Capital Account Management:

Case Study of Germany

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Outline

- Introduction
- Time Windows (A quarterly assessment)
- Experience with liberalization
- Sequencing
- Conclusion

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1.Introduction

- Period under consideration: 1957-88
- Germany one of the first few advanced economies to liberalize
- By early 1980s,Germany, Netherlands and the UK were the only 3 European countries with fully liberalized capital account

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2. Time windows of the liberalization process

- Steps toward full capital account liberalization (1958-59)
- Further liberalization of outflows coupled with new restrictions on inflows (1966-67)
- Abolition of controls and steps toward further liberalization (1974-75)
- A period of intense capital account management (1980-81)
- Capital account liberalization (1983-88)- An overview

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3. Experience with liberalization

- Management of speculative attacks.
- Competitiveness of the export economy.
- Management of persistent surpluses.

During Bretton Woods regime

Post Bretton Woods

Germany as a part of the EEC

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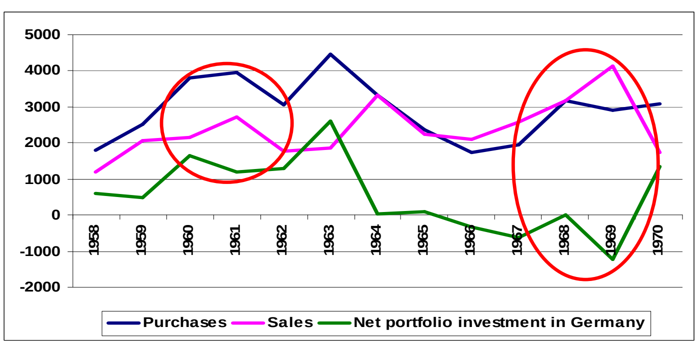
3.1 Management of speculative attacks (During Bretton Woods regime)

Portfolio Investment in Germany (DM in millions)



Source: Data obtained from the Bundesbank

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3.1 Management of the speculative attacks (During Bretton Woods regime)

- Management flawed
  - *Bundesbank's prime focus – exchange rate management*
  - *conflict between monetary and fixed exchange rate management*
- Imposition of capital controls –

  e.g. minimum reserve requirements, Bardepot restrictions
- Inflation continued to be high
- Revaluation in 1961 and 1969
- Monetary management overpowered exchange rate management

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3.1 Management of the speculative attacks (Post Bretton Woods)

- Switch to Flexible exchange rate regime -1973
- Monetary targeting (new assignment) -1974
- Capital controls:
  - Tightened immediately after the switch
  - Relaxed thereafter
- Shift of focus from exchange rate to monetary management
- Policy response relatively effective- Inflation dropped

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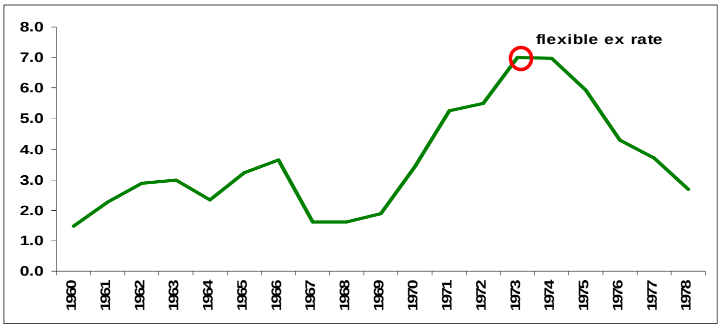
3.1 Management of the speculative attacks (During and Post Bretton Woods)

CPI Inflation (year-on-year) %



Source: own calculations from the data available on International Financial Statistics (IFS), IMF

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3.2 Competitiveness of the export economy (During Bretton Woods regime)

- Competitiveness directly affected by changes in Real effective exchange rate (REER)
- Bundesbank watched movements in both nominal exchange rate and inflation
- Competitiveness relevant against the backdrop of revaluation of the DM
- Current account balance fell after both revaluations

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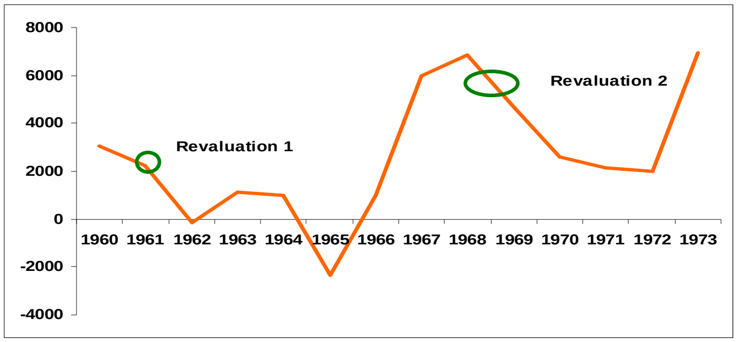
3.2 Competitiveness of the export economy (During Bretton Woods regime)

Current Account Balance (DM in millions)



Source: OECD statistical database

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3.2 Competitiveness of the export economy (Post Bretton Woods)

- REER depreciated and appreciated in phases post 1973
- Depreciation in the1980s (figure)

  12.7% depreciation from 1979 to 1981
- Improvement in the current account balance-
  - exception: deficits in 1979-82 (2nd oil crisis)
  - persistent surpluses: 1982-88
- Accompanied by falling inflation

  CPI inflation fell from 5.3% in 1982 to 1.3% in 1988

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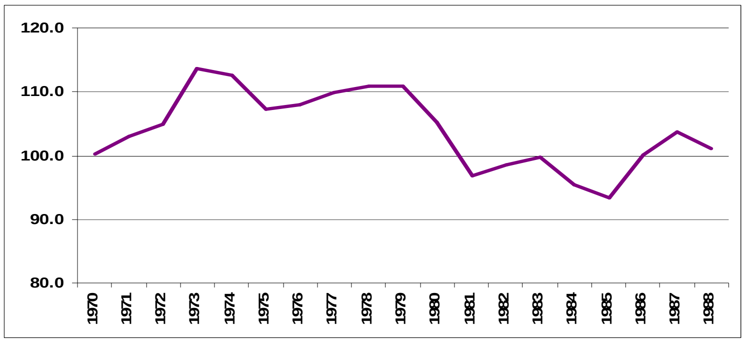
3.2 Competitiveness of the export economy (Post Bretton Woods) (text)

REER based on CPI



Source: OECD statistical database

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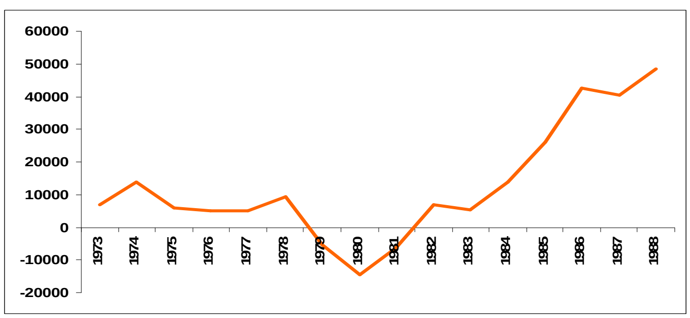
3.2 Competitiveness of the export economy (Post Bretton Woods)

Current Account Balance (DM in millions)



Source: OECD statistical database

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3.3 Management of persistent surpluses (During and Post Bretton Woods regime)

- **Surpluses not persistent in 1960s and 1970s**
- **Management applicable to 1980s**
- **2 aspects:**
  - Pressure from the rest of the world
  - Capital exports
- **Large capital outflows** (of all maturities) **in 1980s**

  German FDI abroad increased by almost 4 times between 1971 and 1985
- **REER depreciation- 1980s**

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3.4 Germany as a part of the European Economic Community (EEC)

- **Treaty of Rome- 1957**
- **Germany leading the liberalization process**
  - **Erhard favoured full liberalization**
  - **To reap the benefits of a common market and cooperation in the EEC**
- **2 directives**
  - First directive of 1960
  - Second directive of 1962

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4. Sequencing of the liberalization process

- Capital account fully liberalized (*de jure*) by 1959
- Outflows liberalized relatively faster than inflows

"In line with its policy of giving free reins to market forces in Sept. 1957 all remaining controls on outflows were abolished, whereas only a small number of inward capital controls was retained" (Age F.P., 1995)

- Capital account management in 1960s and 1970s:

Imposition, abolition and reintroduction of controls

- Full capital account liberalization by 1981

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5. Conclusion

- **Big Bang approach to liberalization in 1950s**
- **Capital account management in 1960s and 1970s**
- **Unable to solve the riddle of impossible trinity until 1973**
- **Switch to flexible exchange rate and monetary targeting augured well**
- **Liberalization of capital account does not take away the responsibility of its management**

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Thank You!

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