

Under fixed exchange rates, a basic macro-economic problem is that the economy is susceptible to speculative attacks. One reason for such attacks is that macro policy of the country is perceived as inconsistent with maintaining a fixed price of its currency. Capital controls could effect the timing and the likelihood of speculative attacks based on this reason. There is an extensive literature analyzing speculative attacks in the presence of capital controls.¹⁵ A general conclusion of this literature is that:

- although capital controls may considerably lengthen the life of an inconsistent regime, they do not prevent an attack on such a regime.

A tax or a deposit requirement adds a cost to speculative transactions, and would discourage such activity when a devaluation is expected in distant future so that the expected payoff from a speculative position is low. However, when a devaluation is imminent, the expected capital gains from speculation become very large and can easily offset the cost imposed by capital controls.¹⁶ Capital controls can, thus, postpone but not eliminate speculative attacks on an inconsistent regime.

Supporters of capital controls argue that the extra time allowed by controls would enable a regime to improve its short-run macro-economic performance and introduce measures to make its policies consistent with the fixed exchange rate in the long-run. An alternative view is that political and economic pressures that lead to inconsistent policies are unlikely to be diminished by the availability of extra time. Capital controls would, thus, simply postpone the inevitable crisis. It is also argued that:

- monetary policy autonomy available from these controls would, in fact, weaken the monetary discipline and increase the likelihood that the regime would follow inconsistent policies.

¹⁵ For a review of this literature, see Michael P. Dooley, "A Survey of Academic Literature on Controls Over International Capital Transactions", National Bureau of Economic Research Working Paper no. 5352, November 1995.

¹⁶ For example, if a 10% devaluation is expected in a week with a probability, say, equal to 0.2, the expected return from speculation is 2 % per week, which translates to over 100% at an annual rate.