

Under flexible exchange rates, restrictions on capital mobility are likely to reduce exchange-rate movements in response to small changes in interest-rate differentials or expected levels of future exchange rates. These restrictions may not, however, have an appreciable effect on exchange-rate fluctuations caused by large shifts in yield differentials or expectations. According to these considerations, it is not clear whether capital controls would significantly reduce exchange-rate variability.

- An argument against capital controls is that they would tend to weaken a country's commitment to its long-term money growth targets and make its policy more unpredictable. Exchange-rate variability could, in fact, increase in this case.

The arguments discussed above suggest a considerable difference of opinion about how capital controls affect macro-economic conditions in economies with fixed or flexible exchange rates. It is generally agreed, on the other hand, that these controls restrict foreign-exchange transactions and thus impede international flows of goods and capital. As many countries have recently adopted measures to liberalize international trade and investment, capital controls would hinder such liberalization. Given that the benefits of capital controls are uncertain, except as a limited prudential measure, it is not prudent to adopt a policy that jeopardizes economic gains expected from freer trade and investment.

3.4. Empirical Evidence on the Effects of Capital Controls

A large number of studies have investigated the effects of capital controls for both industrial and developing economies.¹⁷ Much of this empirical analysis has focused on the influence of controls on the differential between domestic and international short-term interest rates (or the difference between returns on on-shore and off-shore bank deposits). This research suggests that although capital controls have a quantifiable effect on yield differentials, the effect tends to be small and decreases over time. Large effects are rarely observed even among regimes that

¹⁷ For an extensive review of this literature, see Michael Dooley, *op.cit.*, section V.