

Richard AlmJournalist
Dallas, Texas**David M. Gould**Senior Economist
Federal Reserve Bank of Dallas

The Saving Grace

A nation's savings matters. Money set aside from today's consumption can be invested, through financial markets, in productive assets embodying the latest innovations. A newer and better capital stock can provide the fuel to sustain higher rates of growth and improve living standards.

In a nutshell, that's the current view of many economists, one that places savings among the most important pillars of a nation's long-term economic health. Michael Mussa, economic counselor and director of research at the International Monetary Fund, summed it up: "Why is saving important? Primarily because investment is important....Growth tends to be high in economies where savings and investments are both high and reasonably well deployed, and growth tends to be poor in economies in which savings and investments are low or not well deployed."

The past decade has brought a greater appreciation of the beneficial role of savings in an economy. Before that, many economists, using Robert Solow's 1956 work, argued that saving didn't contribute all that much to growth. Additional saving might increase the capital stock and raise living standards, but it didn't boost long-run growth prospects. In the 1980s, endogenous growth theorists began to see that additional capital, both physical and human, gave society a growth bonus, usually related to more rapid technological progress. Now, most economists recognize saving as an important factor in growth as well as standards of living.

This shift in the profession's views on saving's role in economic growth puts a spotlight on a number of related issues. They include:

- What are the key factors that have positive and negative influences on saving?
- Should government's role in creating a better environment for saving be one of

intervention or one of financial liberalization?


- To what extent can a country make up for low domestic saving by tapping into the savings of other countries?

To explore these topics, the Federal Reserve Bank of Dallas invited economists, bankers, and officials from the United States, Latin America, and Europe to a symposium on "The Role of Saving in Economic Growth," held March 18–19, 1994, at Houston's Woodlands Conference Center. This article summarizes the proceedings. In a statement to open the conference, Federal Reserve Chairman Alan Greenspan said: "We need to understand better the role of various factors determining saving currently and in the past so we can shape policies that encourage rather than discourage saving and investment. Only in that event will we be able to achieve sustainable increases in real output and standards of living for our respective countries."

America's low saving rate

Real-world observations on savings vary over time and among countries. The national saving rate, defined as a percentage of gross national product (GNP), is low in the United States compared with other industrial countries and most of the developing world. In recent years, U.S. saving hovered around 15 percent of GNP. In European nations, the rates are slightly higher. In Japan and other Asian economies, the figure often exceeded 30 percent in the past two decades.

The low U.S. saving rate troubles William J. McDonough, president of the Federal Reserve Bank of New York. "The saving decline has occurred across the board—by households, by



business in the form of retained earnings and by government, federal as well as state and local,” he said. McDonough cited Fed research estimating that the U.S. economy would have gained \$300 billion a year, or 5 percent of potential output, if the saving rate of 1961 to 1981 had prevailed during the 1980s.

Interestingly, the United States hasn't always been a low-saving country. From the end of the Civil War to World War II, saving and investment were much higher in the United States than in Europe or Japan. The U.S. postwar experience isn't unique, however. Other Western industrial countries show a similar decline in saving. For both the United States and Europe, a slight slippage of private saving has been worsened by growing public-sector dissaving, or deficit spending. Looking at developing countries, the situation is much different. There is a general upswing in saving and investment, which has become associated with a quickening of the pace of economic growth, particularly in East Asia.

The keys to saving

A nation's savings includes money individuals put into banks or invest in stocks, bonds, and other financial instruments. Companies also save in the form of retained earnings, but for the most part, the business sector taps into society's savings for capital spending. The public sector contributes to a nation's saving rate, either positively or negatively. Government borrowing for current spending can siphon funds away from productive investment, reducing the benefits of saving and investment to the economy. Conventional statistics often miss other spending that might properly count as saving. The list includes the acquisition of consumer durables and investments in human capital, especially education and training. Infrastructure projects add to a nation's productive assets, too.

Saving depends on myriad factors, many beyond easy control of policymakers. In his remarks, Greenspan identified many of the influences. Demographic characteristics, such as age and the population's average income, play a role. So might the riskiness of available assets. Uncertainty about jobs and future income can lead to extra saving as individuals seek additional secu-

urity. Inflation can induce households to save more to make up for the erosion of nominal assets' values, but it redirects funds into such unproductive activities as land speculation. Financial institutions' stage of development will determine how efficiently the savings of the private sector can be channeled to its best uses. The openness of the financial sector will affect how well an economy can attract savings from around the world.

Lamberto Dini, director general of the Bank of Italy, added psychological and cultural factors to the list of factors that influence saving. In ethics and religion, saving is praised. Personal experience is also probably important: the survivors of the Great Depression or World War II “developed a deeply rooted sense of prudence which led them to be more frugal than those who have no memory of the hardship brought by these tragic events,” Dini said. Guillermo Barnes, director general of development planning at Mexico's Ministry of Finance, said culture shapes saving behavior, too. In Mexico, he said, the father of a bride often will deplete his life savings on a three-day wedding party.

Institutional arrangements might also affect saving. In Asia, postal savings systems do a better job than banks in collecting the funds of small savers. In Chile in 1980 and Mexico in 1992, fully funded pension plans for individuals replaced taxpayer-funded schemes, simultaneously increasing the propensity to save and reducing the tendency for public-sector dissaving.

Dini offered an explanation for the decline in saving in the Western industrial countries. In Italy, where private saving fell from 18 percent to 12 percent of net domestic product in three decades, studies show that a slowdown in economic growth explains nearly two-thirds of the erosion of private saving. A threefold increase in benefits for the elderly accounted for an additional third. Another factor, more prevalent in other countries, might be financial liberalization, which allows households greater access to credit. As people buy more, their saving falls. In Italy, consumer credit is still rather thin, and Dini estimates that freeing it up would slice 2.5 percentage points off the saving rate. Household saving dropped 6 percentage points in the United Kingdom with financial deregulation between 1984 and 1988. Society's changing institutions, more-

over, might help explain declining saving rates. Greater availability of insurance and welfare programs may lead individuals to spend more freely, believing they are protected against most misfortunes. Dini rejected aging of the population as a significant factor in the decline in saving. Overall, he concluded, “I do not believe that private saving rates will recover significantly in the industrial countries.”

If saving fosters economic growth, governments will be tempted to try to induce more saving by offering incentives, often in the form of tax breaks. Dini contended that such rainmaking programs are more likely to alter the allocation of savings from one market to another rather than increase its aggregate level. Economic policy is more likely to stimulate saving by pursuing general objectives of stability and financial market flexibility than by offering specific incentives to savers, he concluded.


Latin America's experience

The economies of Latin America provide a prism for viewing saving and investment. Over the past 15 years, the region went through crisis and recovery. Many economic relationships were convoluted by bad policies, then restored by good ones. What's perhaps most intriguing, from a policy perspective, is saving's relationship to macroeconomic performance. In general, stability, with low inflation and responsible fiscal policies, favors saving and investment, both foreign and domestic. A wild ride with inflation and excess spending skew saving and investment decisions, eventually strangling growth. Axel Leijonhufvud, a professor at the University of California, looked at Latin America's record in the 1980s, finding that high inflation created massive uncertainty. The responses included shortening the length of contracts and avoiding certain types of transactions altogether, particularly long-term ones. In Argentina in the late 1980s, when inflation approached 30 percent a month, it was difficult to find much lending beyond 30 days. Capital flight is another way of dropping out of a risky, chaotic market. Leijonhufvud drew another, more hopeful lesson from Argentina's recent history: once stability returned to the economy, functional financial markets reemerged very quickly.

Vittorio Corbo, professor of economics at Catholic University of Chile, pointed out that his country's recent experience shows that saving does swing as a result of an economy's ups and downs. Chile's gross national saving rate fell from 12 percent in the late 1970s to 7 percent in 1981 and to an all-time low of 2.4 percent in 1984. The country suffered from external shocks and a sharp recession. The economy recovered in the mid-1980s, becoming the strongest in Latin America, and the national saving rate rose to a historical peak of 22.5 percent in 1992. Indeed, most empirical work suggests a strong correlation between a nation's saving and the growth rate of income, although the direction of causality can't be easily untangled. “It is a virtuous circle,” Corbo said. “A higher saving rate makes possible a higher investment rate, and [a] higher investment rate in a low distorted policy environment results in a higher growth rate, and the higher growth rate results in a higher saving rate, and so on. The challenge is to get the process started.”

Ariel Buira, director of international relations at the Bank of Mexico, presented a study of factors shaping saving in his country. Mexico shares many of the characteristics of developing countries, especially those in Latin America. Its saving rate is relatively high now—at 22 percent to 25 percent of GDP—and the economy suffered through several financial shocks in the 1980s. Buira finds savings positively correlated with income when looking at data for the period since 1965. The public sector also has a big effect. Each 1 peso reduction in deficit spending led to a 44- to 54-centavo increase in national saving. However, private saving fell by 46 to 54 centavos, revealing a trade-off between government and private saving that's less than one to one. “Public saving only partially crowds out private saving,” observed John Welch, vice president and market analyst at Lehman Brothers.

In Mexico, as in many other countries, there's an inverse relationship between saving and rising wealth, and between saving and the proportion of the population over age 65. These results support a lifecycle explanation for saving, which holds that people save to ensure adequate consumption after their working days end. The Mexican experience shows a higher saving rate for earners of nonwage income than for workers,



but the difference may not be all that important. Laborers still put away 19 percent of their pay, a figure not too far below the general rate. Inflation-adjusted interest rates have only a marginal impact on saving.

Buira's research provided some insight into some unusual aspects of Mexican saving. The first involved effects of financial upheaval. Saving was higher than it probably should have been from 1981 to 1985. Buira suggested Mexicans realized income gains in 1981 were transitory, thus they saved. A severe contraction of credit and real wages boosted saving after 1982. Saving fell below its predicted path in 1986, largely because of a rise in public dissaving. The second phenomenon is a troublesome decline in Mexico's saving in the late 1980s and early 1990s. A host of factors might be at work, but Buira stressed two of them. An increase in wealth from a boom in stock market and real estate prices led to more consumption and less saving. A cut in the budget deficits left private-sector incomes lower, thus reducing the ability to save.

Barnes added that it will be important to determine whether some of the factors affecting Mexico's saving and investment would be temporary or permanent. In his mind, the reduction in public-sector dissaving will last. The increased consumption of durable goods from abroad owes itself to pent-up demand and may not endure. "In Mexico, we are convinced that savings are a necessary but not sufficient condition for growth, and those savings have to come from the country itself," Barnes said. "In Mexico, we are also convinced that the financial sector plays a crucial role in the saving and investment process. Therefore, important efforts have to be made to have a more efficient and competitive financial system."

A high saving rate, by itself, isn't enough to guarantee growth and progress. Societies must funnel resources toward productive uses. Many of the centrally planned economies established good saving performances over the past twenty-five years, but the absence of market mechanisms caused investment to inefficient and economically wasteful projects. The economies stagnated and eventually collapsed. Markets are not foolproof either. Excessively cheap lending by the U.S. savings and loan industry in the 1970s and early 1980s left an embarrassing legacy of unwanted

real estate. "It's a mistake to believe that there is an automatic and inflexible link between a high level of saving and a high rate of growth," said the IMF's Mussa.


Government's role: Repression or liberalization?

If saving and investment are a big part of what makes an economy grow, the have-not nations aspiring to join the world's haves will possess plenty of reasons to learn what they can on the subject. Interestingly, the saving part of the equation isn't necessarily a problem in developing nations. Most poor countries outdo the wealthier ones by setting aside a larger portion of GDP. Among the reasons for this: populations tend to be young, people don't have the safety net of the rich nations, and consumer credit is scarce. With saving usually available, the critical element for growth will be how well a society mobilizes its savings and directs it toward productive uses. That, of course, will depend on the institutions, regulations, and practices that shape financial markets.

A crucial question is whether governments can do a better job than financial markets in allocating savings and investment. If that's the case, the creation of efficient financial markets can be left on a back burner. In the early post-World War II years, policies aimed at directing saving and investment were popular. Central banks in many poorer nations kept interest rates artificially low, with the intent of promoting additional investment. Regulations restricted capital flows in an attempt to keep resources at home. Various government schemes tried to channel money into preferred projects.

Do these policies work? The real world seems to offer many contradictions. Japan in the 1950s and 1960s and Korea until the mid-1980s apparently succeeded with interventionist governments. Hong Kong and Singapore had less meddling but still developed rapidly. Many countries with interventionist policies had initial success in boosting growth rates but later paid a heavy price as economies crumbled—the former Soviet Union in its heyday; Argentina, Brazil, Mexico, and other Latin American countries in the late 1970s; Poland and Yugoslavia in the 1980s.

Allan Meltzer, professor of political economy



and public policy at Carnegie–Mellon University, made the point that it's difficult to make an iron-clad case either for or against intervention in saving and investment. Theoretical propositions are contradictory; the evidence of experience is inconsistent. For example, relying on private capital markets instead of government borrowing or guarantees in Latin America might have produced slower growth in the 1970s. Market mechanisms, however, probably would have yielded faster growth in the 1980s, when governments had to stifle demand and investment to keep creditors at bay.

The state may indeed direct resources to efficient uses, especially when investing in technologies that proved their worth elsewhere. Even so, government-directed saving and investment raises a number of problems. Low interest rates might inhibit saving and stifle development of the financial sector. Money can be diverted to less efficient or wasteful projects. Opportunities for political intervention, favoritism, and corruption increase with government meddling in financial decisions. Overall, Meltzer concludes that “repressed financial systems” haven't offered an advantage over liberalized financial markets: “Countries that allow interest rates to respond to market forces do not pay a penalty for higher rates; they generally benefit by getting greater efficiency (or more output) per unit or dollar invested.”

Meltzer sees the value of banks and other financial institutions: “Developed financial markets increase efficiency by saving transaction costs, by eliminating the costs of barter, by reducing costs of acquiring information, and increasing the efficiency of investment.” Yet, the benefits don't make a case for activist policies to promote the expansion of the financial sector itself. “When there is sufficient demand for a particular service, a competitive market will supply the service,” Meltzer said. “Government can help to keep financial markets competitive by permitting entry and expansion of domestic and foreign intermediaries and can increase efficiency by reducing regulation, reserve requirements and interest rate controls.”


Mexico's liberalization. Agustín Carstens, director general of economic research of the Bank of Mexico, agrees. In his mind, the government's role ought to be limited to offering efficient judicial, regulatory, and supervisory systems. “This

type of government intervention is necessary to keep financial institutions from overexposing themselves, and the wealth of their depositors, to risks that might be higher than socially desirable,” Carstens said.

In developing countries, intervention for many years had gone well beyond this, but a wave of financial liberalization gained momentum across Latin America in the 1980s. Mexico entered the decade with a mass of interest rate restrictions, domestic credit controls, fragmented financial markets, and high reserve requirements. Compulsory lending to the public sector crowded out credit to the private sector.

Mexico ended the decade by letting markets set interest rates. It reprivatized its banks. It eliminated reserve requirements on bank deposits in 1989 and a liquidity ratio in 1991. The government encouraged development of new financial intermediaries and the establishment of new commercial banks. The country had 18 banks at the time of privatization. It will end 1994 with 55 to 60 institutions, including as many as 25 subsidiaries of foreign banks. In addition, the North American Free Trade Agreement (NAFTA) will continue the opening and liberalization of Mexico's financial structure. Liberalization hasn't solved all of Mexico's financial market problems. For example, there's still a scarcity of long-term saving, but Carstens is counting on the government's new system of retirement saving to help. Barnes pointed to another risk: the inability of regulators to keep up with changes in the financial marketplace. “Financial innovation runs rapidly,” he said. “Regulation doesn't run rapidly. Sometimes supervision in practice may lag behind. This is where problems start.”

Did financial liberalization spur growth in Mexico? In a statistical study, Carstens did find a correlation between the new policies and a burst of economic activity in the late 1980s. Even so, the role of the reforms isn't clear. While freeing up financial markets, Mexico also pursued an aggressive stabilization program, cutting inflation and deficit spending. “It is difficult to distinguish between the effects of financial liberalization and those of the economic adjustment program on financial variables,” Carstens said. In the end, the proof that freer financial markets make a positive contribution to growth awaits better theoretical or



empirical foundations. Carsten’s practical advice: “Policymakers should act as if its contribution were meaningful. The social costs of not acting accordingly can far outweigh any benefits.”

Liliana Rojas-Suarez, deputy division chief for capital markets and financial studies at the International Monetary Fund, noted that initial conditions shape financial liberalization. Often, the legacies of years of government intervention in banking and finance don’t give financial reforms a solid ground on which to start. Banks might hold assets lent at below-market rates, or they may be plagued by nonperforming loans. There might be stifled demand for credit. “The problem with liberalizing financial markets is that after years and decades of financial market repression, the financial sector didn’t know how to behave as intermediaries,” Rojas-Suarez said. “The issue is not ‘to liberalize’ or ‘not to liberalize’ but when to liberalize.” In Argentina, for example, banking problems triggered an intervention that led to hyperinflation because the overexpansion of credit did not stop. Chile faced a similar crunch, and it avoided a price explosion by interjecting money on the condition that banks restructure and reform themselves. Importantly, real interest rates remained positive in Chile, so the country did not go through the hyperinflation of excessive credit creation.

According to most economists, reducing deficit spending can benefit saving in two ways. Directly, it will reduce the drain on domestic saving caused by the need to finance the public sector. Indirectly, cutting red ink will reduce excesses that often lead to high inflation. Public indebtedness plagues just about every Western industrial nation. In the United States, a succession of deficits since 1960 has left public debt at 60 percent of annual gross domestic product (GDP), with perhaps an additional 40 percent in invisible liabilities, Social Security, and public pensions. “A key issue in terms of improving the national saving performance and making room for the finance of a higher level of investment needs to focus on diminishing both the visible and invisible components of public-sector dissaving,” Mussa said.

A contrarian view came from Robert Eisner, a professor at Northwestern University. He argued that most notions of saving and investment neglect the driving force of economic growth. There’s


little incentive for companies to invest in a stagnant economy and thus little need for additional saving. “If output stops growing, the stock of capital cannot increase,” Eisner said. “Perhaps the decline in the net saving ratio is a consequence, not a cause, of the slowing of our rate of growth.”

Eisner’s emphasis on growth leads to an iconoclastic slant on deficit spending with respect to national saving. In 1992, gross saving and investment in the United States totaled \$741.4 billion—\$986.9 billion in private saving, less \$269.1 billion on public dissaving (plus a statistical discrepancy). In the conventional view, raising taxes or cutting government spending would reduce budget deficits and thus increase saving. Eisner doubts it. Raising taxes would leave Americans less to save. Cutting spending would reduce incomes and the ability to save. Furthermore, when consumers have less to spend, they buy less, hurting businesses’ sales, production, and investment. Eisner asks: “Is the Chrysler Corp. going to invest more or less if you stop buying?”

As a result, Eisner opposes cutting the budget deficit as a remedy for America’s low saving. Quite to the contrary, he sees the nation’s problem as slack growth. It would be a mistake, then, to reduce the government’s economic stimulus. Another issue arises out of the failure to recognize that some government spending is properly regarded as investment—education, infrastructure, health and research, for example. With this included, the government dissaving falls to \$96.7 billion. Budget cutting will reduce public-sector investment, Eisner said, and the decline will not be offset by the private sector. The economy will suffer. In an empirical analysis, Eisner finds a positive relationship between deficit spending and investment. Each percentage point of red ink as a portion of GDP added more than 1.2 percentage points to gross private domestic investment as a portion of GDP. Eisner’s bottom line: “The solution to imagined or real problems of an insufficiency of saving would not appear...to be found in reducing or eliminating the budget deficit, or in monetary tightness to slow down the economy.”

Thy neighbor’s saving

Today, money can move quickly across borders. The opening of financial markets and



new technology have made it easier for investors to seek higher rates of return outside their own countries. Today, companies routinely invest in enterprises abroad, and individuals buy stocks or bonds on overseas markets. One view of the world envisions a great savings pool: every saver throws surplus income into a pot. Those with projects to finance dip into the pot, at least as long as the investment yields a positive value at prevailing interest rates.

Conference participants doubt this is the way the world works, even in an age of highly integrated financial markets. Low-saving countries aren't likely to make up for their shortfalls by tapping the saving of foreigners. Dini said: "My own view is that we will certainly see greater international integration and mobility of capital, but also that it would be illusory and dangerous to believe external capital can substitute [for] rather than complement domestic saving."

National savings still vital. Mussa assessed some of the evidence against the notion of a single savings pool. The international ebb and flow of capital shows up in each country's balance of payments statistics. Capital importing countries run a current account deficit, and exporters run a current account surplus. In recent years, the United States emerged as a major magnet for foreign money, with a current account deficit as high as \$168 billion in 1987. Japan has become the world's largest capital exporter, running a current account surplus of \$140 billion in 1993. Even so, current account deficits or surpluses rarely exceed 3 percent of GDP for industrial countries, meaning that net capital flows generally aren't a dominant factor in any country's total savings and investment.


A single savings pool, moreover, would send money flowing here and there until all countries offered the same rate of return. However, inflation-adjusted returns differ from one country to another, even for publicly traded assets. Once again, the evidence is that financial markets retain a national character. What's more, some types of investment—reinvested profits and improvements in human capital, for example—don't generally flow through financial markets. Mussa concluded: "A national economy such as [that of] the U.S. cannot escape the implications of a low saving rate by expecting to draw on the

world pool of saving. If saving is low in the U.S., that will translate into an effect on investment in the U.S. and, in effect, on growth."

With foreign investment no longer anathema, developing countries are opening their financial markets and welcoming money from overseas. In some capitals, the foreign funds are regarded as a linchpin for growth. The inability of foreign savings to compensate for low domestic savings carries a message for these nations. The emerging economies may be able to get some help from foreign investors, but their own savers will have to bear most of the burden of supplying capital to fuel growth. The same applies to the former Soviet republics, Eastern Europe, and China. They will have enormous needs for new investment. Mussa estimated it would require \$8 trillion just to raise living standards in the former Soviet Union and Eastern Europe to half that of Western Europe and China to a third of those levels. In each case, virtually all of the money will have to come from the country itself, Mussa said.

Moises Schwartz, the Bank of Mexico's deputy manager for monetary policy, worries that Latin American countries in the 1990s may be relying too little on domestic savings and too much on foreign capital. "This source of financing can disappear rapidly," he said. According to Schwartz, another problem could be the bidding up of currency values, which may dampen growth for countries that are looking to exports for economic development.

Stephen H. Axilrod, vice chairman and director at Nikko Securities Co. International in New York, agreed that long-term reliance on foreign capital is a chimera, but he contended "there are moments in time where you can get real benefit from net flows of capital from abroad." The United States in the 1980s and early 1990s might be a case in point. The country ran huge budget deficits at a time of sagging saving. Private investment didn't suffer as much as it might have because the country was able to run current account deficits, a sign of importing capital. "I am beginning to think it helped to protect our standard of living to a degree, while we were going through a rather radical restructuring of our domestic industry, thereby in the end making us more competitive." Axilrod acknowledged that all foreign money isn't equal. Countries should prefer



direct investment, which brings skills and technology helpful to development, over portfolio investment, which may bring general savings from abroad but can be highly volatile. A herky-jerky flow of foreign money can be unsettling for an economy, especially one that's not fully developed.

The 1980s roller coaster. The Latin American debt crisis is evidence that money from overseas isn't always a blessing. A great inflow of other people's savings came into Mexico, Argentina, Brazil, Chile, and other countries in the wake of the oil boom in 1979, lent largely through international banks. In 1981, for example, Chile experienced a capital inflow equal to 15 percent of GDP. Economic growth did perk up, for at least a little while. When economic shocks caused international lenders to lose faith in Latin America, the money stopped, and Latin America suffered through a miserable decade of hyperinflation, stagnant output, and falling standards of living. "It was worse in some countries than the Great Depression was in the United States," UCLA economist Arnold Harberger said.

If the money flows hadn't been so large, the problems might have been smaller, but Harberger finds structural factors and policy responses worsened the crisis. Latin America's dependence on agriculture and mining, for example, made adjustment to the slowing of foreign investment especially difficult. Unlike manufacturing, these industries can't quickly increase exports to generate foreign exchange. Supply is inelastic, and it takes a long time to find alternatives to foreign money. Korea, a manufacturing dynamo, also had debt problems in the early 1980s, but it didn't suffer nearly as much. Its factories could quickly make up for any change in investment flows. Harberger also sees a "hot stove syndrome" in Latin America: citizens burned time and again by the economy's zigs and zags adopt a short-term planning horizon that only adds to instability.


On policy matters, Harberger focused on inflation-adjusted exchange rates. With flexible exchange rates, a big inflow of capital ought to force an appreciation of a country's currency. A sharp slowdown calls for a depreciation. In Latin America, however, exchange rate policies tended to aim at stability in nominal terms against the dollar. When there are negative shocks, necessary adjustments to changes in the nominal ex-

change rate are short-circuited, leaving the adjustment to occur in falling domestic prices. If the deflation entails an economic slowdown that's too difficult for the government to handle, then there's usually a sudden, large devaluation. When they come, the devaluations, inflations, or other shocks are huge.

Argentina in the 1980s provides an example of misguided policy. The government allowed the exchange rate against the dollar to slip on average just 1.25 percent a month. Domestic prices rose much faster, at about 6 percent a month, in part due to the stimulus from the capital inflows. In effect, Argentina pursued a policy of paying a real return of 4 percent to 4.5 percent a month to holders of its currency. Had the authorities managed the real exchange rate by allowing a devaluation of 6 percent a month, Harberger said, the later collapse and crises could have been avoided, or at least substantially reduced.

The key to avoiding crises lies in stabilizing real exchange rates. A few countries have done it, but Harberger argued that monetary instruments alone will be insufficient. Many Latin American countries in the past resorted to trade restrictions. Interest rates are another tool, but they can be only partly effective in countries that aren't fully integrated with world capital markets. These actions may not be the wisest course for a region that relies on agriculture and mining instead of manufacturing and that embodies the short-term outlook of the hot stove syndrome. Obtaining the desired results on real exchange rates, Harberger said, may take a dose of strong medicine—a 200-percent tariff or a very large increase in interest rates. These, however, could have very costly side effects. "In the end, the equilibrium real exchange rate has its own life, and it's hard to influence by instruments that we like," Harberger said.

Another debt crisis can't be ruled out, especially in a region that's getting a strong flow of foreign money. Yet, Harberger contended that recent changes in the region make it less likely. For starters, with more manufacturing, there's been a diversification away from agriculture and mining. The stability of economic policy will improve long-term confidence. Finally, financial reforms are allowing markets to set interest rates and exchange values, lessening the prospects for policies that will allow pressure to build.



Roque Fernandez, chairman of the Central Bank of Argentina, said countries that maintain sound economic policies at home have a better chance of avoiding destabilizing capital flows. In Argentina, economic reforms of the late 1980s were negated by massive government borrowing and hyperinflation. "All of the saving and time deposits were government debt," Fernandez said. "Any expectation of inflation that built up in nominal interest rates or produced higher interest rates was an increase in the deficit that sooner or later would have to be repaid by printing money." The government failed to convince Argentines that it was serious about rectifying the fundamental imbalances in the economy, and the national pastime became protecting wealth by investing in dollars. Government policy became an exercise in trying to stop capital flight.

The current reform effort in Argentina has the confidence to allow unlimited convertibility of pesos into dollars. "We just gave up the idea of forcing people to hold pesos," Fernandez said. "It was impossible to control capital flight outside the country." Most significant, in Fernandez's view, the internationalization of the capital market has been accompanied by a fiscal reform that has eliminated crowding out of private borrowing by government debt. As a result, Argentina isn't likely to fall into the short-term trap of raising interest rates to prevent a temporary ebb of money overseas. Capital flows into Argentina are coming to the private sector, not the government.

Easy convertibility does pose risks. Argentina will import any instability that might affect the United States. There's a chance of renewed capital flight, presenting Argentina with Harberger's dilemma of deflation or devaluation. Fernandez contends Argentina would be better off maintaining its fixed exchange rate policy and weathering any decline in the domestic economy. Failure to honor the pledge of convertibility would carry the additional burden of eroding the hard-won credibility of the government's fiscal policies. "We believe one sure way of having a reversal in the capital flow is to have a reversal of the structural reforms," Fernandez said. "If we go back to the old policy of nationalization of public enterprises or running our economy with big deficits financed by printing money, surely we will have a real depreciation of our currency."

The arrival of NAFTA. The North American Free Trade Agreement will affect saving and investment in the United States, Mexico, and Canada. Eventually, it may impact other countries if free trade expands farther into Latin America. According to Edward W. Kelley, a member of the Federal Reserve System's Board of Governors, NAFTA will facilitate the integration of the continent's financial markets through provisions for capital mobility, unrestricted market entry, and effective but nondiscriminatory regulation. According to Barnes, Mexico expects to benefit: "NAFTA will create a better and more competitive financial system in Mexico, improve the financial technology and innovation."

The new openness should improve the allocation of resources in North America. In fact, emerging patterns of cross-border money flows can already be detected. After implementation of the U.S.–Canada free trade pact in 1989, the United States quickly became a net exporter of capital to Canada for the first time in a decade. Mexico's inflows began rising even before the trade deal became official, and Kelley expects the movement of money to the south to continue.

Edwin M. Truman, staff director of the Division of International Finance for the Fed's Board of Governors, said NAFTA brings together nations that might not be setting aside enough money to meet their investment needs. "The first thing, perhaps, we should worry about is the fact that all three countries have declining saving rates," he said. "From that perspective, some have suggested that this [NAFTA] is not the ideal combination of countries." Truman noted, however, that under NAFTA's market integration there is increased mutual interest in the success of policies that are beneficial to all partner countries.

The new trade agreement might expose the United States, Mexico, and Canada to real or financial shocks beyond their immediate control. Both Kelley and Truman stressed that North American financial integration of the financial markets put a premium on policy consistency and cooperation. Truman saw a need for greater cooperation in banking supervision, including such topics as interstate banking in the United States. "Policymakers must be on their toes, alert to deal with problems, real and perceived, anticipated and unanticipated," he said. Kelley con-



tends that sound macroeconomic policies will become more important. “A country with inappropriate or unstable policies, such as persistent fiscal deficits or low domestic savings, may have difficulty in attracting foreign investment, especially if investors perceive significant risk of repayment problems,” Kelley said. “Such an economy may also experience capital flight.” Monetary policies, moreover, need to keep price increases from diverging too far from the inflation of neighboring nations. In the past seven years, Mexico eliminated its budget deficit. U.S. attempts to reduce its red ink have been less successful. The Canadian deficit at 5 percent of GDP presents a challenge to the new government of Prime Minister Jean Chretien. If the United States and Canada can reduce their deficits, public borrowing will cease to dominate the capital flows in North America. “As the largest economy in North America, the United States must pursue sound policies, not just in its own interests but also because U.S. policy actions can have serious repercussions for its regional partners,” Kelley said.

The banking sectors in Mexico and Canada are much smaller than that of the United States. Both countries will face the possibility of competition with the opening of their markets. John Chant, a professor at Simon Fraser University in British Columbia, expects NAFTA to have little impact on Canada’s domestic banking industry. Nationwide banking makes Canada’s institutions the size they need to compete. Extensive, geographically dispersed networks of branches makes it expensive for newcomers to gain a foothold in the market. “Canadian banks will not have to worry much about the home front,” Chant said. Rather than inroads by U.S. banks, Chant foresees opportunities for Canadian banks in the United States, especially with the removal of barriers to interstate banking. Canadian banks are already established in the

United States, and they understand well how to operate branch systems. Ricardo Guajardo, director general of Grupo Financiero Bancomer in Mexico City, believes that Mexico will experience a significant increase in U.S. and Canadian competition in both the consumer and corporate markets. NAFTA phases in the opening of Mexico’s market, giving domestic banks some breathing room, but eventually they will have to adjust. “We have to reorient the way we do business,” Guajardo said. “We have to obtain a high degree of specialization. We have to have a very clear focus on where we can compete and where we cannot.”

Conclusions

The Dallas Fed’s conference on saving coalesced around several conclusions: saving is important to economic growth because it promotes investment and technological progress. Many factors influence saving, but from a policy perspective, low inflation, sound fiscal policy, stability, and financial liberalization increase at least the efficiency of saving. Even in a world of increasingly large cross-border capital flows, nations still rely overwhelmingly on their own domestic savings. Open capital markets carry risks, but they will be minimized in countries that avoid excesses in fiscal and monetary policies.

In most respects, these conclusions centered on the ideological trends shaping the 1990s. Countries in most parts of the world—especially in Latin America—are moving away from reliance on government and toward free market policies that emphasize macroeconomic stability. These policies may not be coming into favor primarily with saving in mind, but it is reassuring to know that they help with what’s now recognized as an important component of an economy’s long-term prospects.