„Germany‛s experience with capital account liberalization“

by

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A comment

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#1 1. General remark

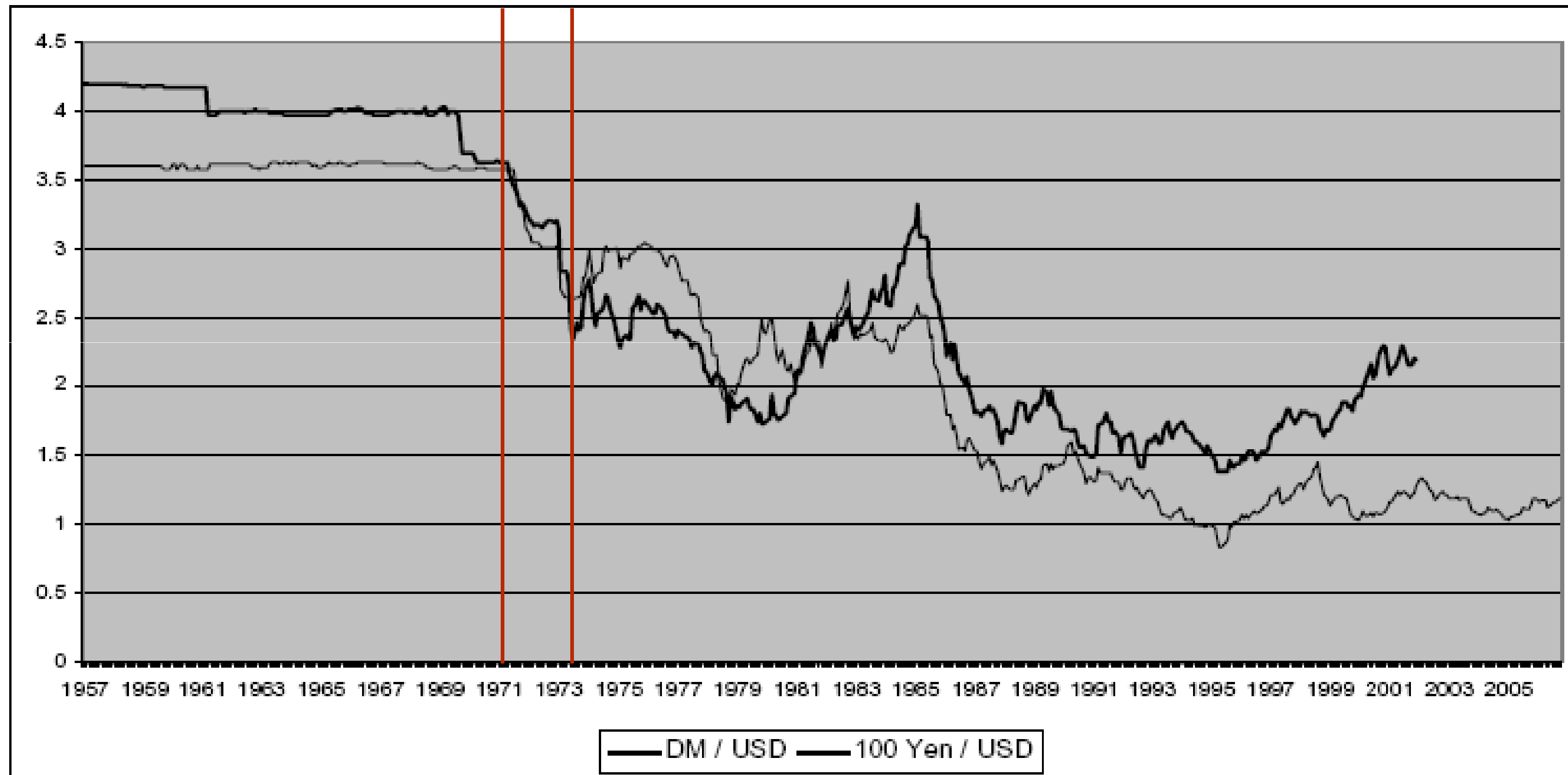
- I share the thrust of the analysis on Germany`s Capital Account Liberalization (CAL)
- Little literature on topic, valuable empirical insights given
- Important lessons to be learnt for emerging market economies, esp. for excessive capital inflows

#2 2. Methodology

- Focus in paper is on critical episodes when capital controls were used → „loupe focus“
- Downside: the long-run tendencies for the whole period 1950-1988 are not in the centre of analysis
- Hence a brief complementary overview 1950-1989 here

#3 Nominal exchange rate DM / USD and Yen (in 100s) / USD

Abbildung 2: Nominelle Wechselkurse zwischen dem US-Dollar, dem Japanischen Yen and der D-Mark 1957 – 2006*

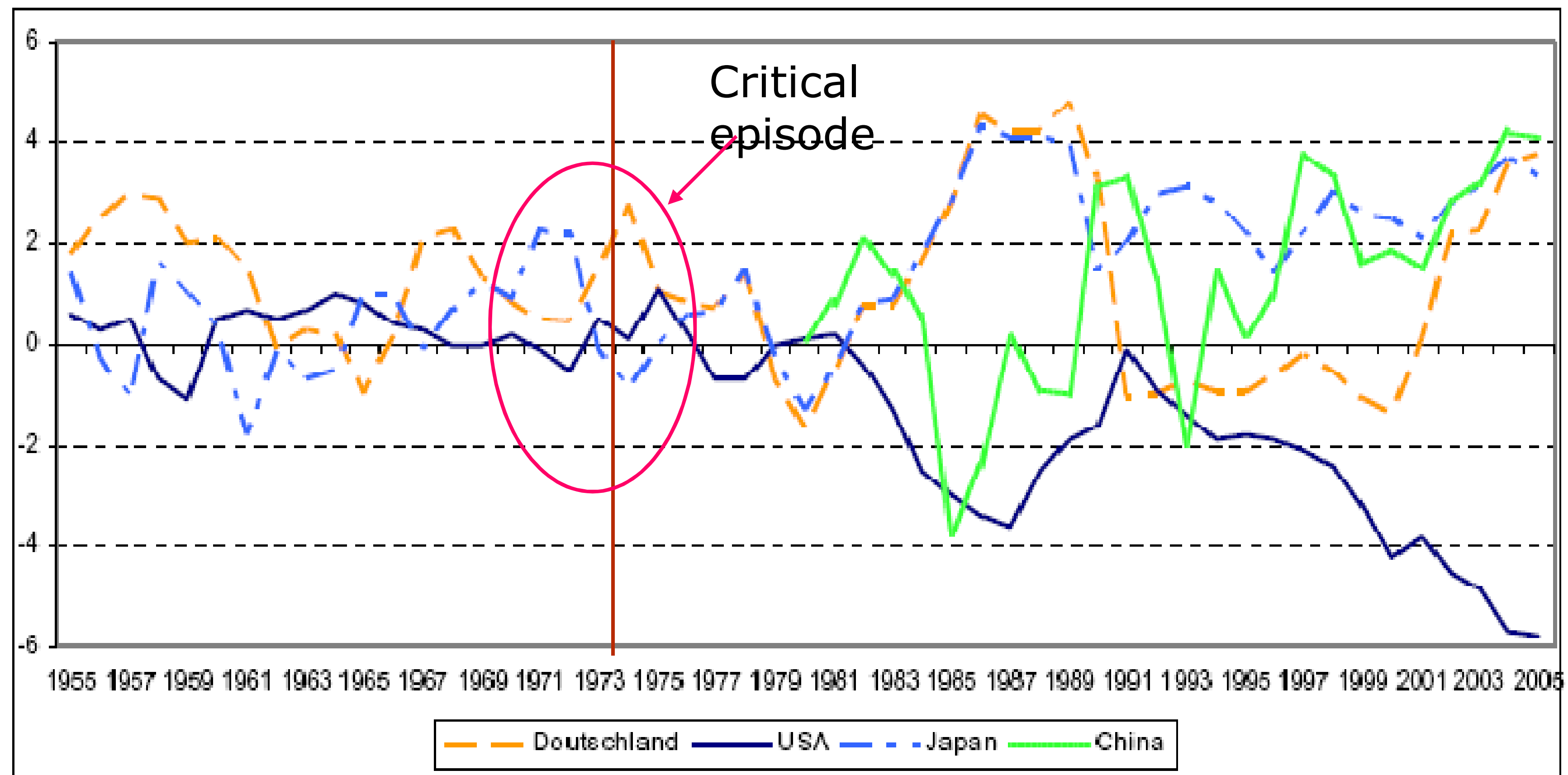


* Ein Anstieg bedeutet eine Abwertung von D-Mark und Yen.

Quelle: IWF, International Financial Statistics 2005, Federal Reserve Bank of St. Louis 2006

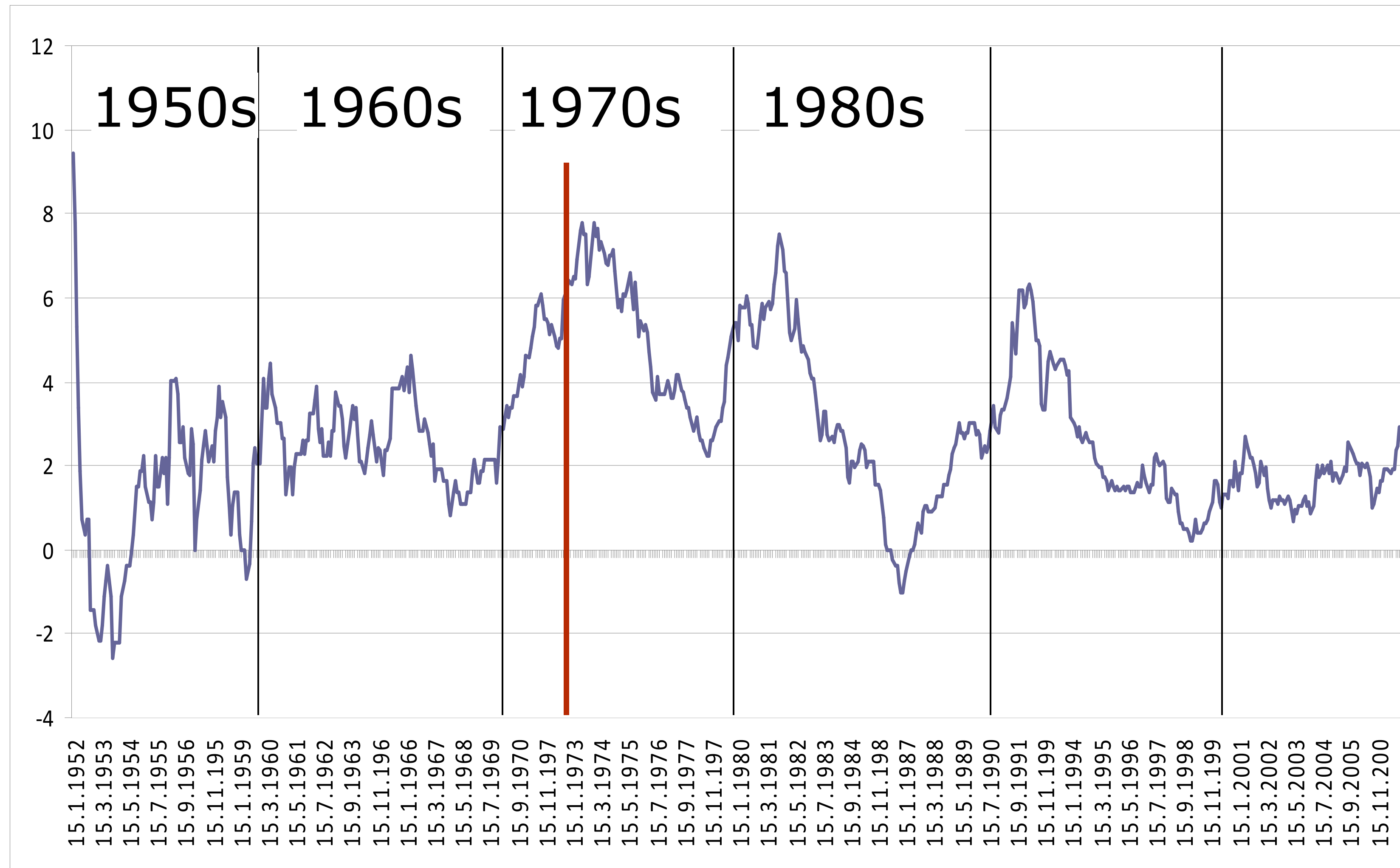
#4 Current account balance Germany, USA, Japan and China in % of GDP 1955-2005

Abbildung 5: Leistungsbilanzsalden der USA, Japans, Deutschlands und Chinas in Prozent am Bruttoinlandsprodukt, 1955-2005



Quelle: OECD, Historical Statistics; IMF, Economic Outlook, World Bank, World Development Indicators 2005

#5 Inflation in Germany 1951-2006, less than in US



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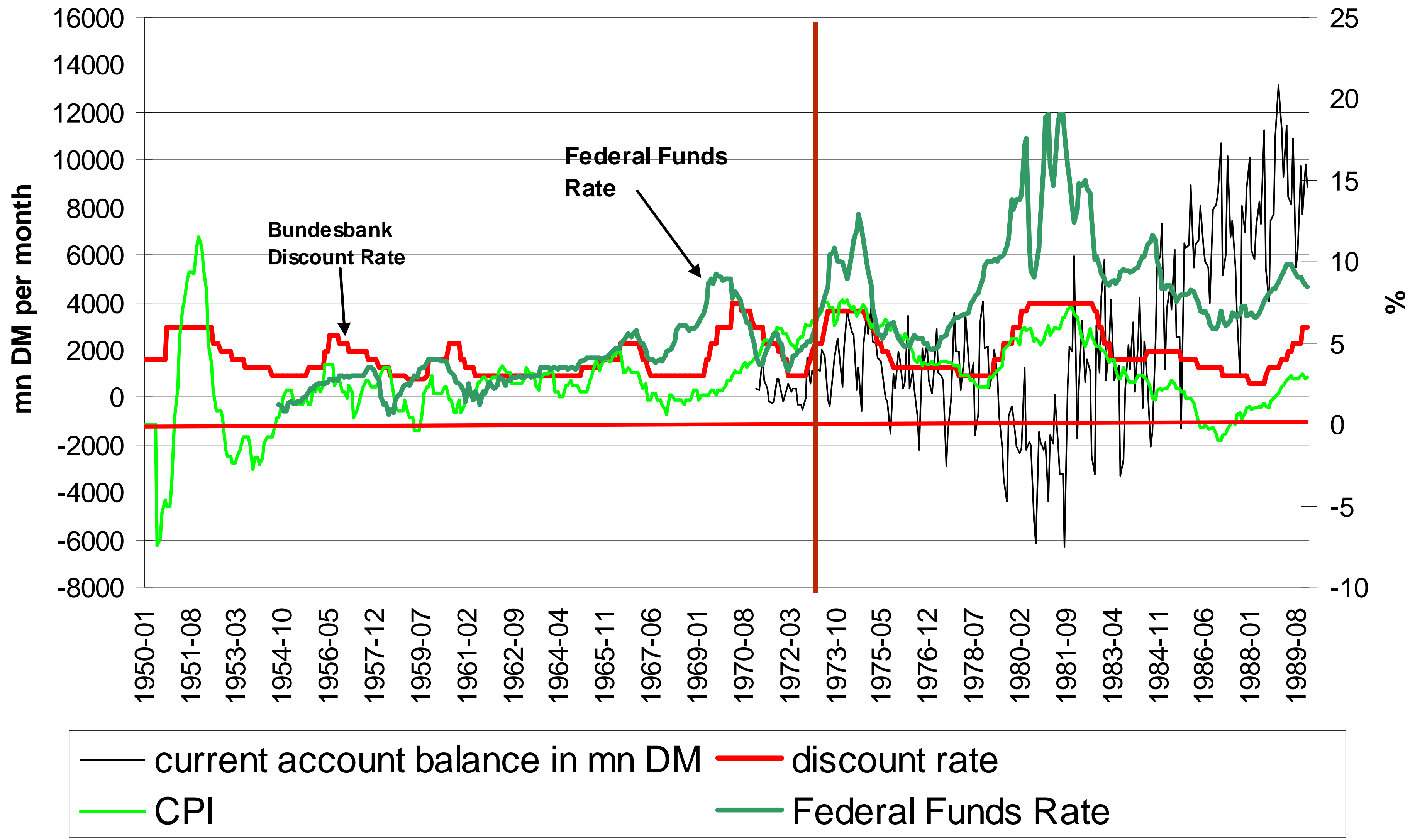
#6
Germany 1950-1989: CPI, discount rate, current account balance
mn DM per month
%
Federal Funds Rate
Bundesbank Discount Rate
16000
14000
12000
10000
8000
6000
4000
2000
0
-2000
-4000
-6000
-8000
25
20
15
10
5
0
-5
-10
1950-01
1951-08
1953-03
1954-10
1956-05
1957-12
1959-07
1961-02
1962-09
1964-04
1965-11
1967-06
1969-01
1970-08
1972-03
1973-10
1975-05
1976-12
1978-07
1980-02
1981-09
1983-04
1984-11
1986-06
1988-01
1989-08
current account balance in mn DM
discount rate
CPI
Federal Funds Rate

#7 3. A note on sequencing of CAL

- There was no intentional sequencing by German authorities
- Treaty of Rome 1957: general pledge to liberal capital account regime, to be achieved in 12 years, but national capital controls possible
- Return to controls in 1960s and early 1970s, to keep appreciation small and to cope with inflation
- Full liberalisation came not before European Monetary System (EMS) was installed 1979
- In EMS other form of „capital account management“ → „European Bretton Woods“

#8 4. What forms of capital controls?

- Many mostly „market-based" types of selective controls → focus on inflow controls
- Special minimum reserve requirements for non-residents, limited interest payments to abroad, limited borrowing from abroad, exchange rate swaps
- Shortcomings: many loopholes, easy to circumvent
- § 23 Außenwirtschaftsgesetz (Foreign Economy Law) provided option for comprehensive exchange controls → never used!
- Commitment to free market economy - tight capital controls rejected

#9 5. Why didn‘t capital controls work?

- They did work until late 1960s within Bretton Woods framework; finance was mainly national
- No comprehensive controls later
- Short-term „hot money“ reached huge magnitude in certain very short episodes (days, weeks)
- Missing international coordination to defend exchange rates, German policy overstrained
- monetary policy in US in late 1960s and early 1970s could not cope with inflation & current account deficit → capital flight towards DM

#10 6. A political addition to the paper

- Heavy political struggles in Germany 1968-1974 on use of capital controls
- Fear of DM appreciation → unemployment risk
- Minister of Finance (1966-72) Karl Schiller (SPD) opposed, resigned 1972 in protest
- successor Helmut Schmidt (SPD, became chancellor 1974) strongly in favour, ready to defend peg to US-$ and to fight against speculative inflows, co-founder of EMS 1979
- Bundesbank supported Schmidt, more or less
- Public opinion tilted over towards CAL in 1970s

#11 7. A note on monetary policy in Germany

- Bundesbank focused on exchange rate until 1971 → „real undervaluation“ strategy
- … but there was no serious threat of inflation until 1968 ff.
- Full employment reached 1960 → wage pressures
- Priority to sovereign monetary policy necessary since end of 1960s, since no effective counter-cyclical fiscal policy and no income policy
- Money targeting after 1974 was more rhetorical than real

#12 8. Lesson learnt

1. To fend off strong capital inflows under fixed exchange rates
   - either temporary tight and comprehensive capital controls indispensible
   - or international coordination to cooperatively defend exchange rates
2. Fully floating exchange rates are never in fundamental equilibrium – high volatility! Capital account management very difficult
3. Germany: full floating mitigated by EMS and Euro-zone

   → burden of full floating shared by all partners