguez

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- Open invitation to staff members of the ECLAC/ILPES system.