



DOMESTIC RESOURCE MOBILIZATION

TRENDS IN SAVINGS AND INVESTMENT

The largest share of financing for development has to originate from domestic resources. This is an inescapable necessity. Official development assistance has been declining. The tremendous increase in international private capital flows has bypassed the overwhelming majority of developing countries and a significant part of such flows is highly volatile, responding to the vagaries of unpredictable market sentiment. Data on savings and investment in the ESCAP region since 1985 show that overall the ratio of savings to GDP has been on a slight upward trend from around 21 per cent in 1985 to 29 per cent in 1999. This is a very positive sign for the region. However, when the overall picture is disaggregated, it is clear that this relatively high level of the overall savings rate is mainly accounted for by the high-growth countries in East Asia and South-East Asia. Four ASEAN members (Indonesia, Malaysia, Singapore and Thailand) as well as China; Hong Kong, China; and the Republic of Korea have all had savings rates greater than 30 per cent since 1990 (except Indonesia in the last three years). Savings rates in South and South-West Asia and the new members of ASEAN have historically been and remain, with a few exceptions, below 20 per cent. Most of the Central Asian republics also have quite low savings rates, two (Armenia and Kyrgyzstan) even having negative rates.

The contribution of government savings to overall savings has been small, or even negative, in most countries in the region. Indeed, the figures prepared by countries are probably overestimates as account has not been taken of off-budget expenditures and non-transparent subsidies. Thus, it is the private sector (households and enterprises) which generates most of the savings and stores them in monetary form for intermediation to investment. However, as government savings is a net concept, it is the level of resources raised by the government

relative to its level of recurrent expenditure which actually determines its capacity to undertake investment.

For the ESCAP region as a whole there is a relatively close correspondence between the savings rate and the investment rate. This implies that the region is generating almost enough resources itself for its development purposes. However, this is not true across subregions or countries. All South and South-West Asian countries, except the Islamic Republic of Iran, have had investment rates higher than their savings rates, implying a significant inflow of external resources. Much of this has come in the form of ODA, rather than FDI. This is also true overall for many of the Central Asian republics in recent years, where the domestic savings rate is about one half of the investment rate. (As exceptions, the Russian Federation has an increasing excess of savings over investment, whereas in Kazakhstan and Uzbekistan, the two have been almost in balance.) In South-East Asia and the Republic of Korea there has generally been a close balance between the savings and investment rates, except in the heydays of high growth in the early 1990s when FDI and other private flows surged in, and in the aftermath of the recent crisis when savings considerably exceeded investment. In most of these countries, except Indonesia, savings rates have been more or less maintained whereas investment rates have fallen considerably. Among these countries Singapore appears similar to China and Hong Kong, China where the savings rate has usually been larger than the investment rate and there has been a net outflow of funds.

THE DETERMINANTS OF PRIVATE SAVINGS

Analyses of the determinants of savings have been undertaken by economists over many decades with no conclusive result. The factors which motivate households or enterprises to save are many, complex and often interrelated. Most analyses

conclude that the most important factors are those related to economic growth (lagged savings, level of per capita income and growth rates of real per capita income), demographic structures and changes therein, as well as the degree of financial sector development. The results of one recent global study provided in table V.1 strongly support similar conclusions.

The capacity of a household to hold savings voluntarily in monetary terms depends mainly on the level and growth of personal income and its sustainability. Households also often keep their savings in non-monetary forms, such as gold bars, jewellery, land and buildings, livestock or other goods kept in store at the household level. The motivation to save in monetary terms depends crucially on the credibility and convenience of access to savings

Table V.1. The determinants of savings

<i>Determinants</i>	<i>National savings</i>		<i>Private savings</i>	
	<i>Global dataset</i>	<i>Global dataset</i>	<i>Global dataset</i>	<i>Developing countries dataset</i>
Lagged national (private) savings rate	0.381 (6.650)	0.587 (9.254)	0.476 (17.820)	
Real per capita gross national (private) disposable income ^a	0.102 (2.685)	0.049 (2.458)	0.071 (7.473)	
Real growth rate of per capita gross national (private) disposable income ^b	0.447 (4.831)	0.450 (5.828)	0.425 (13.282)	
Real interest rate ^{a,c}	-0.136 (-1.215)	-0.253 (-5.011)	0.002 (0.084)	
M2/GNP	-0.019 (-0.410)	-0.020 (-0.562)	0.024 (1.001)	
Terms of trade ^a	0.057 (5.243)	0.078 (5.096)	0.044 (4.875)	
Urbanization ratio	-0.500 (-3.373)	-0.382 (-3.538)	-0.240 (-5.101)	
Old dependency ratio	-0.772 (-1.687)	-0.655 (-3.069)	-1.370 (-4.321)	
Young dependency ratio	-0.156 (-2.236)	-0.299 (-4.017)	-0.279 (-5.816)	
Domestic credit flow/gross national disposable income	-0.359 (-4.136)			
Government saving/gross private disposable income		-0.285 (-5.097)	-0.238 (-8.333)	
Private credit flow/gross private disposable income		-0.318 (-3.989)	-0.508 (-9.955)	
Inflation rate ^{a,c}	0.180 (2.044)	0.143 (2.034)	0.177 (4.181)	
Number of observations (number of countries)	1 640 (98)	872 (69)	475 (49)	

Source: N. Loayza, K. Schmidt-Hebbel and L. Servén, "What drives private saving across the world?", *The Review of Economics and Statistics*, vol. LXXXII, No. 2 (May 2000), pp. 165-181.

Notes: Statistical significance computed using the generalized-method-of-moments system estimator, *T*-statistics (in brackets) computed with heteroskedasticity-consistent standard errors.

^a Expressed in log form. For the real interest rate and the inflation rate, log of $[1 + x]$.

^b Measured by the first difference of the log.

^c Both the real interest rate and the inflation rate are bounded between -50 and 50 per cent.

institutions. Once the capacity to save exists, savings decisions are influenced by several other factors. High and sustained growth in per capita income tends to increase the savings rate (see, for example, the large coefficient for both the level and the growth rate of per capita income in table V.1). Once savings rates start to increase, they are usually self-sustaining (hence the significance of lagged savings). However, the propensity to save may rise even though the economic growth rate stays the same, depending, inter alia, on the tax structure and government fiscal policies. For example, fiscal stimuli, such as lowering taxes or increasing spending or subsidies, can increase the savings rate. An important consideration in this context is the level and composition of taxes; high personal income taxes tend to discourage household savings. Various cross-country and time-series studies on savings behaviour indicate that growth in real GDP and real deposit rates have positive, and growth in fiscal deficits and foreign and domestic debt have negative, impacts on savings. Expectations of high inflation or an unstable macroeconomic environment or both create uncertainty in the system, especially for future growth. Public policies that reduce economic uncertainties, including keeping the rate of inflation down, thus have a positive impact on savings.

The influence of demographics is significant. It is clear that a transition to a smaller household size (lower fertility rates) can help improve the savings rate. Several cross-country studies show that both the rate of growth of population and the share of population below 15 years of age have a negative relationship with the savings rate.¹ At the same time a growing proportion of the 60 and over appears to have a negative impact. The net effect on per capita savings depends on the initial conditions, such as the share of individual cohorts in the total population and the rate of participation in the labour force. Increasing urbanization is sometimes seen as negatively related to savings owing to the better availability of consumer and other goods in urban areas, but this is of less significance when rural and urban differences are reduced.

¹ For example, evidence from South-East Asia indicates that a reduction in population growth increases the savings rate by reducing the young dependant cohort. See Stefano Manzonchi, *Foreign Capital in Developing Economies: Perspectives from the Theory of Economic Growth* (New York, St. Martin's Press, 1999), pp. 49-51 and 123-125.

The sensitivity of national or private savings to real interest rates is ambiguous in most studies. However, there is some evidence that the significance of the interest rate on savings rises as the income level of a country increases. For the very poor developing countries, the coefficient is rather low and in most of these countries it is not even statistically significant. However, interest sensitivity for middle and upper-income groups is relatively much higher.² This is probably related to the degree of development and use of the financial sector, particularly banks and other savings institutions. It should be noted, however, that any positive relationship between the interest rate and savings can be outweighed by the negative effect of increased consumption expenditure permitted by easier consumer credit and expanded use of credit cards. In fact, as shown in table V.1, there appears to be a significantly negative relationship between flows of credit and savings, particularly in developing countries.

As mentioned earlier, the willingness of the public to save in monetary terms is influenced by the functioning of financial markets.³ For example, as financial repression forces financial institutions to pay low and often negative real interest rates, it can result in a reduction of the amount of household savings held in these institutions, and therefore makes it more difficult to intermediate savings to investment. A high level of NPLs reduces the confidence of potential depositors in the ability of banks to honour their deposits, thus inducing a lower supply of funds to them. A large share of bad loans in the portfolio also induces banks to widen the spread between borrowing and lending interest rates, and so to make the returns on savings accounts less attractive. Accordingly, reform of the financial sector of an economy in terms of improving the functioning of financial institutions and reducing

² Masao Ogaki, Jonathan Ostry and Carmen Reinhart, "Saving behaviour in low- and middle-income developing countries: a comparison", *IMF Working Paper WP/95/3*, 1995, pp. 25-26.

³ The financial sector development comprises liberalization, deepening and broadening. Liberalization implies removal of entry barriers, reduction of directed credit allocation, deregulation of interest rates and removal of controls on inflows and outflows of capital. Financial deepening involves the growth of financial instruments measured by the ratio of turnover in the financial sector to GDP. Financial broadening refers to an increase in the variety of financial institutions and instruments in a country.

NPLs can help significantly in increasing the savings rate. It appears that financial deregulation leads to higher savings mainly in the longer run. While some countries show immediate positive results from such deregulation, in others the negative short-term association which has been observed is attributed to increased consumer spending because of more liberal access to consumer credit.

Corporate savings can be important in the aggregate savings rate of an economy, but they are difficult to estimate. Many firms in Asia, particularly those that are family-owned, save in the form of retained earnings, which are then reinvested in the business. These savings are not recorded in any systematic way. In all countries the majority of firms have used only bank loans as a source of investment finance. This practice has not led to any systematic demand for corporate transparency because of client-related banking practices and so retained earnings are not properly reported. However, firms listed on stock markets or firms that issue bonds have to meet the related reporting requirements on their earnings profiles. These are the firms for which it is possible to report corporate savings. For example, in Taiwan Province of China, it is reported that they account for almost one quarter of the total savings. It is known that fiscal measures can be used to encourage corporate retention; a tax structure that creates incentives to retain profits may result in a higher level of corporate savings.

As the motivations for savings are complex, and not easy to address in a policy format, it seems preferable to concentrate the analysis of domestic resource mobilization on the instruments available to savers for storing their funds and the institutions which hold these funds and intermediate them to investors. If savers have access to a diversified array of instruments in well-regulated, supervised and sound financial institutions in their own country, they will most likely put their cash savings in these instruments. If they face a narrow range of instruments in poorly supervised and financially insecure financial firms, they would prefer to save in non-monetary terms or park their savings abroad. Therefore, the following sections review the instruments and institutions available to savers in the ESCAP region, analyse the problems being faced and the reforms under way, and suggest further actions to widen the range of attractive instruments and strengthen the institutions offering them.

INSTRUMENTS AND INSTITUTIONS

The principal instruments in the ESCAP region to attract private-sector (both households and enterprises) savings have been bank deposits of various sorts. There has been very limited diversification in most developing economies into the holding of stocks, bonds and related financial instruments, and some development of pension and insurance funds as well as postal savings or unit trust systems, provident funds and other institutional forms for holding deposits. In a large- and medium-sized economy there should be a more diverse financial system with not only banks (and equity markets) but also markets for longer-term instruments such as public and private bonds and mortgage markets, as well as institutional investment groups such as pension funds, life insurance and mutual funds and various non-bank financial institutions. There is also a need for some securitization modalities⁴ particularly for infrastructure development and real estate markets. For smaller economies, the banking structure might be better complemented with access to capital markets of larger neighbours or regional capital markets, as domestic ones would be too small, too shallow and too thin to be viable. Nevertheless, the development of a professional and modern banking system remains crucial for all countries.

The sound functioning of a financial system requires both the internal discipline provided by market forces and the external governance provided by regulation and supervision. The regulations that impinge on transactions in financial markets relate to governance arrangements, transparency requirements, financial accounting and auditing rules, debt covenants, and bankruptcy procedures. A well-functioning financial sector is one that has a transparent and efficient overall legal framework and administration, complemented by efficient and independent regulatory and supervisory institutions to reduce excessive risk-taking and moral hazard as well as an effective insolvency regime that properly balances the rights and obligations of debtors and creditors. The system should foster good corporate

⁴ Securitization is a means used by a financial institution to package a group of unrelated loans it has made (such as mortgages) into a security which can be sold to another financial institution and so clear its books of these outstanding debits.