

1. Introduction

The purpose of this paper is to:

- examine the case for and against capital controls, and
- discuss implications for Canadian trade and investment policy with special reference to potential NAFTA partners, who currently regulate capital movements.

The benefits of foreign direct investment (FDI) resulting from capital and trade liberalization are well-known. Accordingly, the NAFTA seeks not only to eliminate barriers to trade in goods and services but also to increase substantially the opportunities for cross-border credit. The control of capital movements, except in limited circumstances for prudential reasons, is in conflict with various NAFTA provisions.³

- The basic argument for capital controls is based on the concern that free capital mobility subordinates domestic macro policy to foreign conditions.

Our review of theory and empirical evidence on macro policy constraints implied by unrestricted capital mobility for flexible as well as fixed exchange rates reveals the following.

- Flexible exchange rates allow a country freedom to implement short-term interest rates that are different from those prevailing abroad. In the presence of unrestricted capital mobility, however, an independent interest-rate policy can lead to considerable fluctuations in the exchange rate.
- Fixed exchange rates avoid undesirable effects of excessive exchange rate variability but lead to a significant loss of monetary policy independence

³ For example, see section 1109 of the NAFTA on capital transfers and section 1410 on prudential capital-investment measures.