INTRODUCTION

AKIRA KOHSAKA

ONE macroeconomic policy target for economic development is to expand the production capacity of an economy while maintaining both internal and external balances, where investment activity is supposed to play a rôle of an engine. There have been a lot of pros and cons over the role of selective monetary and fiscal policies for the purpose. Recently, increasing numbers of economists have suggested more use of market force than selective policies, and this "liberalization policy" has been put into effect in some Latin American countries from the 1970's on. As their diverse performances have indicated, however, we cannot generally tell whether or not the policy framework relying on market force is preferable for long-run development, without examining the institutional and structural conditions relevant for those policies above which are usually rather specific to each and every economy. Thus, it seems worthwhile at this time to reexamine the process of saving-investment interaction in the context of each economy's experience. This was the purpose of papers presented at the Workshop Conference on Monetary and Fiscal Aspects of Economic Development held at the Institute of Developing Economies, Tokyo, in March 1984. The present volume contains revised versions of some of these papers.

For development purposes, an emphasis has often been placed on investment promotion and, then, monetary and fiscal policies have been utilized to reinforce it in less developed countries (LDC's), whereas, at least relatively speaking, the expansion of domestic saving to support the investment has not always received adequate attention. One reason for this would be because it was believed that, since saving depends mainly on income levels, a priority should first be placed on an increase in income levels. As a result, policy measures have prevalently taken the form of low interest rate policies and credit rationing for monetary policies, and of various types of tax incentives for investment promotion for fiscal policies. We should note here that these measures have been applied selectively for preferred or key sectors as regarded by policy authorities.

These policies, however, have frequently yielded both internal and external imbalances; chronic inflation to finance large fiscal deficit through money creation and balance-of-payments deficit due to excess investment. Thus, economists like Ronald I. McKinnon and Edward S. Shaw favor deregulation of interest rates and market allocation of funds. That is, they assert that liberalization in various fields, including international trade and financial markets, would not only relax the I-S gap through mobilization of saving thereby controlling inflation

and diminishing external imbalances; but also accelerate expansion of production capacity through increased marginal efficiency of investment. It is emphasized here that the broad concept of "money" plays the role of "conduit" in transferring productive resources from savers to investors.

A paper by Warren L. Coats, Jr. and Deena R. Khatkhate reviews and summarizes mainstream discussion over the two roles of money and monetary policy in LDCs, i.e., stabilization in the short run and promotion of economic growth in the longer run, on the basis of the experience of the past decades. It is claimed that the longer-run role of monetary policy to enhance the function of "money" as a producer goods is far more important than its short-run role of stabilization.

For the latter, the endogeneity of money supply under pegged exchange rates and the supply-determined nature of output in developing economies are often raised as the reasons why discretionary monetary policy is ineffective. Moreover, Coats and Khatkhate disfavor this *active* monetary policy for stabilization pointing out its destabilizing character in the context of a financially repressed economy, which is described by Akiyoshi Horiuchi as the "abuse of monetary discretion."

As to the "developmental monetary policy" or the role of money for development, Coats and Khatkhate assert that its main aim is to efficiently utilize what is saved and that, for the purpose, raising real return on "money" in the organized sectors would play a crucial role in transforming *unproductive* savings into *transferable* ones. The former takes the form of real estate, precious metals and jewels, consumer durables, or other inflation hedges; the latter bank deposits or other liabilities of the financial intermediaries. They emphasize that what matters with the higher real interest rate is its effect on the *stock shift* between unproductive and transferable savings rather than whether or not it increases *flow* savings.[1] This leads to the proposition that the choice of a deflator in calculating the "real" interest rate is to rely on the portfolio choice of different assets (i.e., the relative rates of return from holding financial assets or physical goods) rather than on the consumption-saving decision (i.e., the real rate of return on an asset); though the choice among price indices is generally difficult in practice because of the asymmetry between lenders and borrowers, price distortion due to government intervention, etc.

Coats and Khatkhate seem to leave several issues open even within the above context which are not necessarily unambiguous. First, when the unorganized financial market is of significant size, the higher real interest rates may decrease financial intermediation through high substitution *within* transferable savings, that is, between financial assets in the organized and unorganized markets. Second, the (positive) responsiveness of flow saving to real interest rates may matter for the higher real rate to promote economic growth in a less inflationary way.

[1] Horiuchi suggested in his comment: Whether the higher real interest rates cause the desirable portfolio adjustment may depend on the distribution of asset holdings, because there is significant economy of scale in transaction costs with the adjustment. The more equal is the distribution, the less responsive the portfolio adjustment would be.

Third, increased transferable saving is a necessary, but not a sufficient condition for aggregate investment to grow in cases where the mechanism of fund allocation is imperfect. Particularly under financial repression where the abuse of monetary discretion is likely, one might possibly expect the magnified misallocation of saving. The first two points are discussed more in detail by Horiuchi and Kohsaka in different contexts, and the last point is dealt with by Itō in the case of Korea.

In the above context of the role of money for development, the monetary and fiscal policies during the postwar "rapid growth" period of Japan is of great interest. For, while the economic growth in those days was remarkable, it has been regarded that strict controls on interest rates and fund allocation by the monetary authorities were prevalent. If those controls were effective, postwar Japan could be a counter-example against pro-liberalization arguments including McKinnon and Shaw's hypothesis.

Akiyoshi Horiuchi's paper reexamines the role of the monetary policy in this broad sense for the period of postwar rapid growth (1955–70) in Japan, which has been called "the artificial low interest rate policy," defined as a "combination of regulation on some interest rates and comprehensive control on financial allocation." He sums up the conventional view as follows: first, the regulated interest rates on bank deposits and loans reduced financial costs for ultimate borrowers, especially business firms which played a dominant role in the "rapid growth"; second, administrative guidance of private banks influenced their loan supply behavior so as to allocate more funds to certain key industries than would have been otherwise allocated.

Horiuchi claims: first, while a part of nominal interest rates (the official discount rate and deposit rates) were regulated at the lower than market determined levels, they were not low even in real terms in comparison with those of other developed economies; second, theoretical consideration can show that whether or not controls on interest rates are effective in promoting economic growth generally depends on their effects on aggregate saving rather than their effects on the portfolio composition of the private sector. Therefore, since aggregate saving was not significantly positively related to interest rates, the pattern of economic growth was not essentially influenced by the existence of controlled interest rates; third, regarding bank loans which were the primary source of finance to private firms, it is not clear whether controls on nominal loan rates were effective, because "effective" loan rates were believed to be higher than nominal rates due to pervasive compensating balances; finally, though we cannot fully explain why Japan's saving rate was so high for the period, the relatively mild inflation resulted from a generally non-accommodative monetary policy might be one of the factors that determined the high saving rate.

Thus, summing up the above, Horiuchi concludes that, while there was little room for the interest rate policy to play any role in mobilization of saving, private banks obtained some implicit subsidy transferred from both depositors and the Bank of Japan under the artificial low interest rate policy; but it is not

certain whether or not the subsidy was transferred to the business sector and contributed to industrial development.

In his original version at the conference, Horiuchi indicated that there is no evidence that control of fund allocation was systematic, nor effective in attaining rapid growth.[2] Indeed fund allocation was controlled through loans of public financial institutions, government guarantees, and other direct and indirect measures; but it was so diversified both over time and among various types of industries such as growing and declining, large- and small-scale, etc., that the authorities did not appear to exert a systematic impact on fund allocation.[3] He conjectured that the control of the authorities over the mechanism of fund allocation was not systematic, but either ambiguous or "ad hoc," and thus we may say that market force played a dominant role in the allocation of funds.

In contrast with literature on selective credit policies, there have been few studies on the effectiveness of selective tax-incentives policies on investment, while they are potentially powerful measures for reducing capital costs to the key sectors from the fiscal side along with those from the monetary side, i.e., preferential low interest rates and credit allocation. This fiscal aspect is dealt with by the following two papers in the context of postwar Japan and recent Malaysia.

In parallel with the not uneven diversification in fund allocation claimed by Horiuchi, some economists have asserted that there was no differential *provision* of fiscal incentives for investment among industries in postwar Japan. Contrary to this assertion, a paper by Yukio Ikemoto, Eiji Tajika, and Yūji Yui shows that fiscal incentives for investment were *utilized* in a differential way among industries and over time for the period of 1963–80 in Japan. Concentrating on the two representative types of fiscal incentives—tax-free reserves and accelerated depreciation—they show that there existed significant differences among industries and periods in terms of the utilization of these incentives and the resulting tax-saving rates. For instance, in the case of accelerated depreciation, manufacturing industries utilized it more intensively than others. Particularly among the manufacturing, so was the case for both the declining (textile) and the growing (iron and metal) industries. Moreover, the tax saving rates of these industries increased steadily until 1970 and declined thereafter. As to whether or not these differential fiscal incentives have differential impacts on capital costs, and then investment decisions among industries, however, they do not conclude with a definite answer, thereby suggesting that further research is necessary.

A paper by Fong Chan Onn and Lim Kok Cheong is an attempt to examine the effects of the investment incentives policy on manufacturing investment in the recent process of industrialization in Malaysia. In addition to providing

[2] [1, Section III].

[3] McKinnon found this point quite instructive in his comment in that it constitutes a counter-argument against setting up a National Development Bank in the United States in response to Japan's industrial challenge.

unpublished data on disaggregated investment figures within the manufacturing industry, this paper shows to what extent tax incentives for investment have been utilized among industries and derives their implication for the choice of technologies. The paper is not only informative, but also seems to be a pioneering advance in this field.

Horiuchi's paper casts serious doubt upon the conventional view that the controls over interest rates and fund allocation had favorable effects on the "rapid growth" of postwar Japan. The paper suggests that the rapid growth was attained not necessarily under "financial repression," but under the relatively liberal financial system in practice and, thus, the deregulation of the controls would not have contributed to economic growth in the case of postwar Japan. Even if this were the case, however, it is not still clear whether or not abolishment of selective policies and/or deregulation in various fields are generally preferable for rapid growth in the context of financial repression. More specifically, as far as the total size of investable funds are concerned, the "high interest rate policy" is not necessarily successful in increasing available funds, under certain conditions on reserve requirement policy of the monetary authorities and portfolio balance behavior of the private sector. In particular, when substitution between transferable (financial) assets in the organized and unorganized markets dominates substitution between transferable (financial) assets and unproductive (non-financial) inflation hedges, higher reserve requirements and/or higher substitution between bank deposits and "securities" in the unorganized financial market tend to bring about *total* financial disintermediation.

Using a simple general equilibrium model of a financially repressed economy, a paper by Akira Kohsaka reexamines, first, the necessary conditions under which an increase in regulated interest rates or the "high interest rate" policy —one form of deregulation—is successful in both accelerating real growth and controlling inflation in a financially repressed economy with a significant scale of the "unorganized financial market" which is characterized by persistent inflation and the low level of saving. It is emphasized here that, in addition to these *stock shift* conditions above, the higher responsiveness of *flow* saving with respect to the real interest rate on bank deposits is also necessary for the successful high interest rate policy. Without this condition, the high interest rate policy accompanying an increase in "inside money" is shown to make no difference from the conventional policy of inflationary "outside money" creation.

Then, the paper examines the experiences of the high interest rate policy in Taiwan (the 1950s) and in Korea (1965–71) in terms of those conditions above by analyzing sectoral portfolio balance behaviors. It is indicated that, in contrast with the Taiwanese case, the Korean case showed mixed results of a successful high interest rate policy and conflicting monetary policies accompanied. That is, while bank deposits cumulated explosively with the private saving rate increasing remarkably, financial intermediation through the organized financial market did not expand proportionately in the short run because of

offsetting increased reserve requirements. Furthermore, the reckless provision of government guarantees allowed the firm sector to depend heavily on foreign loans in the longer run. As foreign loans lead to inflationary outside money creation, they could erode the desirable effect of mobilized saving. Thus the effects of the high interest rate policy should be evaluated separately from those of other policies undertaken simultaneously.

These conflicting policies contain two aspects to note. One is regulated credit allocation in the bank sector even under the high interest rate policy. The other is monetary accommodation with foreign capital inflow or how to cope with it in the process of liberalization. As to the latter, automatic provision of government guarantee to the export sector with accommodative monetary policy seriously eroded the performance of the high interest rate policy in the case of Korea. This point is discussed more extensively by McKinnon later on.

As for the former, if the organized financial market were not superior to the unorganized market in terms of the efficiency of fund allocation because of authorities' regulation and/or the overall immaturity of the financial market, the increased financial intermediation in the organized financial market by the high interest rate policy may not necessarily improve the efficiency of investment. Kazuhisa Itō's paper deals with this issue by examining the lending policies and profit/loss conditions of Korean commercial banks for the last decade. It is shown that the "preferential loans" constrained commercial bank lending so significantly that intermediation has no longer been the principal source of bank profits. This, he concludes, reduced the efficiency in fund allocation by banks on the one hand, and induced the monetary authorities to lose the monetary discipline through compensating banks' profitability with various measures on the other.

Under financial repression without adequate domestic saving, there are two alternative ways other than mobilization of saving via the high interest rate policy in order to finance the required level of investment for accelerated growth. One is to collect "inflation tax" by money creation, but it tends to lead to a vicious circle by lowering the saving rate further. The other is to utilize foreign saving or capital inflow. In cases where the expected rate of return of investment is so high that the short-run deficit in the current account can be financed by capital inflow and the current balance is expected to be sustainable in the longer run, then this "growth-cum-debt" policy could be the promising alternative. The reality, however, has not necessarily appeared to support the policy when we look at the performances of Korea as noted and of some Latin American countries these days. Why?

The final paper, by Ronald I. McKinnon,[4] finds its causes in the individual LDC's macroeconomic controls on the one hand and the imperfections of the

[4] The paper is originally to supplement McKinnon and Mathieson [4] which pursued second best policies subject to given economic repression, including the optimal reserve requirement, exchange controls and indexed exchange rates.

international capital market per se on the other. For the former, McKinnon claims that strict controls on sudden short-term capital inflows would be indispensable during the liberalization process. Because, first, at the initial stage of liberalization of trade and/or capital transactions, expectations of future profitability tend to be incorrect and give excess capital inflow due to lack of general equilibrium consideration or "macroeconomic myopia." Second, since pervasive government guarantees for borrowing from abroad make the riskiness undervalued or negligible, this "microeconomic distortion" tends to magnify the excess capital inflow above.

For the latter, McKinnon enumerates the imperfections as: (1) indifferent provision of government credit guarantees for international lending, (2) lack of regulation on commercial banks' risk-taking in their international lending and "external" effects of moral hazard induced by the deposit insurance system, and (3) underdevelopment of a long-term securities market. In order to prevent reckless risk-taking in commercial banks' international lending and to develop an international long-term primary securities market, he proposes that it is necessary to phase out official guarantees of private credits, to circumscribe deposit insurance, and to strengthen the regulation of the commercial banks' international activities.

Market imperfections as above are not limited only to the international capital market. Particularly, with regard to the roles of monetary and fiscal policies for economic development, it is not quite clear whether market force works as expected in those economies where discretionary policies are likely to be abused. Rather, the reality is that the policy authorities as well as the private sector are in the process of learning by doing. Moreover, as is seen in some of the papers, policy prescriptions along the line of deregulation may differ depending on different structures given. Accordingly, instead of extending general discussion over authorities' discretion versus market force, it seems necessary to attempt a positive and empirical analysis of the transmission mechanism of the monetary and fiscal policies under given structural conditions of each individual developing country.[5] This volume is intended as a step in this direction, and we hope its publication conveys the rationale of such a positive approach.

[5] One of the main issues for future research which is not mentioned in this Introduction is the difficulty inherent in the transition from financial repression to liberalization or "how to get there from here" as expressed by Coats and Khatkhate. Though they are skeptical about its presupposition of "a high level of technical sophistication and political discipline," the "order of liberalization," or a "scheme of carefully phased implementation of financial liberalization" is no doubt called for. McKinnon [3] and Kahn and Zahler [2] are studies in this direction.

REFERENCES

1. HORIUCHI, A. "Economic Growth and Financial Allocation in Postwar Japan," paper presented at the Workshop Conference on Monetary and Fiscal Aspects of Economic Development held at the Institute of Developing Economies, March 1984.
2. KAHN, M. S., and ZAHLER, R. "The Macroeconomic Effects of Changes in Barriers to Trade and Capital Flows: A Simulation Analysis," International Monetary Fund, *Staff Papers,* Vol. 30, No. 2 (June 1983).
3. McKINNON, R. I. "The Order of Economic Liberalization: Lessons from Chile and Argentina," in *Economic Policy in a World of Change,* ed. Karl Brunner and Allan Meltzer, Carnegie-Rochester Conference Series on Public Policy, Vol. 17 (Amsterdam: North-Holland Publishing Co., 1982).
4. McKINNON, R. I., and MATHIESON, D. J. *How to Manage a Repressed Economy,* Essays in International Finance, No. 145 (Princeton, N.J.: Princeton University Press, 1981).