

Executive Summary

Since the late 1980s, trade and capital market liberalization, coupled with prudent macro-economic policies have allowed a number of countries in Asia and in South America to attract significant amounts of FDI. The benefits of such policies are also well illustrated in the case of Chile. This Paper uses the Chilean case to examine how further deregulation of capital markets can improve a country's financial and investment climate.

Foreign capital can finance investment and stimulate economic growth in the recipient country. However, short-term capital inflows in large amounts are feared to have less desirable macro-economic effects, such as inflationary pressures, real exchange rate appreciation and widening current account deficits.

- One policy option restricts the outflow of capital invested for a particular period of time.
- Another policy prescription requires a deposit (or a reserve) requirement on international credit.

Such schemes are designed to provide more macro-economic policy autonomy by slowing down international capital movements. However, serious doubts have been raised about the motive, effectiveness and the desirability of capital controls. Our research indicates that:

- International financial markets are likely to develop sophisticated mechanisms for evading national regulations on capital movements and, thus, capital controls may not be effective in segmenting international capital markets.
- Capital controls, if effective, reduce economic efficiency by restricting international trade and investment.
- It is not clear whether these controls improve macro-economic performance sufficiently to justify the loss in economic efficiency.