

Capital Controls as an Alternative to Credit Policy in a Small Open Economy*

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Abstract

We develop a sticky price, small open economy model with financial frictions à la Gertler and Karadi (2011), in combination with liability dollarization. An agency problem between domestic financial intermediaries and foreign investors of emerging economies introduces financial frictions in the form of time-varying endogenous balance sheet constraints on the domestic financial intermediaries. We consider a shock that tightens the balance sheet constraint and show that capital controls, the possibility of which is rigorously examined as a policy tool for the emerging economies, can be an alternative to credit policy employed by advanced economy central banks in mitigating the negative shock.

Keywords: capital control; credit policy; balance sheets; small open economy; nominal rigidities; New Keynesian; DSGE; financial intermediaries; financial frictions; crisis.

JEL Classification: E44, E58, F32, F38, F41.

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