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Source: *World Politics*, Vol. 46, No. 1 (Oct., 1993), pp. 50-82

Published by: Cambridge University Press

Stable URL: <http://www.jstor.org/stable/2950666>

Accessed: 28-05-2018 21:39 UTC

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THE OBSOLESCENCE OF CAPITAL CONTROLS?

Economic Management in an Age of Global Markets

By JOHN B. GOODMAN and LOUIS W. PAULY*

THE movement of capital across national borders has long raised sensitive political questions. Whatever the benefits, international investment complicates national economic management. Most research on this subject has focused on the causes and consequences of foreign direct investment. Less studied, but no less important, are short-term capital flows—those arising from the purchase or sale of financial instruments with maturities of less than one year. In contrast to investments in plant and equipment, short-term flows are highly sensitive to interest rate differentials and exchange rate expectations. Indeed, the mere announcement of a change in economic policy can trigger massive capital inflows or outflows, undermining the anticipated benefits of the new policy. For this reason, most governments regularly resorted to various types of controls on short-term capital movements in the decades following World War II.

In recent years, however, the world has witnessed a remarkable shift away from the use of capital controls. In country after country, governments have abolished controls and dismantled the bureaucratic machinery used to administer them. And in the rare instances where governments have fallen back on controls, their temporary nature has usually been emphasized. This general trend toward liberalization has stimulated a growing body of research on the political and economic consequences of capital mobility.¹ In this article, our principal aim is to address

* We thank the Harvard Business School Division of Research and the Social Sciences and Humanities Research Council of Canada (grant #410-91-1308) for financial support; Chris Allen and Sanjai Bijawat for research assistance; and Vinod Aggarwal, Iain Begg, Benjamin Cohen, Dennis Encarnation, Jeffrey Frieden, Gikas Hardouvelis, Eric Helleiner, C. Randall Henning, Ethan Kapstein, Peter Katzenstein, Peter Kenen, Robert Keohane, Stephen Krasner, John Odell, Frances McCall Rosenbluth, Debora Spar, Louis Wells, and David Yoffie for helpful comments. Final responsibility for the article, of course, remains ours.

¹ See, e.g., Jeffrey Frieden, "Invested Interests: The Politics of National Economic Policies in a World of Global Finance," *International Organization* 45 (Autumn 1991); Michael C. Webb, "International Economic Structures, Government Interests, and the International Co-

two prior puzzles: First, why did policies of capital decontrol converge across a rising number of industrial states between the late 1970s and the early 1990s? Second, why did some states move to eliminate controls more rapidly than others? We argue that the movement away from controls on short-term capital flows did not result, as regime or epistemic community theories might predict, from the emergence of a common normative framework or widespread belief in the benefits of unfettered capital mobility.² Nor has it simply reflected the overarching power of a liberal state. Instead, we contend that it has been driven by fundamental changes in the structures of international production and financial intermediation, which made it easier and more urgent for private firms—specifically, corporations and financial institutions whose aspirations had become increasingly global—effectively to pursue strategies of evasion and exit. For governments, the utility of controls declined as their perceived cost thereby increased.

Still, not all governments abandoned capital controls at the same pace. In order to examine both the process through which these pressures impinged on policy at the national level and variations in the timing of policy reform, we analyze policy developments in four advanced industrial states that relied extensively on capital controls—Japan, Germany, France, and Italy. The first two moved decisively away from capital controls in 1980 and 1981, the latter two, at the end of the decade. These differences can be traced to the interaction between generic types of external pressure and remaining distinctions in domestic structures. Specifically, governments facing capital inflows liberalized sooner than governments facing capital outflows—a conclusion that is not obvious, since capital inflows can be as threatening to national policy-making autonomy as capital outflows. Our analysis at the national level highlights the mechanisms by which such systemic economic pressures were transmitted to unique domestic political arenas. But it also provides a clue as to the increasingly common constraints governments would now have to overcome if they wanted to move back to policies designed to influence and control short-term capital flows.

In theoretical terms, our argument and evidence address a central question in international political economy regarding the relative impor-

ordination of Macroeconomic Adjustment Policies,” *International Organization* 45 (Summer 1991); and Donald J. Mathieson and Lilibiana Rojas-Suarez, “Liberalization of the Capital Account: Experiences and Issues,” *IMF Occasional Papers Series* 103 (March 1993).

² See Stephen D. Krasner, *International Regimes* (Ithaca, N.Y.: Cornell University Press, 1983); and Peter M. Haas, “Introduction: Epistemic Communities and International Policy Coordination,” *International Organization* 46 (Winter 1992).

tance of, and relationship between, international and domestic variables.³ In the crucial area of capital flows, the two interact in a clear pattern: global financial structures affect the dynamics of national policy-making by changing and privileging the interests and actions of certain types of firms. Once those interests have been embedded in policy, movement back is not necessarily precluded but is certainly rendered much more difficult.⁴

The rest of this article is divided into four sections. The first section examines the debate over capital controls in the postwar period and shows that the normative conclusion of this debate remained remarkably consistent throughout subsequent decades. The second section analyzes how changes in international financial markets influenced firm behavior and reframed the issue of capital controls for governments. The third section compares the way in which such changes affected government decisions to eliminate controls in Japan and Germany, which confronted problems associated with chronic capital inflows, and in France and Italy, which faced problems associated with capital outflows. Finally, the fourth section explores the conditions under which a retreat from liberal capital policies could occur and speculates on the normative implications of policy convergence witnessed thus far.

CAPITAL CONTROLS IN THE POSTWAR MONETARY ORDER

Following World War II, capital controls were an accepted part of the international monetary system. Despite pressure from the United States to allow investment as well as goods to cross borders without governmental interference, the 1944 Bretton Woods agreement intentionally legitimated the imposition of controls on capital movements that were not directly linked to trade flows. The agreement gave the International Monetary Fund (IMF) a mandate to discourage exchange restrictions and other financial impediments to trade but pointedly did not give it jurisdiction over capital controls.⁵ Most industrial countries accepted the logic

³ Three distinct views that have framed much of the subsequent theoretical debate can be found in Robert O. Keohane and Joseph S. Nye, *Power and Interdependence: World Politics in Transition* (Boston: Little Brown, 1977); Peter Katzenstein, ed., *Between Power and Plenty: Foreign Economic Policies of Advanced Industrial Countries* (Madison: University of Wisconsin Press, 1978); and Peter Gourevitch, *Politics in Hard Times: Comparative Responses to International Economic Crises* (Ithaca, N.Y.: Cornell University Press, 1986).

⁴ Helen Milner has made a compatible argument with regard to trade policy; see Milner, *Resisting Protectionism: Global Industries and the Politics of International Trade* (Princeton: Princeton University Press, 1988).

⁵ See Article VI, sections 1 and 3, of the IMF's original Articles of Agreement. John Maynard Keynes, the chief British spokesman at the Bretton Woods conference and the chief opponent of the American view, bluntly explained this to Parliament:

of restoring currency convertibility but jealously guarded their right to control short-term capital flows.

In 1961 member states of the Organization for Economic Cooperation and Development (OECD) formally agreed in the Code of Liberalization of Capital Movements to “progressively abolish between one another” restrictions on capital movements “to the extent necessary for effective economic cooperation.” However, the code left significant scope for states to make exceptions for certain types of capital transfers and, more broadly, to take any actions necessary for the “maintenance of public order or . . . the protection of essential security interests” *as defined by the member states themselves*. States were also permitted to derogate from their obligations under the code in the event of payments imbalances that *they themselves* considered severe.⁶ As this loosely defined set of exceptions made clear, OECD member states retained the right to reimpose controls whenever conditions warranted. The reason they attached such importance to that right quickly became apparent.

Facing persistent payments imbalances and problematic exchange rate rigidities in the 1960s, virtually all leading industrial states resorted to some type of control on capital movements. Even the United States adopted controls to prevent “disequilibrating” outflows.⁷ Similar controls were put in place by other states with external deficits, while states with external surpluses adopted measures to ward off unwelcome capital inflows. Ironically, these controls gave a boost to incipient “offshore” financial markets in Europe and elsewhere. The subsequent growth of Euro-currency banking, bond, and equity markets reflected a number of factors—including the unwillingness of governments to coordinate their associated regulatory and tax policies and the development of new technologies.⁸ (See Table 1).

Not merely as a feature of the transition, but as a permanent arrangement, the plan accords to every member government the explicit right to control all capital movements. What used to be heresy is now endorsed as orthodox. . . . It follows that our right to control the domestic capital market is secured on firmer foundations than ever before, and is formally accepted as a proper part of agreed international agreements.

Quoted in Joseph Gold, “International Capital Movements under the Law of the International Monetary Fund,” *IMF Pamphlet Series* 21 (1977), 11.

⁶ OECD, *Code of Liberalization of Capital Movements* (Paris: OECD, October 1986), articles 1, 3, 7.

⁷ See John Conybeare, *U.S. Foreign Economic Policy and the International Capital Markets: The Case of Capital Export Controls, 1963–74* (New York: Garland, 1988). For relevant background, see Alec Cairncross, *Control of Long-Term International Capital Movements* (Washington, D.C.: Brookings Institution, 1973); and Alexandre Lamfalussy, “Changing Attitudes towards Capital Movements,” in *Changing Perceptions of Economic Policy: Essays in Honor of the 70th Birthday of Sir Alec Cairncross* (London: Methuen, 1981).

⁸ A separate article could, of course, easily be devoted to an examination of the most prominent explanations for the explosive development of the international capital markets in the

TABLE 1
INTERNATIONAL FINANCIAL TRANSACTIONS
(U.S. \$ BILLIONS)

	1978	1980	1982	1984	1986	1988	1989	1990	1991
International bank lending (net stocks)	530	810	1,020	1,285	1,790	2,380	2,640	3,350	3,610
International bond financing (net stocks)	NA	NA	NA	390	700	1,085	1,252	1,473	1,651
Net international bond issues (net flows)	29	28	58	90	163	144	166	122	163
Euro-commercial paper outstanding	NA	NA	NA	NA	14	53	59	70	80
Gross international equity flows	NA	NA	NA	NA	801	1,213	1,598	1,441	825

Sources: Bank for International Settlements, *Annual Reports* (various issues); International Monetary Fund, *International Capital Markets: Developments and Prospects* (1992).

The disintegration in the early 1970s of the Bretton Woods system of pegged exchange rates potentially opened the door for a new normative framework to coordinate efforts to influence international capital flows. An intergovernmental forum on international monetary reform, the Committee of Twenty of the IMF board of governors was established in 1972, and a group of technical experts was appointed by the committee to examine the problem of disequilibrating capital flows. They concluded that controls should not become a permanent feature of a reformed system because of their potentially negative impact on trade and investment flows. But since capital flows could continue to disrupt even a more flexible exchange rate arrangement, they recommended the adoption of a code of conduct monitored by the IMF to govern the future use of controls. In the end, however, their recommendation was not pursued by the committee.

When the IMF Articles of Agreement were finally amended in 1976 to accommodate floating exchange rates, the normative framework guiding international capital movements originally articulated at Bretton Woods remained intact. States retained the right to resort to controls at their own discretion. In sum, at the official level, neither the beliefs concerning capital controls nor the rules governing them changed significantly over the postwar period. The forces behind the wave of policy liberalization that was about to occur were located elsewhere.

GLOBAL FINANCE AND FIRM BEHAVIOR

Between the late 1970s and the early 1990s, the development of truly international financial markets and the globalization of production undercut the rationale for capital controls. To analyze how these changes affected policies designed to limit capital mobility, it is useful to begin by looking at why such policies were deemed necessary in the first place. In the early 1960s strong theoretical support for the use of capital controls was provided by J. Marcus Fleming and Robert Mundell, who demonstrated that a government could achieve at most two of the following three conditions: capital mobility, monetary autonomy, and a fixed ex-

1960s. For purposes of analyzing subsequent decisions to remove capital controls, the growth of the Euro-markets is treated as exogenous. For background, see Richard O'Brien, *Global Financial Integration* (London: Pinter, 1992); Ralph Bryant, *International Financial Intermediation* (Washington, D.C.: Brookings Institution, 1987); Susan Strange, *Casino Capitalism* (London: Basil Blackwell, 1986); John S. Odell, *U.S. International Monetary Policy* (Princeton: Princeton University Press, 1982); and Benjamin J. Cohen, *Organizing the World's Money* (New York: Basic Books, 1977).

change rate.⁹ Consider what happens when a government decides to tighten monetary policy and maintain a constant exchange rate. Without capital mobility, the rise in interest rates will simply reduce aggregate demand. With capital mobility, such autonomy is lost, as funds attracted from abroad drive interest rates back down to world levels. A decision to loosen monetary policy would have the opposite effect.¹⁰ Of course, few countries have ever sought to insulate themselves completely from capital inflows or outflows. But throughout the postwar period, many did seek to limit the volume of those flows and thus preserve a degree of autonomy.

During the 1960s a growing number of economists argued that a preferable way to preserve national monetary autonomy was to abandon fixed exchange rates. With flexible exchange rates, a decision to tighten monetary policy might still attract capital, but its principal effect would be on the value of the national currency, not domestic interest rates. In this light, Harry Johnson explained, flexible exchange rates would “allow countries autonomy with respect to their use of monetary, fiscal, and other policy instruments, consistent with the maintenance of whatever degree of freedom in international transactions they choose to allow their citizens.”¹¹

In practice, the shift to flexible exchange rates in the 1970s did not provide the desired panacea. The Mundell-Fleming analysis (upon which Johnson’s recommendation was based) ignored feedback effects between exchange rates and domestic prices. As predicted, a country that sought to stimulate production by lowering interest rates suffered a depreciation of its currency. This depreciation, in turn, raised the price of its imports. If the country could not reduce imports quickly, higher import costs translated into higher prices for domestic production, thereby reducing the anticipated increase in output.¹² Despite the shift to floating

⁹ See Fleming, “Domestic Financial Policies under Fixed and Floating Exchange Rates,” *IMF Staff Papers* 9 (1962); Mundell, “The Monetary Dynamics of International Adjustment under Fixed and Flexible Exchange Rates,” *Quarterly Journal of Economics* 74 (May 1960); and idem, “Capital Mobility and Stabilization Policy under Fixed and Flexible Exchange Rates,” *Canadian Journal of Economics and Political Science* 29 (November 1963).

¹⁰ The Mundell-Fleming conclusion that a government has no control over monetary policy under such conditions depends on the assumption that sterilization does not or cannot occur. Evaluating the effectiveness of sterilization is a complicated matter. See Michael Goldstein, *Have Flexible Exchange Rates Handicapped Monetary Policy?* Special Papers on International Economics, no. 14 (Princeton: Princeton University, International Finance Section, 1980), 36–38.

¹¹ Harry G. Johnson, “The Case for Flexible Exchange Rates, 1969,” in Robert E. Baldwin and J. David Richardson, eds., *International Trade and Finance* (Boston: Little, Brown, 1974), 367–68.

¹² See W. M. Corden, *Inflation, Exchange Rates, and the World Economy: Lectures on Inter-*

rates, many countries therefore still considered capital controls necessary to carve out as much autonomy as possible for their monetary policies.

In the 1970s and 1980s, however, two developments dramatically reduced the usefulness of capital controls. The first was the transformation and rapid growth of international financial markets. Between 1972 and 1985, for example, the size of the international banking market increased at a compound growth rate of 21.4 percent, compared with compound annual growth rates of 10.9 percent for world gross domestic product and 12.7 percent for world trade.¹³ Moreover, just as this pool of funds increased in size, technological changes reduced the time it took to transfer funds across borders. Since the early 1970s the daily turnover on the world's exchange markets has risen tremendously. In the midst of the currency crisis in March 1973, \$3 billion were converted into European currencies in one day. In the late 1970s, daily turnover around the world was estimated at \$100 billion; a decade later, that figure had reached \$650 billion.¹⁴

Just as these changes were occurring, a related development was taking place—an increasing number of businesses were moving toward a global configuration.¹⁵ Multinational enterprises (MNEs) were, of course, not new. What was new was the growth in their number, from just a few hundred in the early 1970s to well over a thousand in 1990. Moreover, for more and more MNEs, the home base was outside the United States. Globalization was also evident in the rapid growth of foreign direct investment. During the latter half of the 1980s, for example, flows of new FDI rose at an annual rate of 29 percent.¹⁶ According to one recent study, more than \$3.5 trillion of business assets came under “foreign control” in the 1980s.¹⁷

These twin changes had dramatic consequences for the use of capital controls. Most importantly, the expansion of financial markets made it progressively easier for private firms whose operations had become increasingly global to adopt strategies of exit and evasion. Evasion had obviously taken place for decades, but the means by which it could be

national Monetary Economics, 2d ed. (Chicago: University of Chicago Press, 1980), chaps. 4–6.

¹³ Bryant (fn. 8), 22.

¹⁴ John B. Goodman, *Monetary Sovereignty: The Politics of Central Banking in Western Europe* (Ithaca, N.Y.: Cornell University Press, 1992), 18.

¹⁵ See David B. Yoffie, *Beyond Free Trade: Governments, Firms, and Global Competition* (Boston: Harvard Business School Press, 1993).

¹⁶ De Anne Julius, *Global Companies and Public Policy: The Growing Challenge of Foreign Direct Investment* (New York: Council on Foreign Relations, 1990).

¹⁷ Edward M. Graham, “The Determinants of Foreign Direct Investment: Alternative Theories and International Evidence” (Manuscript, Institute for International Economics, Washington, D.C., October 15, 1991.)

conducted were now multiplied. Multinational structures enabled firms to evade capital controls by changing transfer prices or the timing of payments to or from foreign subsidiaries. The deepening of financial markets meant that firms could use subsidiaries to raise or lend funds on foreign markets. If controls in a country became too onerous, MNEs could also attempt to escape them altogether by transferring activities abroad, that is, by exercising the exit option.¹⁸

This possibility, in turn, constrained the choices available to governments. Assume that a government maintains a more expansionary monetary policy than the rest of the world in order to stimulate growth and create jobs. Assume further that it recognizes that higher interest rates abroad are likely to attract domestic savings needed to finance domestic investment, and it therefore imposes controls on capital outflows. If MNEs react to these controls by moving certain operations offshore, the domestic savings base essentially shrinks. In this instance, the country finds itself in a worse position than when it started.¹⁹ Clearly, if a government can anticipate this effect, credible threats of exit would deter the imposition of capital controls. To the extent that such threats are indeed credible, they highlight the deepening interrelationship between short-term and long-term investment flows. A government that is truly serious about restricting short-term capital movements would also have to be prepared to restrict offshore direct investments by domestic firms. It would then have to balance the losses (in terms of efficiency) borne by those firms and the national economy against the anticipated benefits of capital controls.²⁰

¹⁸ Albert O. Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge: Harvard University Press, 1970); for a more recent argument regarding the effects of mobility of investment on public policy, see Robert Reich, "Who Is Us?" *Harvard Business Review* 48 (January–February 1990).

¹⁹ In conceptual terms, the burden of capital controls falls most heavily upon fixed factors of production. Thus, labor, presumably one of the intended beneficiaries of expansionary policies that necessitate capital controls, might ultimately pay the heaviest cost.

²⁰ The link between controls on short- and long-term flows depends upon the mobility of savings and investment. For any country, aggregate savings and investment must ultimately be equal. Imposing capital controls has the effect of reducing savings and therefore investment. The extent to which investment declines depends upon the mobility of production. If production is mobile, a drop in savings will lead to a parallel decline in investment. If production is immobile, then companies will pay higher interest rates to attract available savings. Investment will decline, but by a lesser amount. On the mobility of savings and investment, see Martin Feldstein and Charles Horioka, "Domestic Savings and International Capital Flows," *Economic Journal* 90 (June 1980); Martin Feldstein, "Domestic Savings and International Capital Movements in the Long Run and the Short Run," *European Economic Review* 21 (1983); Tamim Bayoumi, "Savings-Investment Correlations: Immobile Capital, Government Policy, or Endogenous Behavior," *IMF Staff Papers* 37 (July 1990); and IMF staff, "Determinants and Systemic Consequences of International Capital Flows," *IMF Occasional Paper Series* 77 (March 1991).

From the perspective of firms, however, neither evasion nor exit is a costless option. Firms surely prefer to avoid capital controls or to have them removed, rather than having to consider either option. Thus, MNEs and financial institutions might be expected to mobilize against controls and promote policies encouraging international capital mobility.²¹ Governments concerned with the issue of national competitiveness might be expected to be especially responsive to such entreaties. They might also be expected to press other governments to liberalize.

Government decisions to abandon capital controls during the 1980s reflected fundamental changes in the markets through which capital could flow. In our examination of specific decisions in the cases of Japan, Germany, France, and Italy, we provide examples of how these changes affected decision-making processes. Not surprisingly, indisputable evidence of evasion and exit on the part of firms is difficult to find—the former because firms have little interest in making apparent their use of loopholes; the latter because it involves, in essence, a kind of structural power. It need not be exercised to have effect.²² What comes out clearly, however, is the perception by national policymakers that capital controls had become less useful and more costly.

Although similar pressures affected all advanced industrial countries, the speed with which specific governments responded depended upon whether they were experiencing capital inflows or outflows. The four countries we examine in the next section provide examples of each. Japan and Germany, typically recording surpluses in their current accounts and experiencing capital inflows, liberalized in 1980–81. France and Italy, typically recording external deficits and experiencing capital outflows, did not abandon capital controls until the end of the decade. This difference in timing should not be exaggerated, but neither should it be overlooked, for it helps to clarify the way in which the pressures discussed above shaped the development of particular national policies.

Countries that sought to control capital inflows faced different incentives from those facing countries that sought to control capital outflows. The reason lies mainly in the asymmetric impact of capital movements on foreign exchange reserves. Current account deficits, capital outflows, weakening exchange rates, and depleting reserves often go together; when they do, governments must either adjust their policies or adopt

²¹ See Frieden (fn. 1).

²² On the structural power of business, see Charles Lindblom, *Politics and Markets: The World's Political and Economic Systems* (New York: Basic Books, 1977); and John Stopford and Susan Strange, *Rival States, Rival Firms: Competition for World Market Shares* (Cambridge: Cambridge University Press, 1991).

controls before the loss of reserves is complete. In contrast, governments facing the obverse situation find it easier to abandon controls since their reserve position is not threatened. This asymmetry can be enhanced for deficit countries committed to maintaining a fixed exchange rate, as was the case for France and Italy in the context of the European Monetary System (EMS).

THE FOUR CASES

GERMANY

DEVELOPMENT OF CONTROLS

In the early years of the Federal Republic, current account deficits and a dearth of foreign exchange reserves led to a strict prohibition on all exports of capital by residents. The legal basis for these controls was provided in the foreign exchange regulations of the Allied Occupation. By the early 1950s, however, West Germany's current account turned to surplus and the country's war-related external debts were finally settled. Restrictions on foreign direct investment abroad began to be liberalized in 1952, and residents were allowed to purchase foreign securities in 1956. By 1957 export of capital by residents was generally permitted without authorization. The relaxation of controls on outflows was effectively completed following restoration of currency convertibility in 1958, a policy stance legally enshrined in the Foreign Trade and Payments Act of 1961.²³

Owing largely to structural pressures on the deutsche mark in the Bretton Woods system of pegged exchange rates, however, this liberalization was not matched by similar progress on capital inflows. These pressures first emerged in the mid-1950s, when West Germany's low inflation rate and growing current account surplus increased the attractiveness of the mark relative to other currencies, notably the dollar. Under the Bretton Woods rules, the Bundesbank was required to enter the foreign exchange market and sell marks whenever the intervention point with the dollar was reached. But, of course, such obligatory purchases served to increase liquidity in the banking system and expand the money supply, thus creating inflation. Capital inflows therefore quickly came to be seen as significant threats to the Bundesbank's goal of maintaining price stability. Periodic expectations of revaluation and the resulting in-

²³ Deutsche Bundesbank, "Freedom of Germany's Capital Transactions with Foreign Countries," *Monthly Report of the Deutsche Bundesbank* 37 (July 1985), 16-17.

crease in speculative capital inflows dramatically underlined the dilemma.²⁴

In this situation, Germany essentially had two options as it struggled to maintain control over its domestic money supply. It could either revalue its currency or impose capital controls. Given the strong opposition of export interests to revaluation, transmitted in the subtle interplay between the government (which had responsibility for exchange rate policy) and the Bundesbank, the central bank's inclination tended in the latter direction.²⁵ In June 1960, for example, the purchase of domestic money market paper by nonresidents was subjected to an authorization requirement. Simultaneously, a ban was imposed on interest payments on bank deposits held by nonresidents. These restrictions remained in place after the mark was revalued in 1961 and were not removed until the second revaluation in October 1969. Controls were reintroduced, however, when pressure once again mounted against the mark in 1971. The following year, the Bundesbank required 40 percent of all loans raised abroad to be placed in non-interest-bearing accounts. It also extended authorization requirements to the purchase of domestic bonds by nonresidents.²⁶ Capital nevertheless continued to pour into Germany and ultimately necessitated two revaluations. Faced with massive speculative pressures in early 1973, the mark was finally allowed to float.

The transition to floating initially eased many of the pressures on the currency; the Bundesbank therefore began loosening some of its earlier restrictions but not dismantling its control apparatus altogether. Indeed, when confidence in the dollar began to decline in 1977, the Bundesbank again tightened existing capital controls and raised minimum reserve requirements on nonresidents' bank deposits to prevent what it considered an excessive appreciation of the mark. These measures were eased somewhat in 1978, when a shift in U.S. economic policy reduced inflows from abroad.²⁷

²⁴ On the problems of capital inflows and imported inflation, see Otmar Emminger, *The D-Mark in the Conflict between Internal and External Equilibrium, 1948-1975*, Princeton Studies in International Finance, no. 122 (Princeton: Princeton University, International Finance Section, 1977); and William Pollard Wadbrook, *West German Balance-of-Payments Policy: The Prelude to European Monetary Integration* (New York: Praeger, 1972).

²⁵ Michael Kreile, "West Germany: The Dynamics of Expansion," in Katzenstein (fn. 3), 213; and Ellen Kennedy, *The Bundesbank: Germany's Central Bank in the International Monetary System* (London: Chatham House, 1991).

²⁶ Deutsche Bundesbank (fn. 23), 17.

²⁷ For a thorough analysis of domestic policy decisions and international economic developments in 1977 and 1978, see Robert D. Putnam and C. Randall Henning, "The Bonn Summit of 1978: A Case Study in Coordination," in Richard N. Cooper et al., *Can Nations Agree? Issues in International Economic Cooperation* (Washington, D.C.: Brookings Institution, 1989).

In the wake of the second oil shock, the German current account moved sharply into an uncharacteristic deficit position. A surplus of DM 17.5 billion in 1978 became a deficit of DM 10.5 billion in 1979 (see Figure 1). Capital inflows suddenly dried up; indeed, capital began exiting the country. The value of the mark slid, and the Bundesbank was forced to finance the deficit first by borrowing and then by dipping into its reserves, which fell by DM 8 billion in 1980 alone.²⁸ Faced with the novel need to attract rather than ward off capital, the Bundesbank lifted remaining controls on capital flows in 1981.

REASONS FOR LIBERALIZATION

The sudden lifting of controls in 1981 was certainly triggered by a shift in Germany's external accounts. What is striking, however, is that the Bundesbank did not consider it necessary to reimpose capital controls when the current account returned to surplus in 1982 or when the mark once again began to appreciate after the Plaza Agreement in 1985. The reasons for this policy turnaround are several.

Official views on the deutsche mark clearly underwent a dramatic

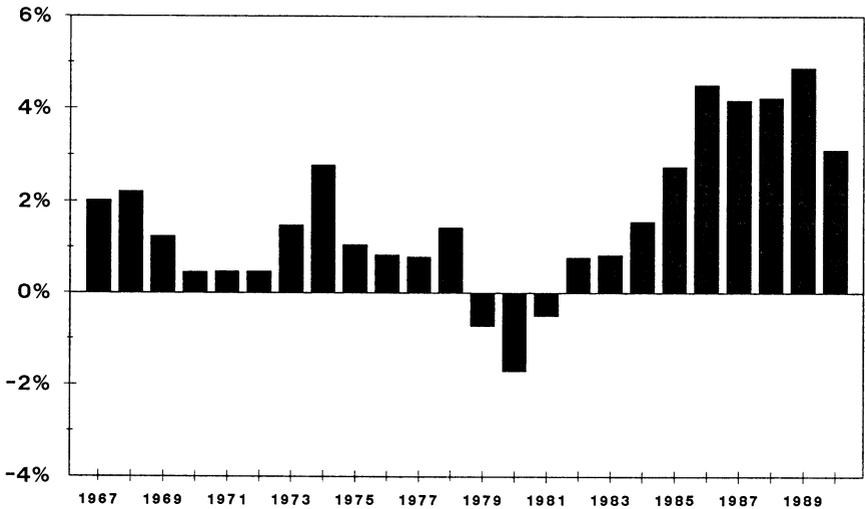


FIGURE 1
CURRENT ACCOUNT AS A PERCENTAGE OF GDP
(GERMANY)

SOURCE: IMF, *International Financial Statistics* (various years).

²⁸ Deutsche Bundesbank, *Report for the Year 1980*, 18–28.

change in the early 1980s. Throughout the 1960s and 1970s, the Bundesbank had, in effect, sought to prevent the mark from becoming a reserve currency largely to protect its ability to conduct an autonomous monetary policy and to deflect pressures for revaluation.²⁹ Yet by 1983 the Bundesbank had reluctantly accepted the mark's increasing role in the world economy. Financial openness was seen to promise benefits; in 1986 the central bank would even boast that Germany "definitely maintained its international position as a financial center."³⁰

The rapid transformation in the Bundesbank's perspective reflected the changing interests of German banks. By the early 1980s, the large West German banks had become extensively involved in external markets. Their international assets (loans), for example, rose from \$6.7 billion in 1973 to \$73.3 billion in 1980 and \$191 billion in 1985. With such rapidly rising international assets subject to world interest rates, banks became concerned about retaining a similar flexibility on the deposit side. In other words, changes on one side of bank balance sheets required similar changes on the other.³¹ Henceforth, the ability of German banks to compete abroad would depend increasingly upon the free movement of capital.

Deregulatory developments in Britain deepened such concerns; so too did policy changes further afield. In 1984, for example, the United States and Japan concluded a bilateral agreement aimed at facilitating the access of American financial firms to the Tokyo markets.³² West German banks feared that this agreement would forever lock them out of Japan unless their government stopped waiting for multilateral liberalization and began to negotiate a similar bilateral deal. The reciprocity provision built into the subsequent German-Japanese discussions of the management of securities issues in one another's markets underlined the new complexities that would have to be addressed if a unilateral movement toward closure were ever again contemplated.³³

More subtle pressures on official policies also emanated from changing corporate strategies. In the 1970s and 1980s German companies became increasingly multinational and directed larger volumes of their investment overseas. Reflecting this evolution, German foreign direct investment in foreign markets rose from DM 3.2 billion in 1970 to DM 7.6

²⁹ Emminger (fn. 24).

³⁰ Deutsche Bundesbank, *Annual Report for the Year 1985*, 50–53.

³¹ We are indebted to Louis Wells for clarification on this point.

³² See Louis W. Pauly, "Regulatory Politics in Japan: The Case of Foreign Banking," *East Asia Papers*, no. 45 (Ithaca, N.Y.: Cornell East Asia Program, 1987), 47–61.

³³ *Economist*, February 2, 1985, p. 69.

billion in 1980 and DM 14.1 billion in 1985.³⁴ The growing internationalization of German business strengthened resistance to the reimposition of capital controls.

In the same vein, financial institutions, which had adapted well to the restrictiveness of the German capital market in the early years of the Federal Republic, gradually became willing to threaten the exit option. The decision, for example, by the Deutsche Bank to buy 5 percent of Morgan Grenfell and move its international capital market operations to London provided the West German authorities with a clear signal that something had to be done to prevent international business from gravitating away from Frankfurt to London. The Deutsche Bank, after all, was not just any bank. It dominated the German capital market, led nearly half of all new mark-denominated Eurobond issues, underwrote 90 percent of new West German equity issues, and accounted for nearly one-quarter of all trading in German securities.³⁵ More generally, since the strength of the major German banks had long been viewed by policymakers as critical to the health of the country's leading industries—for which they served as lenders, shareholders, and advisers—the liberalization of their domestic base quickly became an important goal of policy.³⁶ The subsequent renewal of integration efforts in the European Community, including adoption of the 1992 program and initial planning for monetary union, accelerated policy efforts to expand "Finanzplatz Deutschland."

By the opening of the 1990s, the desire to see Frankfurt more deeply integrated into global financial markets had overwhelmed residual concerns about the implications of capital decontrol. The perennial issue of enhancing the competitiveness of German industry would be advanced by other means, including the expansion of production facilities outside the Federal Republic. The massive financial challenges posed by unification only reinforced the policy movement away from controls. The inflows that had proved so problematic in earlier decades were now deliberately encouraged.

JAPAN

DEVELOPMENT OF CONTROLS

As in Germany, the priority of economic reconstruction in Japan during the immediate years after World War II entailed tight official controls

³⁴ Julius (fn. 16), 119.

³⁵ Ibid.

³⁶ Christopher S. Allen, "Domestic Politics and Private Investment: Financial Regulation in West Germany and the United States," *Research Reports*, no. 2 (Washington, D.C.: American Institute for Contemporary German Studies, 1990).

over both inflows and outflows of short-term capital. The policy was put into place during the early days of the occupation and eventually drew its legal justification from the Foreign Exchange and Foreign Trade Control Law of 1949. In principle, all cross-border flows were forbidden unless specifically authorized by administrative decree. Only in the early 1960s did these arrangements begin to loosen, and then only for certain flows closely related to trade transactions. By 1964 this limited liberalization was enough to qualify Japan for Article VIII status in the IMF and for entry into the OECD.

Notwithstanding the first tentative moves toward financial openness, much publicized at the time, an extremely tight regime of controls over most capital movements remained. To be sure, certain inflows of hard currency, mainly U.S. dollars in the form of portfolio investment and foreign currency loans from American banks, were welcomed, but outflows and direct investment inflows were rigorously discouraged. The rationale for this policy stance was obvious. Even twenty years after the war, the country had no foreign currency reserves and was pursuing an ambitious strategy of indigenous industrial development. In effect, the policy amounted to husbanding and rationing scarce national resources. With an export-oriented economic growth strategy in place, the direct beneficiaries of the policy were leading industries selling their products in external markets. Financing was channeled to them mainly through highly regulated banks. Capital controls were key elements in a complex, but bureaucratically organized and directed financial system.³⁷ In view of its own overarching foreign policy interests, the United States, the only possible challenger to this arrangement, willingly acquiesced.

A string of current account surpluses began to generate increasing volumes of reserves in the early 1970s, and corporate as well as official interest began to shift in the face of impending resource scarcities, domestic environmental problems, and the rise of trade barriers in several foreign markets.³⁸ Restraints on capital outflows consequently started to loosen, but short-term capital inflows continued to be discouraged through a variety of measures. Strict new limitations, for example, were placed on new foreign currency loans. The goal was to counter the need for an upward revaluation of the yen and thereby to protect the competitiveness of the export sector.³⁹

³⁷ For institutional background and comparative assessment, see Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton: Princeton University Press, 1990); and Frederic C. Deyo, ed., *The Political Economy of the New Asian Industrialism* (Ithaca, N.Y.: Cornell University Press, 1987).

³⁸ By 1973 reserves had reached U.S. \$12 billion. Bank of Japan, *Economic Statistics Annual* (1984), Table 135.

³⁹ James Horne, *Japan's Financial Markets* (Sydney: George Allen and Unwin, 1985), 145

With the international monetary crisis of 1971, the subsequent pressure on the yen, and the first oil shock in 1973, the policy environment turned upside down. For three years, Japan registered deficits in its current account (see Figure 2). Controls were quickly eased on short-term inflows and tightened on outflows, particularly those occurring through the overseas networks of Japanese banks.⁴⁰ When the situation improved in 1976, and current account surpluses returned, the controls on outflows gradually came off again, but several new controls on short-term inflows were put in place for the familiar purpose of countering upward pressure on the yen. In 1979 a second oil price shock reversed the current account balance, this time for two years. But new controls on outflows were now surprisingly limited. By then, Japanese money markets had become more deeply integrated with international markets, and stabilizing inflows

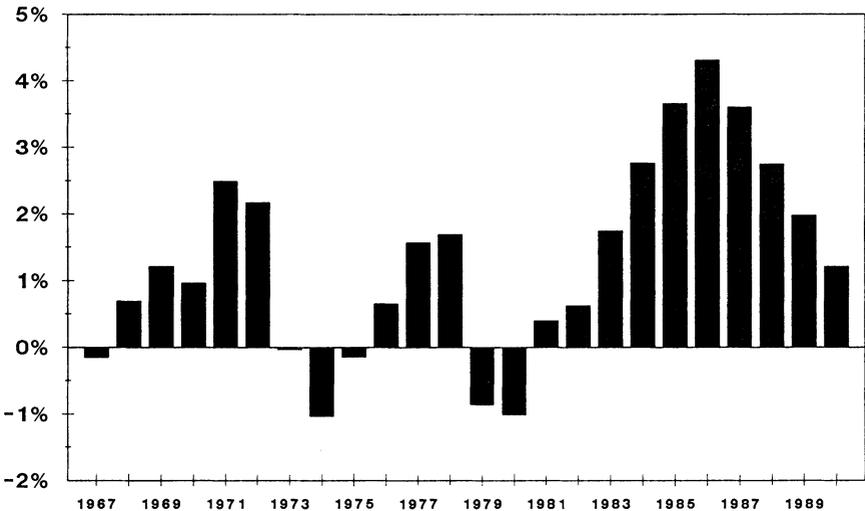


FIGURE 2
CURRENT ACCOUNT AS A PERCENTAGE OF GDP
(JAPAN)

SOURCE: IMF, *International Financial Statistics* (various years).

and Appendix 1. For a detailed discussion of the domestic struggle against revaluation, see Robert C. Angel, *Explaining Economic Policy Failure: Japan in the 1969–71 International Monetary Crisis* (New York: Columbia University Press, 1991). On the sensitivity of the exchange rate question, see also C. Randall Henning, “Finance, Industry, and External Monetary Policy” (Manuscript, Institute for International Economics, Washington, D.C., September 1991).

⁴⁰ Frances McCall Rosenbluth, *Financial Politics in Contemporary Japan* (Ithaca, N.Y.: Cornell University Press, 1989), 55. Note that the pattern repeated itself in 1979.

more than matched outflows. Instead of being concerned that the new crisis would hurt the value of their investments in Japan, international investors, including OPEC governments, now focused on the underlying strength of the economy, and funds poured into the country.

REASONS FOR LIBERALIZATION

Having contributed to tensions in its economic relations with the United States and Western Europe in the early 1970s and again in 1976, exchange rate issues were in the background in 1979 when the Ministry of Finance announced its intention to initiate a major liberalization program to cover inward as well as outward capital movements. The relative ease with which the economy was adjusting to the second oil crisis provided a permissive policy context for this shift. In 1980 it was codified in a new Foreign Exchange and Foreign Trade Control Law, which replaced the concept of capital flow interdiction with the concept of automaticity-in-principle.⁴¹

It is no coincidence that such a regime was put into place at a time when remarkable changes were under way in the international direct investment strategies of Japanese firms. After decades of slight involvement abroad, Japanese FDI went into a period of explosive growth. Comparable to volumes recorded throughout the late 1960s and early 1970s, net long-term capital movements from Japan totaled U.S. \$3.1 billion in 1977. In 1978 that number jumped to \$12.4 billion, or 1.5 percent of Japan's GNP. By 1986 it had reached \$132.1 billion, or 6.7 percent of GNP.⁴² In the face of these flows, and the options of evasion and exit that they implied for externally oriented Japanese firms, the control regime originally enshrined in law in 1949 had outlived its usefulness.

Although the new law did not limit the government's formal capacity to intervene in Japanese financial markets, in practice a policy of decontrol was aggressively pursued.⁴³ The apparatus for controlling capital movements was dismantled, a policy reinforced by parallel moves to free

⁴¹ See Michele Schmiegelow, "The Reform of Japan's Foreign Exchange and Foreign Trade Control Law: A Case of Qualitative Economic Policy," in Schmiegelow, ed., *Japan's Response to Crisis and Change in the World Economy* (Armonk, N.Y.: M. E. Sharpe, 1986).

⁴² Bank of Japan, *Balance of Payments Monthly*, and Ministry of Finance, *Monthly Finance Review*, cited in Edward J. Lincoln, *Japan: Facing Economic Maturity* (Washington, D.C.: Brookings Institution, 1988), 248.

⁴³ Note that insurance against the perceived negative consequences of too-rapid decontrol was provided in various ways, including the retention of "notice" requirements tailored to particular types of transactions, an insistence that capital outflows take place through "designated financial institutions" (two hundred domestic as well as foreign financial institutions resident in Japan), impediments to overseas investments by individuals resident in Japan, and graduated implementation timetables. Such techniques promised simultaneously to deflect foreign criticism and to allow time for domestic institutional adjustments to occur.

up gradually the operations of both domestic and foreign financial intermediaries. Although external pressures from private markets and foreign governments may have hastened the overt pace of change in each area, it is worth noting that foreign financial interests were far from unanimous in welcoming this shift. Foreign banks long established in Japan, for example, benefited materially from the earlier regime.⁴⁴

It is clear, however, that well-positioned Japanese intermediaries had the most to gain from the deepening of domestic capital markets promised by the twin policies of decontrol and deregulation, while Japanese manufacturing and financial firms overseas benefited to the extent that such policies defended their positions in foreign markets. In the mid-1960s Japan's cross-border banking business was mainly related to trade flows, and the Bank of Tokyo, the officially designated international bank, accounted for most of the fifty Japanese branches abroad. Twenty years later all of the major banks, as well as many smaller intermediaries, maintained physical networks overseas, comprising over two hundred branches and subsidiaries and three hundred representative offices. Japanese securities companies and insurance vendors followed the banks in major international expansions. Japanese intermediaries and some of their foreign rivals formed the institutional infrastructure for Euro-yen markets, whose development received a boost from the so-called yen-dollar negotiations that the United States and Japan concluded in 1984. Thereafter, it would become much more difficult to prevent the yen from evolving into a major international reserve currency.⁴⁵

By the early 1980s Japan was on the way to becoming the world's largest creditor. In practical terms, this meant that Japanese financial institutions began to play an increasingly important role in overseas capital markets⁴⁶—a development that expanded the range of arbitrage (or

⁴⁴ Louis W. Pauly, *Opening Financial Markets: Banking Politics on the Pacific Rim* (Ithaca, N.Y.: Cornell University Press, 1988), chap. 4.

⁴⁵ The causal importance of foreign governmental pressure is not easy to gauge. The U.S. government has not been shy about claiming credit for liberalization moves by Japan. For its own reasons, not the least of which is undoubtedly to shift the blame for moves that have not been universally popular at the domestic level, the Japanese government has often been willing to go along with this assessment. Astute observers have argued that liberalization is, in truth, unlikely in the absence of a sufficiently well developed domestic consensus but that foreign pressure can sometimes help nudge that consensus along. See Kent E. Calder, "Japanese Foreign Economic Policy Formation: Explaining the Reactive State," *World Politics* 40 (July 1988). On the changing balance between the government and the private sector, see T. J. Pempel, "The Unbundling of Japan, Inc.: Changing Dynamics of Japanese Policy Formation," *Journal of Japanese Studies* 13 (Summer 1987); and Richard Samuels, *The Business of the Japanese State* (Ithaca, N.Y.: Cornell University Press, 1987).

⁴⁶ An indication of the underlying trend is provided in a bilateral Japan/U.S. comparison. In 1985 Japanese intermediaries in the United States accounted for assets totaling U.S. \$178 billion; by the end of 1989 that figure had increased to \$421 billion. In contrast, U.S. inter-

“exit”) opportunities for Japanese investors and borrowers and complicated the problem of economic management for the Japanese government.⁴⁷ After Sumitomo Bank purchased a majority interest in the Swiss universal bank Banco del Gottardo, for example, it became exceptionally difficult for the Ministry of Finance to keep the Eurobond market separate from the Japanese domestic market, since major Sumitomo clients could henceforth raise funds more easily in either market.⁴⁸

The private pressure for increased openness thereby generated was matched during much of the 1980s by the effects of rising public sector indebtedness, which further encouraged the deepening of domestic debt markets.⁴⁹ Even without the added pressure coming from foreign governmental demands for decontrol, by 1990 high volumes of inward as well as outward capital flows translated into a broadening domestic political base for progressive financial liberalization and capital decontrol.⁵⁰ Although countervailing domestic pressures emerged as inward flows pushed up the exchange value of the yen, the authorities now attempted to manage them more generally through the medium of interest rates and more directly through selective policies of compensation.⁵¹

At the firm level, foreign direct investment was an obvious and increasingly used method for coping with a rising yen. Indeed, such a consideration has been widely cited as an explanation for the rapid pace of growth in Japanese FDI in the 1980s. From a base of U.S. \$2.4 billion in 1980, direct investment outflows from Japan increased to \$6 billion in

mediaries in Japan accounted for assets of \$18.6 billion in 1985 and \$18.8 billion in 1989. U.S. Department of the Treasury, *National Treatment Study* (Washington, D.C.: Department of the Treasury, 1990), 208.

⁴⁷ Note that the overseas bond activity of Japanese companies rose from ¥806.7 billion in 1980 to ¥5.3 trillion in 1988. Tokyo Stock Exchange statistics cited in James K. Jackson, “Foreign Access to Japan’s Capital Markets,” in U.S. Congress, Joint Economic Committee, *Japan’s Economic Challenge* (Washington, D.C.: GPO, 1990), 152.

⁴⁸ Rosenbluth (fn. 40), 156.

⁴⁹ By the mid-1980s central government debt totaled 42% of GNP; the comparable ratio for the United States was 45%. See Bank of Japan-Money Market Study Group, “Japan’s Short-Term Money Market and Its Issues” (Mimeo, Bank of Japan, June 8, 1990); and Yoichi Shinkai, “The Internationalization of Finance in Japan,” in Takashi Inoguchi and Daniel Okimoto, eds., *The Political Economy of Japan: The Changing International Context* (Stanford, Calif.: Stanford University Press, 1988), 251.

⁵⁰ Note, however, the persistent lag with regard to direct investment inflows, especially those connected with acquisitions of existing assets. See Dennis J. Encarnation and Mark Mason, “Neither MITI nor America: The Political Economy of Capital Liberalization in Japan,” *International Organization* 44 (Winter 1990); and Edward Graham and Paul Krugman, *Foreign Direct Investment in the United States*, 2d ed. (Washington, D.C.: Institute for International Economics, 1991).

⁵¹ Kent Calder, *Crisis and Compensation* (Princeton: Princeton University Press, 1988), 479–80; on the role of the Liberal Democratic Party in this regard, see Frances McCall Rosenbluth, “Japan’s Response to the Strong Yen: Party Leadership and the Market for Political Favors,” in Gerald Curtis, ed., *Coping with Change: New Directions in Japan’s Foreign Policy* (New York: M. E. Sharpe, 1993).

1984, \$14.4 billion in 1986, and \$34.1 billion in 1988. During the latter years of the 1980s, Japanese FDI grew at an average rate of 35.5 percent per year.⁵² For Japanese companies, the progressive internationalization of their production facilities was matched by the increasing global diversification of their financing. In 1975 they raised ¥ 2.8 billion on domestic capital markets and ¥ .5 billion on overseas markets. In 1989 the comparable figures were ¥ 17.2 billion on domestic markets and ¥ 11.1 billion overseas.

Despite extreme financial turbulence in the 1990s, including a collapse in stock and real estate prices and an associated pullback of Japanese financial intermediaries from foreign markets, few observers expected a movement back to capital controls. The internationalization of Japanese business and the international integration of Japanese financial markets had proceeded far enough to make such an option much less feasible than it had been even a decade earlier. For leading Japanese firms, in particular, strategies of evasion and exit were now embedded in their very structures. That reality gave them significant new leverage over Japan's capital policies.

FRANCE

DEVELOPMENT OF CONTROLS

Controls on foreign exchange transactions in France, although first introduced in 1915, became firmly established only after the Second World War. Like most other European countries, France initially used capital controls to ensure that its limited foreign exchange be used for domestic reconstruction and development. In later years, controls on capital outflows were kept in place because of persistent current account deficits. In these circumstances, controls were deemed necessary to insulate domestic interest rates from world markets. In 1966 a new law gave the government the right to control all foreign exchange transactions between France and the rest of the world, oversee the liquidation of foreign funds in France and French funds abroad, and prescribe conditions for the repatriation of all income earned abroad.⁵³

These new controls on capital movements added to France's already impressive array of administrative measures designed to direct the flow of savings and investment. The Treasury, for example, channeled funds directly from the government budget to industry. It also controlled the

⁵² Julius (fn. 16), 118; and Edward J. Lincoln, *Japan's Unequal Trade* (Washington, D.C.: Brookings Institution, 1990), 121.

⁵³ Philippe Jurgensen and Daniel Lebegue, *Le Trésor et la politique financière*, fasc. 3 (Paris: Les Cours de Droit, 1984), 48–64.

country's parapublic banks—such as the Banque Française du Commerce Extérieur and the Crédit National—which had been created to provide favored sectors with access to credit at subsidized rates. And finally, it guided the trajectory of financial flows through its use of controls over domestic interest rates and bank lending (the famous *encadrement du crédit*).⁵⁴

The importance of both capital and credit controls increased with France's decision in 1979 to join the EMS. Although French authorities had never allowed the franc to float freely, the EMS fixed the value of the franc more rigidly. Yet between 1979 and 1984, no government, whether of the Right or the Left, was willing to raise interest rates high enough to maintain the value of the franc in the EMS. Capital controls enabled the government to keep interest rates lower than would otherwise have been required.

The use of capital controls intensified following the 1981 election of François Mitterrand, the first socialist president of the Fifth Republic. Mitterrand inherited a currency that had become substantially overvalued, and his government's commitment to fiscal expansion and income redistribution soon triggered a run on the franc.⁵⁵ In the midst of this crisis, Mitterrand and his advisers refused to sacrifice the goal of exchange rate stability. As Jean Peyrelevade, a principal economic adviser, later explained:

Allowing the franc to float . . . would have caused our international partners, who were already suspicious, to doubt the new government's attachment to Europe. Allowing the franc to float would have immediately wakened the old demons . . . that the arrival of the left in power translated immediately into the sacrifice of our currency . . . and the inability to manage the economy.⁵⁶

Nor was the government willing to sacrifice monetary autonomy; despite the fact that France's major trading partners were in recession, the government continued with its plans to stimulate the economy.⁵⁷ With these

⁵⁴ On the instruments and workings of French financial policy, see Jacques Méliuz, "The French Financial System: Mechanisms and Propositions of Reform," *Annales de l'INSEE* 47–48 (July–December 1982); and idem, "Financial Deregulation in France," *European Economic Review* 34 (1990).

⁵⁵ The effects of the Socialist program on capital flows are found in Philippe Bauchard, *La guerre des deux roses* (Paris: Grasset, 1986); Michel Beaud, *Le mirage de la croissance*, vol. 1 (Paris: Syros, 1983); and Peter Hall, *Governing the Economy: The Politics of State Intervention in Britain and France* (New York: Oxford University Press, 1986), chap. 8.

⁵⁶ Cited in Thierry Pfister, *La vie quotidienne à Matignon au temps de l'Union de la Gauche* (Paris: Hachette, 1985), 246; see also Jean Peyrelevade, "Témoignage: fallait-il dévaluer en mai 1981?" *Revue politique et parlementaire* (June 1986).

⁵⁷ Mitterrand's advisers realized that domestic expansion at a time when France's major trading partners were in recession would increase the current account deficit and hence lead

options ruled out, the government therefore tightened controls on the foreign exchange positions of French companies, on the overseas accounts of individuals, and on borrowing by nonresidents in France.

These controls provided the government with some breathing space, but the combination of growth at home and recession abroad soon caused France's trade and current accounts to fall deeply into the red (see Figure 3). Even with more restrictive capital controls and tighter credit ceilings, however, the socialist government was unable to eliminate pressure against the franc and was therefore forced to devalue on three occasions during its first two years in office. In the aftermath of the third devaluation, the government decided to reverse course and replace its earlier expansion plans with deflationary monetary and fiscal policies.⁵⁸ In ad-

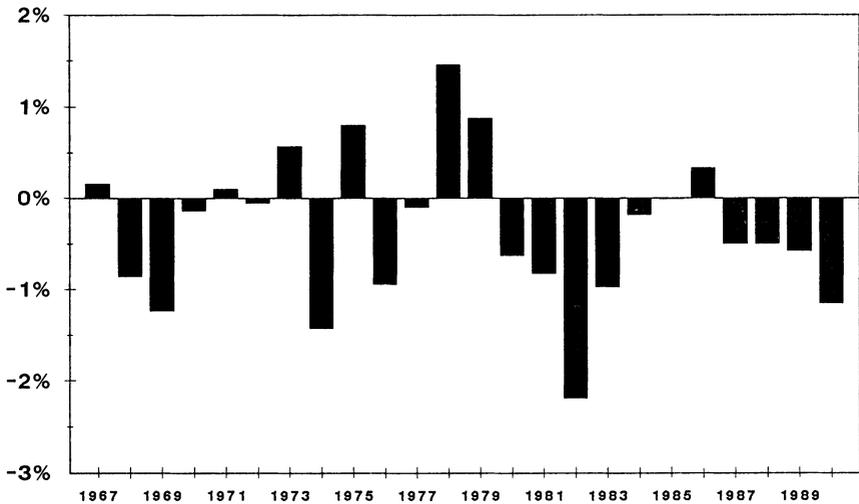


FIGURE 3
CURRENT ACCOUNT AS A PERCENTAGE OF GDP
(FRANCE)

SOURCE: IMF, *International Financial Statistics* (various years).

to more pressure against the franc. However, they expected the world economy to recover by the end of 1981 and counted on that recovery to restore a current account surplus. See Robert D. Putnam and Nicholas Bayne, *Hanging Together: The Seven-Power Summits* (Cambridge: Harvard University Press, 1984), 150.

⁵⁸ On the evolution of Mitterrand's economic policies, see Bauchard (fn. 55); Beaud (fn. 55); Alain Fonteneau and Pierre-Alain Muet, *La gauche face à la crise* (Paris: Presses de la Fondation National des Sciences Politiques, 1985); and Michael Loriaux, *France after Hegemony: International Change and Domestic Reform* (Ithaca, N.Y.: Cornell University Press, 1991), chap. 8.

dition, it adopted draconian capital controls: foreign equities and bonds could only be traded by French citizens among themselves. Importers faced strict limits in their ability to cover their foreign exchange risk, while exporters were forced to repatriate foreign-currency earnings almost immediately. French nationals could only keep a foreign bank account while they resided abroad. French tourists could take only a small amount of foreign exchange outside the country and were deprived of the use of their credit cards.⁵⁹

For the socialists as for their conservative predecessors, heavy reliance on capital controls thus resulted primarily from a desire to keep domestic interest rates lower than those generally prevailing in the rest of the world without abandoning the objective of exchange rate stability. Lower interest rates reduced demand for franc-denominated assets and stimulated domestic demand for imports. Together, these two effects increased net capital outflows and placed pressure on the franc. To avoid a precipitous decline of the franc (even if France left the EMS), tighter capital controls were deemed necessary. As the socialist government discovered, however, such controls had to be continuously tightened if they were to be effective. The controls of 1983 placed the French economy in the tightest corset since World War II.

REASONS FOR LIBERALIZATION

In November 1984 Prime Minister Laurent Fabius announced a dramatic new plan to reform the entire financial system. The government planned not only to eliminate credit ceilings and capital controls, but also to create new money, bond, and futures markets. Such wholesale reform had not been expected. Unlike France's decision to remain in the EMS, pressure from its EC partners was not part of the policy calculation; indeed, the announcement of its financial reform package *preceded* the commission's June 1985 white paper on European financial integration. As Jacques Méliitz has argued, just the opposite appears to have been true:

When economic historians look back at this important juncture in European financial history . . . they will conclude that the French liberalization program was the single most important forerunner of the White Paper. With this liberalization program came the French support for an integrated European market for financial services, without which the proposal of a Single Market would never have gotten off the ground.⁶⁰

⁵⁹ Jacques Méliitz, "Monetary Policy in France," in Michele Fratianni and Dominick Salvatore, eds., *Handbook of Monetary Policy* (Westport, Conn.: Greenwood Press, 1993), chap. 10.

⁶⁰ Méliitz (fn. 54, 1990), 394–95; see also Andrew Moravcsik, "Negotiating the Single Eu-

What drove this new program of financial liberalization? Evasion strategies on the part of individuals and firms were certainly in the background; the famous stories about suitcases filled with foreign currency being carried into Switzerland come to mind. More subtle and ultimately more decisive pressures emanated, however, from the boardrooms of large French firms and financial intermediaries. In the French case, direct threats of exit were muted by the fact that virtually all of these firms were owned or controlled by the state.⁶¹ In this environment, such an option was transmuted into the rising concerns of government officials regarding the competitiveness of those firms relative to their foreign rivals.⁶² Jobs and investment that were promised by growth in the service sector, for example, were seen to be leaving France and migrating to less-restricted markets. In a very real sense, especially in financial services, Paris was increasingly seen to be in direct competition with London and Frankfurt. Such perceptions clearly lay behind the subsequent commitment of Finance Minister Balladur to make Paris "the leading financial market in Europe."⁶³

By 1984 the situation had become severe, and French policymakers recognized the pressing need to change course.⁶⁴ When international capital markets were rapidly developing elsewhere, the competitiveness of both French industry and finance was now seen to be seriously undermined by capital controls. In 1985 the elimination of credit ceilings began, and new money, bond, and futures markets were created. The phaseout of capital controls followed, with major steps taking place in 1986 and 1989; in January 1990 controls disappeared completely with the lifting of the ban on the holding of foreign deposits by French nationals.⁶⁵

The shift in favor of capital mobility eventually tied in directly with plans for European Monetary Union (EMU), and France became a key

ropean Act: National Interests and Conventional Statecraft in the European Community," *International Organization* 45 (Winter 1991).

⁶¹ Some firms sought to escape the wave of nationalization and the subsequent loss of control. The most prominent example was Paribas, the large financial holding company, whose CEO, Pierre Moussa, sought to sell majority control of the company to investors in Switzerland and Luxembourg. Bauchard (fn. 55), 68.

⁶² Interviews with French government officials, Paris, June 1988. See also Wayne Sandholtz and John Zysman, "1992: Recasting the European Bargain," *World Politics* 42 (October 1989). The government's subsequent assessment of the position of French financial firms is reported by Pierre Achard, "Le marché unique de 1992: perspectives pour les banques, les assurances, et le système financier français" (Report of the Ministries of Economy, Finance, and Privatization, December 1987).

⁶³ Cited in *Euromoney*, September 1987, 143.

⁶⁴ See Bauchard (fn. 55), chaps. 3, 4.

⁶⁵ Méritz (fn. 59). See also Peter Oliver and Jean-Pierre Baché, "Free Movements of Capital between the Member States: Recent Developments," *Common Market Law Review* 26 (1989).

promoter of the idea.⁶⁶ The freedom of capital movements across the member states of the prospective union, indeed, was a prerequisite. But the planning for EMU followed the new commitment to restore and enhance the competitiveness of French industrial firms and financial intermediaries. The Delors Committee report on EMU came in 1988, three years after decontrol became the thrust of financial policy within France. That policy remained consistent despite the election of a conservative government in 1986 and the return of the socialists in 1988. In effect, as international financial integration outside France accelerated, French policymakers came to the conclusion that their preference for national monetary autonomy was unrealistic. The decision to initiate capital decontrol followed and accelerated as the country's external accounts improved.

ITALY

DEVELOPMENT OF CONTROLS

Restrictions on capital movements were initially put in place in Italy during the First World War. They were refined and tightened by Mussolini during the following two decades. Controls were relaxed in the late 1950s, a period of current account surpluses and currency stability. The "hot autumn" of 1969, however, dramatically altered Italy's economic trajectory. Facing increased labor militancy, the government put into place an expansionary fiscal policy to spur growth and ensure social peace. By 1973 this policy resulted in fiscal imbalances and current account deficits (see Figure 4). The lira soon came under speculative attack. Rather than reverse its economic policy and risk unrest, the government responded by tightening capital controls.⁶⁷

Italian economic policy after the 1973 oil shock followed a classic stop-and-go cycle that made capital controls even more necessary. The oil shock caught Italy in a difficult position—with both a booming economy and a significant current account deficit. With the backing of the IMF, macroeconomic policy shifted to a decidedly more restrictive course in 1974, and by 1975 the Italian economy had fallen into its deepest recession since the 1950s. A shift to easier monetary and fiscal policy in early 1975, however, brought an exceptionally rapid recovery. Booming imports created downward pressure on the lira, and fears of a communist

⁶⁶ On France and EMU, see Goodman (fn. 14), 202–8.

⁶⁷ For a broader discussion of the economic policies pursued in this period, see Michele Salvati, "The Italian Inflation," in Leon W. Lindberg and Charles S. Maier, eds., *The Politics of Inflation and Economic Stagnation* (Washington, D.C.: Brookings Institution, 1985); and Robert J. Flanagan, David W. Soskice, and Lloyd Ulman, *Unionism, Economic Stabilization, and Incomes Policies* (Washington, D.C.: Brookings Institution, 1983), chap. 9.

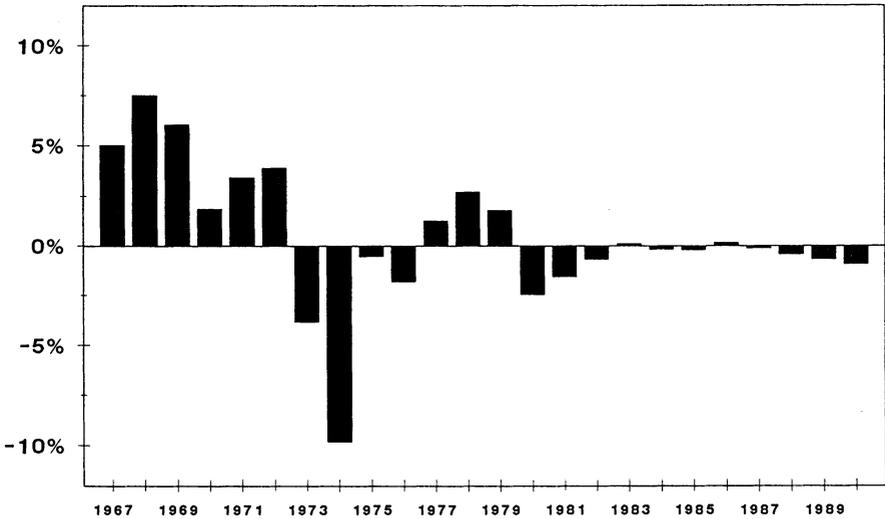


FIGURE 4
CURRENT ACCOUNT AS A PERCENTAGE OF GDP
(ITALY)

SOURCE: IMF, *International Financial Statistics* (various years).

electoral victory accelerated capital flight. Despite heavy intervention in the foreign exchange markets, which left Italy with only \$500 million in reserves, the lira depreciated by 20 percent in the first four months of 1976.⁶⁸

The Italian authorities responded by tightening monetary policy, fiscal policy, and capital controls. The most draconian measures were embedded in Law 159 of 1976, which essentially decreed that every foreign exchange transaction was illegal unless specifically authorized. In particular, the law made it a criminal offense either to send or to hold more than 5 million lire abroad without permission. Moreover, Italians owning residential property abroad were required to sell it and bring the proceeds back to Italy. A year later, these controls were eased somewhat after the communists were finally included in the governing majority, after the trade unions agreed to make wage concessions, and after a standby arrangement was negotiated with the IMF.⁶⁹

⁶⁸ Luigi Spaventa, "Two Letters of Intent: External Crises and Stabilization Policy, Italy, 1973-1977," in John Williamson, ed., *IMF Conditionality* (Washington, D.C.: Institute for International Economics, 1983).

⁶⁹ *Financial Times*, November 5, 1983, and April 4, 1985.

Still, government officials viewed capital controls as a means of avoiding hard choices. By the mid-1980s the annual budget deficit had topped 11 percent of GDP and cumulative debt approached 100 percent of GDP.⁷⁰ To finance these deficits, the government had long relied on a large domestic savings pool. Household savings in Italy amounted to 20 percent of personal disposable income—the second highest savings rate in the world after Japan.⁷¹ Doing away with capital controls in the face of such deficits meant that domestic savers would be able to purchase foreign assets, forcing the government to offer a higher rate of interest on its own debt. As Bank of Italy director general Lamberto Dini explained in 1986: “If we liberalize capital controls at a time when government financing needs are too high, we’d have to accept the risks of much higher interest rate variability.”⁷²

Italy’s decision to join the EMS in 1979 made matters even more difficult. With an economic policy more expansionary than that of its neighbors, exchange markets would not long find credible the country’s commitment to maintain a fixed exchange rate. Here, too, capital controls were seen as a way of avoiding hard choices. Controls were eased and then reimposed each time the lira came under attack in exchange markets.⁷³

REASONS FOR LIBERALIZATION

The elimination of capital controls in Italy did not begin until 1987 and was not completed until 1992. Given the difficulties faced by Italian policymakers, the source of this policy change is particularly interesting. Of the major EC countries, Italy was the only one whose decision was affected by pressure from its partners, particularly Germany, to comply with the EC directive on capital movements. In July 1986, for example, the European Court of Justice ruled that Italy had to give up insisting that every Italian citizen who held securities abroad had to keep 25 percent of their value in a non-interest-bearing account with the central bank. (In this instance, the Italian government responded by reducing the deposit to 15 percent.)⁷⁴

Still, it would be a mistake to attribute Italy’s policy shift primarily to such external pressure, for in Italy—as in Germany, Japan, and France—private pressure for liberalization had become pervasive. Evasion of cap-

⁷⁰ Banca d’Italia, *Annual Report 1989*, 66–69.

⁷¹ OECD Economic Surveys, *Italy* (1988–89), 183.

⁷² Steven Solomon, “Freeing Up Italian Finance,” *Institutional Investor* (November 1986), 308.

⁷³ *Financial Times*, October 25, 1985, and April 24, 1986.

⁷⁴ Alison Macleod, “Train of the Lawless,” *Euromoney*, September 1986, p. 374.

ital controls, of course, was a national sport, practiced by business executives, government ministers, and even church officials.⁷⁵

More important for the shift in policy, however, was the increasingly assertive position taken by private firms. Financial institutions, for example, had become concerned about the effect of controls on their ability to compete. It was perhaps not surprising that foreign companies opposed capital controls. The chairman of Lloyd's of London, Peter Miller, for example, noted that Assicurazione Generali could write business in London and remit proceeds to Italy, but "if we write business in Italy, we are not free to remit the proceeds to England."⁷⁶ Yet domestic institutions also believed they were being disadvantaged. Nerio Nesi, chairman of the Banca Nazionale del Lavoro, the largest Italian bank, argued that if Italy "doesn't want to be left out of the most important financial flows, [it] has to bring its laws into line with the new situation. And that means opening the frontiers."⁷⁷

Manufacturing firms, like Olivetti and Fiat, also favored an end to controls. As the power of organized labor diminished in the 1980s, these firms became more profitable and competitive in foreign markets.⁷⁸ They were therefore also more directly hampered by restrictions on capital movements and concerned about the prospect of not being able to take full advantage of the expanding EC market. Moreover, throughout the 1980s, many corporate groups—including Fiat, Montedison, and Ferruzzi—had entered the financial sector, both individually and in concert with Italian banks. With diversification, these corporations developed new interest in the further development of domestic capital markets, as well as the extension of access to external markets. Capital controls impeded this prospect.⁷⁹ So too did the never-ending rise in public borrowing. Accordingly, corporate leaders pushed for the elimination of controls in the hope of forcing greater discipline upon the government.⁸⁰ In 1987, in a political environment significantly reshaped by changing corporate structures and preferences, the Italian government began stripping away existing controls on capital movements—a move completed in 1992—and pushed through legislation limiting its own power to reimpose new controls during times of currency crisis.

⁷⁵ In 1985 the archbishop of Brescia was arrested at Milan airport for trying to take \$20,000 in Italian currency on a Christmas mission to Africa. *Ibid.*, 376.

⁷⁶ *Ibid.*, 375.

⁷⁷ *Ibid.*

⁷⁸ On the decline of the power of organized labor in Italy, see Flanagan, Soskice, and Ulman (fn. 67), chap. 9.

⁷⁹ Solomon (fn. 72); and Richard I. Kirkland, Jr., "A New Dose of Capitalism Turns Italy Around," *Fortune*, April 14, 1986, p. 98.

⁸⁰ Macleod (fn. 74).

CONCLUSION

In the early years of the postwar period, governments relied on controls over short-term capital movements for one fundamental purpose—to provide their economies with the maximum feasible degree of policy-making autonomy without sacrificing the benefits of economic interdependence. Controls were a shield that helped deflect the blows of international competition and ameliorate its domestic political effects. In the Bretton Woods system of pegged exchange rates, controls promised to provide both the space needed for the design of distinct national economic policies and the time needed for gradual economic adjustment to a changing external environment. To the surprise of some, they remained essential for many governments even when that system was replaced by managed floating.

Between the late 1970s and the early 1990s, a broad movement away from capital controls was evident across the industrialized world. The rapid growth of liquid international funds and the increasing globalization of production drove this process. Offshore markets eroded national financial barriers, not least by providing ever-widening sources of funding for multinational firms engaged in the process of globalizing their production facilities. In so doing, they enhanced the capability of firms to develop evasion and exit strategies. Governments thus first found that controls had to be tightened continuously to remain useful and then discovered that the resulting or potential economic costs of such tightening soon exceeded the benefits.⁸¹

To be sure, governments encouraged or at least acquiesced in both the growth of offshore money markets and the international expansion of firms. Yet as our case histories show, governments continued to impose capital controls long after such developments became salient. In this sense, the diminishing utility of capital controls can be considered the unintended consequence of other and earlier policy decisions.

Strategies of evasion and exit on the part of firms, we have argued, threatened to reduce the volume of domestic savings and investment, the promotion of which often constituted the original rationale for controls. Of course, firms could use direct methods for pushing the decontrol agenda, as we saw in the French case where state ownership was a significant factor. But their ultimate influence on policy came from the pressure to evade controls or exit from their national jurisdictions if they were to remain competitive. In the German case, for example, by making

⁸¹ For a prescient argument in this vein, see Benjamin J. Cohen, "Capital Controls and the U.S. Balance of Payments: Comment," *American Economic Review* 55 (March 1965).

moves offshore, the Deutsche Bank effectively made the case that capital controls were inconsistent with the goal of building a strong national financial center.

Other factors have influenced the elimination of capital controls, but our cases suggest that such factors played a secondary role. The principle of international capital mobility, for example, had long been enshrined in the OECD Code on Capital Movements, but until the 1980s virtually every major signatory country had at some point honored that principle in the breach. Similarly, a common European capital market was a key objective of the 1992 program, but the success of this effort was preceded (and made possible) by national programs of capital decontrol in both France and Germany. Fundamental changes at the domestic level also underpinned the apparent success of direct political pressure by other governments. In the Japanese case, for example, American pressure appeared at most to reinforce firm-level pressures associated with the rapid expansion of Japanese financial intermediaries and companies in overseas markets.

Notwithstanding the general movement in the direction of capital liberalization across the advanced industrial world, our cases point to important differences in the timing of actual decisions to decontrol. It was easier for countries facing capital inflows (Japan and Germany) to lift capital controls, than it was for countries facing capital outflows (France and Italy). The difference in timing—roughly a decade—underlines the mechanism by which systemic forces were translated into national decisions. Our cases do not enable us to reach definitive conclusions in this regard, but it seems likely that these differences in timing are correlated with broader variations in domestic political structures.⁸² Whether a country is facing chronic capital inflows or outflows may depend upon the structure of the state and the relative strength of domestic interest groups.⁸³ But the fundamental convergence in the direction of capital

⁸² On the relationship between the capacities and resources of government institutions and their influence on policy-making, see, e.g., Sven Steinmo, Kathleen Thelen, and Frank Longstreth, eds., *Structuring Politics: Historical Institutionalism in Comparative Analysis* (Cambridge: Cambridge University Press, 1992); John G. March and Johan P. Olsen, *Rediscovering Institutions: The Organizational Basis of Politics* (New York: Free Press, 1989); G. John Ikenberry, *Reasons of State: Oil Politics and the Capacities of American Government* (Ithaca, N.Y.: Cornell University Press, 1988); Hall (fn. 55); Peter J. Katzenstein, *Small States in World Markets* (Ithaca, N.Y.: Cornell University Press, 1985); and John Zysman, *Governments, Markets and Growth: Financial Systems and the Politics of Industrial Change* (Ithaca, N.Y.: Cornell University Press, 1983).

⁸³ A number of scholars have argued, for example, that Italian institutions—characterized by a weak executive, an inefficient bureaucracy, and the existence of multiple political parties—have made it impossible for any government to take the actions necessary to strengthen the national economy. See, e.g., Giuseppe Di Palma, “The Available State: Problems of Reform,” in Peter Lange and Sidney Tarrow, eds., *Italy in Transition* (London: Frank Cass,

mobility noted in all of our cases suggests that systemic forces are now dominant in the financial area and have dramatically reduced the ability of governments to set autonomous economic policies.

Our argument and evidence do not suggest, however, that a movement back toward capital controls or analogous policies to influence the flow of capital are impossible, only that such a movement would be more costly from a national point of view. Indeed, the restoration of controls is not just a theoretical possibility. In the midst of the European currency crisis in September 1992, for example, Spain and Ireland imposed new controls on banks' foreign exchange transactions. Despite the fact that such "temporary" measures did not contravene the letter of a prior agreement to eliminate impediments to capital mobility throughout the European Community, they surely conflicted with its spirit. More generally, continuing instability in global currency markets did subsequently lead the G-7, at the urging of American treasury secretary Nicholas Brady, to commission a new study to explore multilateral approaches to dealing with the consequences of international capital mobility.⁸⁴

If our argument is correct, two theoretical as well as policy implications bear underlining. First, if pressures for capital decontrol are now deeply embedded in firm structure and strategy, any efforts to understand or deal with the political effects of short-term capital mobility would seem to entail dealing with the politics of foreign direct investment. The two issues have long been related, but have also long been viewed as distinguishable for conceptual as well as for policy purposes. The distinction has broken down. The adoption of policies to influence short-term capital flows would now have a clearer impact on long-term investment decisions. Further research on this deepening connection is warranted.

Second, if policy convergence on the issue of capital controls is intimately linked to the development of international financial markets, attempts to understand and manage the effects of short-term capital mobility cannot be divorced from efforts to enhance the cross-national coordination of financial policies. As the negotiators at Bretton Woods recognized in 1944, open and stable markets ultimately depend upon a modicum of shared behavioral norms.⁸⁵ Despite deepening interdepen-

1980); and Alan R. Posner, "Italy: Dependence and Political Fragmentation," in Katzenstein (fn. 3).

⁸⁴ Undertaken by a larger body, the study was released as Group of Ten, *International Foreign Exchange Markets: A Report to the Ministers and Governors by the Group of Deputies* (n.p., April 1993).

⁸⁵ See Friedrich V. Kratochwil, *Rules, Norms, and Decisions* (Cambridge: Cambridge University Press, 1989), chap. 7; John Gerard Ruggie, ed., *Multilateralism Matters: The Theory*

dence across contemporary financial markets, states retain the right to change their policies on capital movements, either individually or on a regional basis. What remains unclear is their obligation to take into account the consequences of such policies for other states and for the world community. Thus, the time may now be ripe to begin considering new international arrangements to define and demarcate national responsibilities in an age of global markets.

and Praxis of an Institutional Form (New York: Columbia University Press, 1992); and Louis W. Pauly, "The Political Foundations of Multilateral Economic Surveillance," *International Journal* 47 (Spring 1992).