The Effectiveness of Capital Controls: 
The Case of Slovenia

Claudia M. Buch 
*The Kiel Institute of World Economics*

Elke Hanschel 
*Swiss Federal Finance Administration*

Abstract

Similar to Chile in the 1990s, Slovenia has introduced an unremunerated reserve requirement (URR) on financial credits in 1995. We find that the URR has not been effective in reducing overall inflows of foreign capital. Hence, the gain in monetary autonomy has been limited. While the overall structure of capital inflows has not differed decidedly from that of other transition economies, Slovenia has raised less short-term bank credit from abroad. Moreover, there are indications that the volatility of exchange rates has declined after the imposition of the URR while the volatility of capital flows has increased.

- **JEL classification:** F21, F32, F36
- **Key Words:** Slovenia, Capital Controls

I. Motivation

Recent financial crises in south-east Asia, Russia, or Brazil have heightened concerns about a speedy liberalization of capital flows.¹ The emerging market

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¹See, for instance, Eichengreen et al. (1998) and Fischer et al. (1998).
economies of central and eastern Europe are a group of countries for which policy lessons seem particularly urgent. Not only have these economies opened up for foreign capital fairly recently and have attracted quite substantial amounts of foreign finance, successfully completing the process of EU accession also requires the abolition of remaining restrictions to the free flow of capital.

Among the most advanced reform states, Slovenia is the country which has taken the most restrictive stance vis-à-vis foreign capital. Slovenia has restricted capital inflows in 1995 and has adjusted the foreign exchange law several times since then. Policy makers have followed the example of Chile by imposing an unremunerated reserve requirement (URR) on financial credits in order to deal with increasing capital inflows. Chile introduced the measure already in 1991. However, it lowered the reserve requirement drastically in 1998, and also Slovenia set the rate to zero in January 1999. The policy stance chosen by Slovenia is in contrast to the relatively speedy progress towards capital account convertibility that other transition economies and accession states have made.

The aim of this paper is to assess Slovenia’s experience with the URR. Section II describes the system of capital account restrictions and compares it to the strategies of other EU accession states. Section III briefly reviews the theoretical and empirical literature on capital controls. Section IV presents stylized facts of Slovenia’s macroeconomic development in the past. Evidence from other advanced reform states (Czech Republic, Estonia, Hungary, and Poland) which are, as Slovenia, included in the first round of EU candidates, is presented as a benchmark. Section V presents an analysis of the effectiveness of Slovenia’s capital controls.

To our knowledge, this is the first study to deal with the Slovene case. Overall, we find that the Slovene URR has not been effective in reducing total inflows of foreign capital. Hence, the gain in monetary autonomy has been limited. While the overall structure of capital inflows has not differed decidedly from that of other transition economies, Slovenia has raised relatively less short-term bank credits from abroad. Moreover, there are indications that the volatility of exchange rates has declined after the imposition of controls while the volatility of capital flows has increased. Hence, the controls have been unsuccessful in shielding the Slovene economy from recent increases in the volatility of financial markets. By and large, these results confirm the findings of earlier studies which found limited and at best short-lived effects of capital controls.