

Domestic Savings And International Capital Flows In Developed And Developing Countries

(A cross country study)

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INTRODUCTION

One way or the other the role of capital has never been detracted from the theory of economic growth. In whatever manner the theory is developed one of the major focus coming into the discussion has always been the capital investment. Productivity does not increase in itself, some investments must be made whether it be to strengthen the human capital or to develop physical infrastructure. It may also require some investment to enhance research and development, to build an entrepreneurship and put innovation into practice.

If an economy has to grow, investment is a must, no matter how the investment is carried out. But it is generally observed that the poor countries in the world are already so poor that they cannot save much. There are a lot of theories which try to examine the determinants of saving. Here we are not after the theories of saving. Whether the people save willingly or are forced to save by the government through various policies, a country must save to enter into the development process, if it is not already developed. Even to maintain and run the existing capital a minimum of 15 percent of the GDP is expected to be invested in the economy. But savings of many poor nations do not meet the minimum requirement either. The average gross domestic saving of the least developed countries is only about 5 percent of total GDP. Some countries like Bangladesh, Benin, Central Africa and Tanzania have the gross domestic saving less than 2 percent of their GDP in 1988 (Appendix A). If the investment is expected only through the domestic savings, the growth of that economy would no more than a fairy dream. This problem has long been recognized. However, investment can be carried out from the savings of other nations whose domestic saving is higher than their domestic investment. So if we want to know whether the countries in need can invest from the 'pool of global savings', it will be of our interest to know how mobile the international capital is across countries. Feldstein & Horioka (1980: 314 - 29) argue that with perfect capital mobility an increase in the saving rate would cause an increase in investment in all countries, the distribution of the incremental

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capital among countries would vary positively with each country's initial capital stock and inversely with the elasticity of country's marginal product of capital.

Here we are interested to know how the rate of investment responses with the rate of savings. If capital is mobile between countries we would expect most of the incremental saving will leave the home country if it is a capital exporter or will replace other foreign source capital that would otherwise be invested in the home country if it is a capital importer. The degree of capital mobility among countries has important implications for various economic issues. It is important to determine optimal saving policy, it is crucial for analysis of tax incidence, it is important for foreign exchange rate determinations and lot of other issues.

In this paper we will examine the relation between domestic savings and international capital flows on similar line that Feldstein and Horioka (1980: 314 -29) have taken for OECD countries. We will examine that relation here for developing and developed countries to see whether there is any significant difference between them. We will also try, in a sense, to overcome some of the short comings of their model as pointed out by Murphy (1984: 327 - 42) and Fry (1986: 57 - 73). However, due to various resource constraints we will restrict our analysis to cross country examination on 1986 data. For this study a total of 93 countries are selected of which, 13 are least developed countries as of OECD classifications, 7 countries are from OPEC, 19 are developed countries and the rest, 54 are middle income developing countries. (Since the financial markets are in very rudimentary stage and almost non-existent in the least developed countries, later, we will drop these countries from the group of developing countries in our analysis. However, we will include OPEC members in the group of developing countries). All necessary data are obtained from World Development report, 1988.

THEORETICAL FRAMEWORK

From the point of national accounting, the resource balance is the difference between gross domestic saving and gross domestic investment.

$$R = S - I$$

If R is negative it implies a capital inflow in that country and if it is positive it implies a capital outflow from that country. So R can be interpreted as a foreign investment flow. With low saving rate, countries generally end up with negative resource balance. Low income countries are in dire need for high level of investment to push their economic growth further. In other words, if investment level is high and if the investment is not coming from within the country, the country must manage to get it from outside. Then resource balance, R will be negative. But higher investment alone does not imply that country will have negative resource balance. Saving may be high to

match the investment. Thus the examination of resource balance in a sense is an examination of domestic savings and domestic investment.

To examine the relation between saving rate and investment rate we will estimate the equation of the form

$$(I/Y) = \alpha + \beta(S/Y)$$

Or,

$$i = \alpha + \beta s \dots\dots\dots (I)$$

- Where *i* : Ratio of gross domestic investment to gross domestic product (= I/Y), and
 s : Ratio of gross domestic savings to gross domestic product (= S/Y) -

We expect $0 < \beta < 1$

if β is close to zero gross domestic investment is not affected by the gross domestic saving, which implies that there would be a perfect capital mobility and that an increase in the saving would cause an increase in investment in all countries not only in the country concerned. On the other hand if β is close to one, whatever the country saves will be invested in that country which implies that the capital does not move. Investors do not seek other countries to invest other than home country.

Note that, equation (I) can also be written as

$$(S-R)/Y = \alpha + \beta(S/Y)$$

or,

$$-R/Y = \alpha + \epsilon(S/Y)$$

Where $\epsilon = \beta - 1$

So if ϵ is close to zero, then this implies that foreign capital inflow is independent of domestic savings rate.

However, it seems reasonable to think that small countries with substantial international trade may have a much weaker relation between domestic saving and domestic investment than the large countries which operate nearly at autarky. We like to examine this possibility that the link between domestic investment and domestic saving varies with the degree of openness of the economy. We will estimate an extension of equation (I) in which the value of β is permitted to vary with the measure of openness of the economy:

$$(I/Y) = \alpha + (\beta_0 + \beta_1 x) (S/Y)$$

or

$$i = \alpha + \beta_0 s + \beta_1 (x*s) \dots\dots\dots (II)$$

Where X : The share of trade in GDP as measured by the sum of exports and imports per dollar of GDP. (A measure of openness).

Evidence that the Feldstein-Horioka conclusions may be influenced by the size of the country considerations is presented in Harberger (1980: 331 - 37). He argues that the correlations between savings and investment rates will grow as the unit of observation increases in size. Harberger expresses the difference of gross domestic saving and gross domestic investment as a share of gross domestic investment, and he notes that this measure has greater variability and larger absolute value for small countries than for large countries. These results are in line with lower correlations between savings and investment rates for small countries relative to large countries. Murphy (1984: 327 - 42) has shown that the regression of investment rate on the saving rate is an attempt to capture the effect of autonomous shifts in saving on investment demand. He has shown that the perfect capital mobility alone does not necessarily imply a negligible effect of autonomous shift in domestic saving on domestic investment demand. The additional assumption that the country is small in relation to world capital market is needed. This suggests that there is a possible role for country size in estimating the effect of autonomous shift in domestic saving on domestic investment. We will use the log of GDP to measure the country size so that the variance of the variable would not be dominated by few large observations. Hence, the model to be estimated becomes,

$$I/Y = \alpha + \beta(S/Y) + \delta (x * S/Y) + \tau \ln \text{GDP}$$

or,

$$i = \alpha + \beta s + \delta (x * s) + \tau z \dots \dots \dots \text{(III)}$$

Where, $z = \ln \text{GDP}$

We Expect,
 $0 < \beta < 1$ and $\delta, \tau < 0$

RESULT

Using Ordinary Least Square Method for a sample of 93 countries around the world the estimated model appears as:

$$i = 9.954 + 0.555 s$$

(9.14) (10.10)

R-Sq (Adj) = 0.52
 F-Stat = 101.99

The model explains about 52 percent of the total variation. The coefficients are significantly different from zero. Figures in parenthesis are t-Statistics. On the other hand, when regression of Resource Balance on savings rate is run, the estimated equation is:

$$\text{II.} \quad R/Y = -9.734 + 0.432 S$$

$$(-9.95) \quad (7.86)$$

$$R\text{-Sq (Adj)} = 0.40$$

$$F\text{-Stat} = 62.03$$

This hypothesis that $\Sigma=0$ could not be rejected. That is, β is also not closed to one either, implying that some investors do seek other countries to invest. However, the hypothesis of perfect capital mobility across countries has to be rejected.

But since we suspected that the openness in economy could be a powerful explanation to have impact on investment, we have estimated model II. But even with the inclusion of a measure of openness, x , neither R^2 improved nor the coefficient of X appeared significantly different from zero.

Similarly, we also expected that the size of the country may well be good explanatory variable for investment rate. So we also estimated model III. But inclusion of the measure of the size of the country also did not improve the model, nor the coefficient of the size appeared significantly different from zero.

In the estimated equations above, we had included even the least developed countries where the financial market is still in very rudimentary stage. So it would be reasonable to excluded the least developed countries from the sample. After excluding these least developed countries model I was re-estimated and was obtained as:

$$\text{III.} \quad i = 8.958 + 0.598 s$$

$$(6.06) \quad (8.58)$$

$$R\text{-Sq (Adj)} = 0.48$$

$$F\text{-Stat} = 73.65$$

However, we do not see any remarkable change in the coefficient of the savings rate. Also neither the inclusion of the measure of openness nor the inclusion of the size of the country measured by the log of GDP seem to have any impact on gross domestic investment in these countries. The hypothesis that the perfect mobility is still rejected.

But once we distinguish developing and developed world and run separated regressions for them, we see that the openness in international trade becomes extremely important in investment equation for developed countries. We summarize the results in table 1.

Table 1
Summary of Investment Equation

Dependant Variable: i						
Variables	Model I		Model II		Model III	
	Coef.	t-Stat	Coef.	t-Stat	Coef.	t-Stat
Developing Countries						
C	9.089	5.41	9.3134	5.34	9.1308	2.02
s	0.610	7.46	0.5813	5.88	0.5792	5.20
s*X			0.0003	0.52	0.0003	0.51
z					0.0533	0.04
Developed Countries						
C	4.433	1.38	5.2594	5.98	16.0935	2.36
s	0.746	5.36	0.7898	7.02	0.7672	6.22
s*X			-0.0015	-0.43	-0.0025	-2.75
z					-1.7076	-1.74
All Countries						
C	8.958	6.06	9.103	5.98	11.067	3.70
s	0.597	8.58	0.579	7.02	0.611	6.58
s*X			0.0002	0.43	0.0001	0.21
z					-0.5700	-0.76

So far we have not given attention to the problem of endogeneity in saving ratio. The saving-investment relationship is compatible with a perfect world capital market. But their close relationship can also be explained by the fact that both are influenced by a third variable. Under the condition of imperfect international labor mobility both the savings and investment are determined in part by the rate of economic growth. In such a case higher aggregate real income growth caused in part by higher investment rate implies higher per capita real income growth that in turn raises the savings rate (Fry, 1986: 57 - 73). So income growth is a key determinant of both national savings and investment rates. So we like to include a simple saving function and formulate a model in simultaneous system approach. Feldstein and Horioka (1980: 314 - 29) have mentioned that the traditional life-cycle model implies that a country's saving rate will be higher where the rate of growth of private income is faster and where the working age population is large relative to the number of retirees and young dependency. In other words, saving rate depends also on growth rate and the dependency ratio of a country in addition to income level. So to correct the endogeneity problem we framed the model in simultaneous system as:

$$i = f(s, x, v, z)$$

$$s = g(y, v, d)$$

Where

s	:	Proportion of Gross Domestic Savings to GDP (= S/Y)
i	:	Proportion of Gross Domestic Investment to GDP (= I/Y)
x	:	Proportion of Total Trade (Export + Import) to GDP (Measuring the openness of the economy)
Y	:	Per Capita Income
v	:	Growth rate of Per Capita Income
z	:	log of GDP (Measuring the Size of the economy)
d	:	Dependency ratio.

Using Two Stage Least Square technique to investment equation, we obtained the result and summarized in Table 2.

Table 2
Summary of Two Stage Least Square Investment Equation

TSLS\Dependant Variable: i			
Instrument list : C s (x*s) y z d v			
Variables	Coef.	TSLS t-Stat	Prob.
Developing Countries			
C	13.4856	3.03	0.004
s	0.4548	4.07	0.000
s*X	-0.0000	-0.06	0.955
v	1.1636	3.07	0.003
z	-0.9581	-0.81	0.420
Developed Countries			
C	16.4776	2.26	0.040
s	0.7469	4.67	0.000
s*X	-0.0025	-2.64	0.020
v	0.1535	0.21	0.838
z	-1.7654	-1.68	0.115
All Countries			
C	13.4529	4.70	0.000
s	0.4769	5.07	0.000
s*X	-0.0002	-0.35	0.727
v	1.1506	3.60	0.001
z	-1.0129	-1.44	0.155

Notice that simultaneous treatment of the model made no influence on the investment equation of the countries, while we see a reduction in the coefficient of saving rate in the case of developing countries. This may suggest that the factor, growth rate of income, that was suspected to introduce endogeneity in the system was in fact influencing both investment and savings in case of developing countries but not in developed countries.

Once we have included growth rate of per capita GNP in the investment equation, the growth rate appeared to be a significant variable to explain investment equation for developing countries but not so for developed countries. The apparent low response of growth rate to investment in Developed Countries may also be due to the low variation in growth rate in Developed Countries as compared to that in Developing Countries. Variances in per capita GNP growth rate in Developed Countries and in Developing Countries are 0.61 and 5.20 respectively. (Appendix A). On the other hand, openness in the economy is observed to be an important factor to explain the investment equation for developed countries but not so for the investment equation for developing countries. In developed countries openness in the economy has tendency to reduce investment inside the home country. That is, the capital is more mobile in developed countries which are more open to international trade. But the same thing may not be true for the developing countries.

CONCLUSION:

When capital is highly mobile internationally, savings from abroad can finance the investment needed at home, but when capital is not mobile internationally, investment at home will be limited by domestic savings. What we found that in developing countries about 45 percent of the incremental saving is invested domestically, while in developed countries about 75 percent of the incremental savings is invested domestically. This suggests that the capital is more mobile in developing countries than in developed countries. This may be an indication that the more efficient capital markets of developed countries are actually drawing funds from the less efficient developing countries. This result is in line with Gertler and Rogoff (1990: 245 - 66) who pointed out that the improved efficiency of foreign capital markets causes investment funds to be siphoned away from poor-country entrepreneurs. But due to the fact that the efficiency of capital markets are more or less comparable among the developed countries, it seems reasonable to have their incremental saving invested at home rather than moving away from home. This may explain why there is a higher correlation between domestic savings and domestic investment in developed countries than that in developing countries.

In general, developing countries are in need of more investment. This means that they require even more savings. But it seems that the developing countries face more difficult problems. A policy that encourages domestic saving would not be that beneficial unless the capital markets are made more efficient. The developing countries

could benefit from the "pool of global savings" only if they could attract more capital from the developed world or from the country which has less efficient capital market and make their own savings to retain in their own country. This is, however, a very generalized statement. If we are to recommend any policy to any particular country, we should analyze the situation on country by country basis.

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APPENDIX

Per Capita GNP, Growth Rate, GDP, GDI, GDS, and XM
Least Developed Countries

SN	COUNTRY	pcGNP86	GNP6586	GDP86	GDI86P	GDS86P	XM86P
1	Bangladesh	160.00	0.40	15460.00	12.00	2.00	23.16
2	Benin	270.00	0.20	1320.00	13.00	0.00	42.95
3	Burundi	240.00	1.80	1090.00	17.00	9.00	34.31
4	Central African Rep	290.00	-0.60	900.00	16.00	2.00	38.78
5	Ethiopia	120.00	0.00	4960.00	9.00	3.00	31.35
6	Haiti	330.00	0.60	2150.00	12.00	6.00	40.74
7	Malawi	160.00	1.50	1100.00	10.00	7.00	45.73
8	Nepal	150.00	1.90	2200.00	19.00	9.00	27.32
9	Niger	260.00	-2.20	2080.00	11.00	7.00	36.88
10	Rwanda	290.00	1.50	1850.00	19.00	9.00	28.97
11	Sudan	320.00	-0.20	7470.00	12.00	4.00	21.89
12	Tanzania	250.00	-0.30	4020.00	17.00	2.00	34.65
13	Uganda	230.00	-2.60	3310.00	14.00	11.00	22.33
	MEAN	236.15	0.15	3685.38	13.92	5.46	33.00
	Standard Deviation	65.70	1.35	3844.33	3.22	3.37	7.64

Developing Countries

SN	COUNTRY	pcGNP86	GNP6586	GDP86	GDI86P	GDS86P	XM86P
1	Algeria	2590.00	3.50	60760.00	32.00	31.00	29.69
2	Argentina	2350.00	0.20	69820.00	9.00	11.00	16.58
3	Bolivia	600.00	-0.40	4180.00	8.00	5.00	30.60
4	Botswana	840.00	8.80	1150.00	26.00	26.00	0.00
5	Brazil	1810.00	4.30	206750.00	21.00	24.00	18.36
6	Burma	200.00	2.30	8180.00	15.00	12.00	11.20
7	Cameroon	910.00	3.90	11280.00	25.00	28.00	31.66
8	Chile	1320.00	-0.20	16820.00	15.00	18.00	45.53
9	China	300.00	5.10	271880.00	39.00	36.00	27.34
10	Colombia	1230.00	2.80	29660.00	18.00	20.00	30.22
11	Congo, People's Rep.	990.00	3.60	2000.00	29.00	30.00	65.10
12	Costa Rica	1480.00	1.60	4260.00	23.00	24.00	53.33
13	Cote d'Ivoire	730.00	1.20	7320.00	12.00	22.00	71.37
14	Dominican Rep.	710.00	2.50	5280.00	18.00	12.00	40.74
15	Ecuador	1160.00	3.50	11510.00	20.00	20.00	34.67
16	Egypt, Arab Rep.	760.00	3.10	40850.00	19.00	9.00	34.60

17	El Salvador	820.00	-0.30	3980.00	13.00	7.00	41.68
18	Gabon	3080.00	1.90	3190.00	37.00	19.00	62.79
19	Ghana	390.00	-1.70	5720.00	10.00	8.00	28.78
20	Greece	3680.00	3.30	35210.00	23.00	14.00	48.28
21	Guatemala	930.00	1.40	7470.00	11.00	9.00	25.98
22	Honduras	740.00	0.30	2960.00	17.00	13.00	58.41
23	Hong Kong	6910.00	6.20	32250.00	23.00	27.00	219.55
24	India	290.00	1.80	203790.00	23.00	21.00	13.74
25	Indonesia	490.00	4.60	75230.001	26.00	24.00	37.48
26	Israel	6210.00	2.60	29460.00	17.00	11.00	60.67
27	Jamaica	840.00	-1.40	2430.00	19.00	19.00	64.20
28	Kenya	300.00	1.90	5960.00	26.00	26.00	48.07
29	Korea, Rep. of	2370.00	6.70	98150.00	29.00	35.00	67.55
30	Liberia	460.00	-1.40	990.00	10.00	18.00	64.55
31	Madagascar	230.00	-1.70	2670.00	14.00	10.00	27.19
32	Malaysia	1830.00	4.30	27580.00	25.00	32.00	89.57
33	Mauritania	420.00	-0.30	750.00	25.00	15.00	104.27
34	Mauritius	1200.00	3.00	1160.00	17.00	25.00	117.16
35	Mexico	1860.00	2.60	127140.00	21.00	27.00	22.21
36	Morocco	590.00	1.90	14760.00	20.00	13.00	42.39
37	Nigeria	640.00	1.90	49110.00	12.00	10.00	22.60
38	Pakistan	350.00	2.40	30080.00	17.00	7.00	29.13
39	Panama	2330.00	2.40	5120.00	17.00	21.00	104.82
40	Papua New Guinea	720.00	0.50	2530.00	24.00	15.00	85.49
41	Paraguay	1000.00	3.60	3590.00	24.00	7.00	22.59
42	Peru	1090.00	0.10	25370.00	20.00	18.00	21.04
43	Philippines	560.00	1.90	30540.00	13.00	19.00	33.28
44	Saudi Arabia	6950.00	4.00	78480.00	27.00	18.00	49.95
45	Senegal	420.00	-0.60	3740.00	14.00	6.00	43.74
46	Sierra Leone	310.00	0.20	1180.00	10.00	8.00	25.17
47	Singapore	7410.00	7.60	17350.00	40.00	40.00	276.69
48	South Africa	1850.00	0.40	56370.00	19.00	30.00	55.78
49	Sri Lanka	400.00	2.90	5880.00	24.00	13.00	53.79
50	Syrian Arab Rep.	1570.00	3.70	17400.00	24.00	14.00	23.15
51	Thailand	810.00	4.00	41780.00	21.00	25.00	43.02
52	Togo	250.00	0.20	980.00	28.00	13.00	66.73
53	Trinidad and Tobago	5360.00	1.60	4830.00	22.00	18.00	56.54
54	Tunisia	1140.00	3.80	7790.00	24.00	17.00	59.68
55	Turkey	1110.00	2.70	52620.00	25.00	22.00	36.13
56	Uruguay	1900.00	1.40	5320.00	8.00	13.00	35.86
57	Venezuela	2920.00	0.40	49980.00	20.00	21.00	39.20
58	Yugoslavia	2300.00	3.90	61640.00	38.00	40.00	35.86
59	Zaire	160.00	-2.20	6020.00	12.00	13.00	55.35
60	Zambia	300.00	-1.70	1660.00	15.00	13.00	84.52

61	Zimbabwe	620.00	1.20	4940.00	18.00	20.00	49.25
	MEAN	1542.46	2.10	32735.25	20.51	18.72	52.37
	Standard Deviation	1706.10	2.28	52221.19	7.46	8.53	43.30

Developed Countries

SN	COUNTRY	pcGNP86	GNP6586	GDP86	GDI86P	GDS86P	XM86P
1	Australia	11920.00	1.70	184940.00	22.00	21.00	26.35
2	Austria	9990.00	3.30	93830.00	24.00	25.00	51.93
3	Belgium	9230.00	2.70	112180.00	16.00	20.00	122.61
4	Canada	14120.00	2.60	323790.00	21.00	22.00	54.13
5	Denmark	12600.00	1.90	68820.00	22.00	22.00	64.18
6	Finland	12160.00	3.20	62370.00	23.00	24.00	50.82
7	France	10720.00	2.80	724200.00	19.00	20.00	35.12
8	Germany, Fed. Rep.	12080.00	2.50	891990.00	19.00	24.00	48.70
9	Ireland	5070.00	1.70	21910.00	19.00	23.00	110.80
10	Italy	8550.00	2.60	599920.00	21.00	23.00	32.88
11	Japan	12840.00	4.30	1955650.00	28.00	32.00	17.30
12	Netherlands	10020.00	1.90	175330.00	21.00	25.00	88.25
13	New Zealand	7460.00	1.50	26630.00	23.00	24.00	44.74
14	Norway	15400.00	3.40	69780.00	29.00	26.00	55.22
15	Spain	4860.00	2.90	229100.00	21.00	23.00	27.17
16	Sweden	13160.00	1.60	114470.00	18.00	21.00	61.11
17	Switzerland	17680.00	1.40	135050.00	26.00	27.00	58.13
18	United Kingdom	8870.00	1.70	468290.00	18.00	17.00	49.81
19	United States	17480.00	1.60	4185490.00	18.00	15.00	14.44
	MEAN	11274.21	2.38	549670.53	21.47	22.84	53.35
	Standard Deviation	3474.53	0.78	967668.76	3.38	3.59	27.74

Note:	pcGNP86	=	Per Capita Income in 1986 in US Dollar
	GNP6586	=	Per Capita Income Growth (1965-86)
	GDP86	=	Total Gross Domestic Product in 1986 in Million US Dollar
	GDI86P	=	Gross Domestic Investment in 1986 as a percentage of GDP
	GDS86P	=	Gross Domestic Saving in 1986 as a percentage of GDP
	XM86P	=	Total of Export & Import in 1986 as a percentage of GDP

Source: The World Bank, World Development Report, 1988.