the entry of direct investment without encouraging speculative inflows.

The rest of the paper presents the following discussion. In section 2, we review the theoretical analysis and empirical evidence on macro policy constraints implied by unrestricted capital mobility. In section 3, we review key proposals for capital controls, and discuss the arguments for and against these controls. Finally, section 4 examines the restrictions on capital inflows erected in Chile. Conclusions are in section 5.

2. Macro Policy Constraints Under Unrestricted Capital Mobility

2.1. Interest Parity

Unrestricted capital flows link financial markets in different countries to each other. These linkages are especially strong between markets that deal with short-term financial claims, usually defined as those having a maturity of less than one year. Short-term claims include a wide variety of instruments and tend to be highly liquid (i.e., can be bought and sold at low transaction costs). The liquidity of these claims allows short-term funds to move rapidly from one national market to another in search of higher returns. Such movements of "hot money" tend to eliminate differences in expected returns between short term claims denominated in different currencies. Under these conditions, short-term interest rates between two countries, A and B, are connected by the following interest-parity relation: the interest rate on a loan denominated in A's currency equals the sum of the rate on a loan (with the same maturity) denominated in B's currency and the expected percentage increase in the relative price of B's currency.[4]

The interest parity represents an important constraint on macro policy in an open economy.

- If a country attempts to influence its short-term interest rates, the exchange rate

[4] This relation is referred to as the uncovered interest parity, and is distinguished from the covered interest parity in which the interest rate differential between A and B would equal the forward premium on B's currency.