equivalent amount through a local bank. Since A's firm would not directly deal with a bank in B, these transactions would be difficult to trace and thus would enable the firm to circumvent B's deposit requirements.[13] Such methods for evading regulations on capital flows significantly weaken the effectiveness of capital controls.

- It is generally believed that the longer a set of regulations is in place, the more sophisticated are the techniques for evasion.
- Thus, the effectiveness of capital controls is decreases over time.

Consequently, this is one reason controls are often proposed as **temporary measures** to deal with transitional problems.[14]

In sum, problems in enforcing regulations on capital movements will make capital controls only partially effective. Therefore, the extent to which the domestic interest rate can diverge from the foreign rate may not be as large as calculated under the assumption of full compliance with capital restrictions.

3.3. Desirability of Capital Controls

Restrictions on foreign-exchange transactions and international credit are generally assumed to reduce economic efficiency because they interfere with optimal decisions regarding international trade and investment. They also waste resources by encouraging evasion-related activities. Despite these costs, it can be argued that capital controls are desirable because they improve macro-economic performance of the economy. To assess this argument, we now examine the macro-economic effects of capital controls under different exchange rate regimes.

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[13] An investor from country A may also finance purchases of materials and equipment by its clients in country B by arranging a line of credit in country A. Thus, the customer in country B buys materials on terms from suppliers in country A and can circumvent the 30% reserve requirement in country B.

[14] The deposit requirement proposed by Eichengreen, Tobin and Wyplosz (op. cit.) is intended to be implemented temporarily in transition to the creation of a European Monetary Union.