

An important issue is how Chilean capital controls would stand up to speculative pressures in periods when large changes in the exchange rate are expected. The experience of other countries suggests that if such conditions were to develop, Chile would be forced to change its parity. The best hope of avoiding a crisis for Chile lies in it following policies that are consistent with the fixed parity. If such policies are not followed, capital controls would not prevent a successful attack but, at best, only delay it.

Over the past decade, Chile has achieved significant improvement in its macro-economic performance. The successful performance of Chile is generally attributed to a prudent and consistent macro policy and a wide range of structural reforms. Capital controls, however, do not appear to have been a significant ingredient of this policy. In fact, our appraisal of capital controls (in the previous section) suggests that they exert only a marginal effect on the variability of the exchange rate, and are not essential to maintaining a stable exchange rate regime. They may involve significant costs in terms of reducing economic efficiency and encouraging wasteful activities directed towards evasion of controls.

- The effectiveness of capital controls also tends to decrease significantly if they are kept in place for a long period of time.

A case can thus be made that Chile should dismantle its capital controls. However, if Chile remains committed to this policy, we discuss below two suggestions for reform which would reduce costs of these controls without significantly affecting their benefits.

4.3. Reforming the Foreign Investment Regime in Chile

The main benefit claimed for capital controls is that they deter destabilizing speculative activity. Speculation normally occurs through movements of liquid short-term funds. Investments under DL 600, however, represent purchases of relatively illiquid assets, and thus these investments are not suitable for speculation. The deposit requirement and the repatriation restriction impose an unnecessary penalty on these investments without promising any significant curtailment of speculative activity. Indeed, portfolio investments in ADRs are more liquid than DL 600 investments and yet they are already exempt from the two restrictions.