Capital Controls and Financial Frictions in a Small Open Economy

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We develop a small open economy model with financial frictions between domestic banks and foreign investors, and examine the welfare-improving effect of capital controls. We show that capital controls are effective in addressing the amplification effect due to financial frictions. As the degree of financial frictions increases, the welfare-improving effect of capital controls becomes larger and a more aggressive policy rule is appropriate. Comparing two economies, one with and one without "liability dollarization," we also find that the welfare-improving effect of capital controls is larger in the presence of "liability dollarization," and the difference between the effects becomes larger as the degree of financial frictions increases.