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MACRO PICTURE:

Rethinking Capital Inflows:

The Case for Policy Tools in the US Context

By

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23 July 2025

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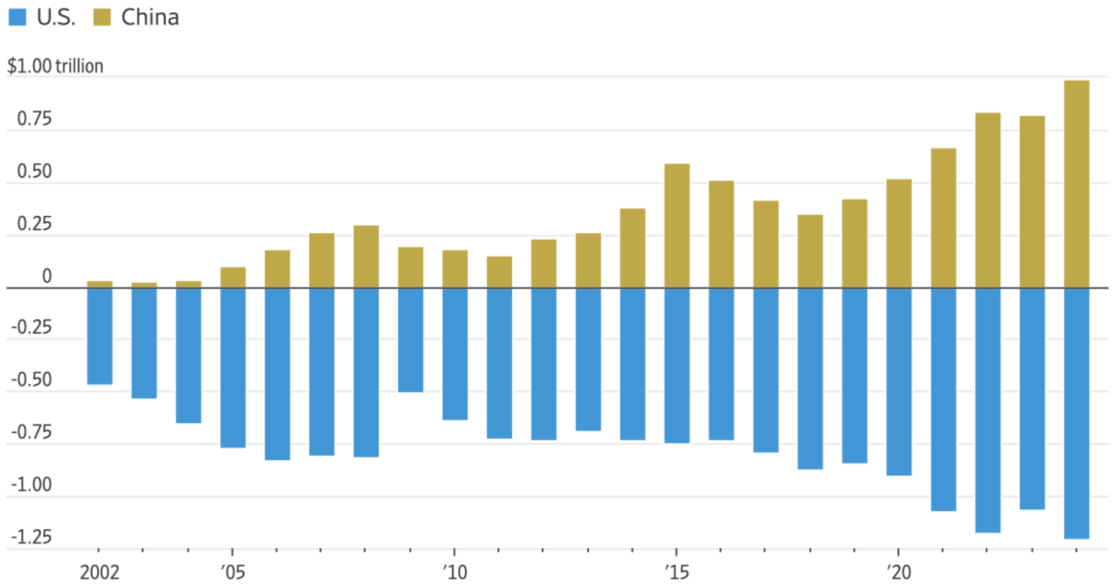
Executive Summary

- Capital controls were foundational to the Bretton Woods system. Keynes and White viewed them as necessary to reconcile domestic policy autonomy with global economic cooperation.
- Inflow controls manage speculative capital and volatility; however, they are often unfairly conflated with crisis-driven outflow restrictions.
- Global trade and capital flows reflect deep asymmetries, surplus countries like China and Germany suppress consumption and export savings, creating chronic inflows to the US.
- These inflows inflate the dollar, drive up public debt, and fuel deindustrialization without boosting private investment—destabilizing both US and global economies.
- Protectionist tariffs fail to address the financial roots of trade imbalances; fiscal deficits and capital inflows keep the dollar high, offsetting tariff effects.
- Taxes on inflows, akin to Tobin's original proposal, could reduce dollar pressure, shift policy space toward industrial revival, and raise significant revenue with minimal market disruption.
- Traditional views that inflows reduce capital costs are outdated; US firms aren't capital-starved, and inflows now undermine competitiveness more than they help.
- Trump's Section 899 proposal, though framed as tax retaliation, may mark a shift toward taxing capital from surplus countries, signaling a broader rethink of global financial norms.
- Despite the proposal, foreign holdings of US Treasuries remain near record highs, as growing trade deficits continue to draw in overseas capital.

Key Picture: Global Goods Trade Balance



Source: [Macrobond]

This paper revisits the role of capital controls, especially taxes on capital inflows, as tools to manage US and global financial imbalances. While global trade deficits are often blamed on tariffs or unfair trade practices, the underlying cause frequently lies in unchecked capital inflows from surplus economies. These inflows inflate the US dollar, fuel deindustrialization, and deepen fiscal dependence on foreign savings, as argued by Mar-a-Lago Accord. While the Trump administration has focused on tariffs to address trade imbalances, such measures risk worsening the problem by attracting more capital and strengthening the dollar. By contrast, targeted inflow taxes, reviving ideas from Keynes' bancor proposal and Tobin's transaction tax, could offer a solution.

Capital Controls Revisited

Capital controls have long been a central, though often contested, instrument of economy policy. In the aftermath of the Great Depression and World War II, they were widely recognized as indispensable tools fro ensuring macroeconomic stability and policy autonomy. The postwar international monetary and financial order, the Bretton Woods system, was built on the legitimazation and active use of capital controls[1]. For its principal architects, John Maynard Keynes and Harry Dexter White, the interwar experience had revealed a fundamental incompatibility between free capital mobility and free trade.

Unregulated capital flows, they argued, not only provoked protectionist respones but also undermined governments' ability to manage domestic demand, maintain fixed xchange rates, and avoid destabilizing devaluations[2]. Consequently, early drafts of the IMF's Articles of Agreement envisioned capital controls as a permanent structural feature of the international financial system. While lobbying by Wall Street interests ultimately watered down these provisions, the final Articles still prioritzed current account cinvertability over liberalized capital flows.

Despite their historical role, capital controls, especially those targeting inflows, bhave acquried an undeservedly negative reputation. Critics often conflate inflow controls which aim to manage the risks of volatile foreign capital entering a country, with outflow controls, which are typically associated with crisis-driven dcapital flight and authoritarian regimes. This "guilt by association" has sahped public and polucy attitudes, even as empirical evidence and IMF research suggest that inflow controls can be a legitimate and effective macroprudential tool[3]. The uncritical rejection of such measures risks leading to suboptimal poilicy decisions, particiularly in the times of heightened financial instability and global imbalances.

Recent debates, including proposals for taxse on capital inflows in advanced economies, signal a potential shfit in thinking[4]. As policymakers confront the tensions between fiscal exopansion, trade imbalances and financial fragility, capital controls may once aagain emerge as a necessary component of the policy toolkit. Understanding their historical rationale, evolving legitimacy, and current relevance is thus essential to rethinking the boundaries of economic sovereignty in an increasingly volatile global financial system.

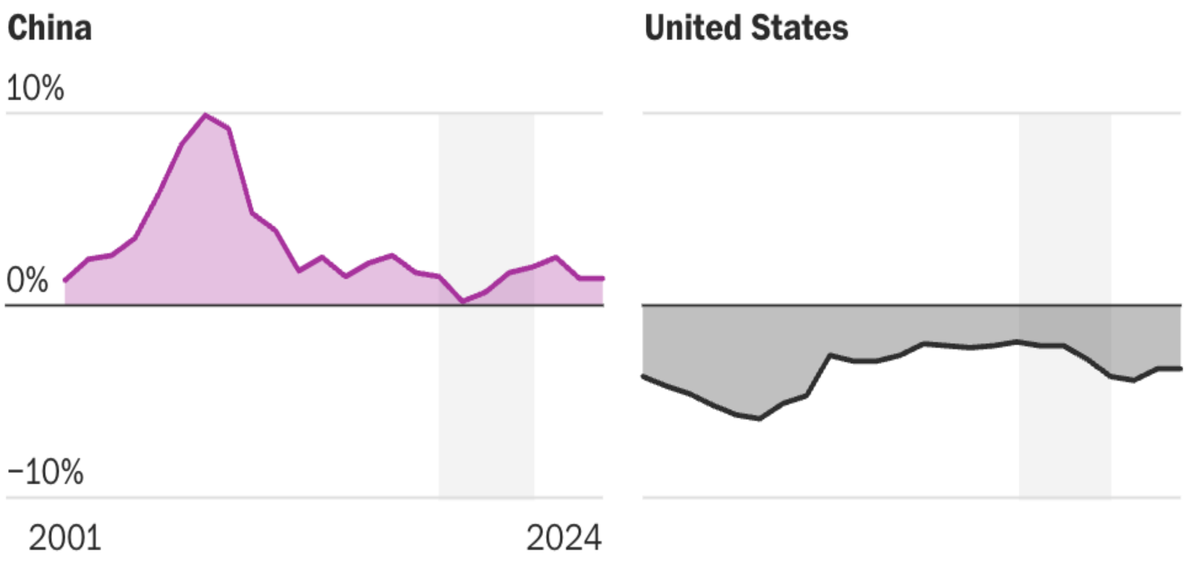
Global Imbalances and the Case for Capital Inflow Taxes

Structural Roots of Global Imbalances

Global trade and financial imbalances remain a defining feature of the international econiomic system (**Key Picture**). Far from being temporary anomalies, these imbalances are rooted in deep structural and political asymmetries. In particular, persistent net capital inflows pose a significant challenge to macroeconomic stability and global financial order.

At the structural level, this reflects deliberate policy choices by economies. For instance, surplus economies such as China and Germany pursue domestic policies that suppress consumption and inflate savings channeling the resulting surpluses into foreign capital markets, most notably the US (**Figure 1**). These persistent capital inflows prop up the US dollar, reinfore the deficits, and fuel deindustrialization, as argued by Mar-a-Lago Accord[5]. The US, in its role as the issuer of the global reserve currency, serves as the shock absorber for the world economy, absorbing excess savings and production from abroad. As British economist Joan Robinson warned, this "beggarthy-neighbour" structure enables surplus countries to maintain internal discipline while offloading the adjustment burden onto more open, consumption-driven economies like the US[6]. The result is a distorted global economy in which capital flows serve to entrench imbalances rather than correct them.

Figure 1: Annual Trade Deficit or Surplus as Percentage of GDP



Source: IMF

Why Capital Inflows Hurt the US Economy

In the context of the US, these capital inflows primarily benefit the federal government, not the private sector, which already maintains adequate levels of savings. The result is an expansion of public debt without a corresponding rise in productive investment.

If Washington were to reduce its fiscal deficit while capital kept pouring in, the adjustment burden would inevitably shift to the private sector either through suppressed income and recession or through increased spending that inflates asset bubbles. Beyond domestic effects, these flows destabilize the global economy by encouraging speculative excess and unsustainable borrowing patterns, particularly in countries that serve as the final destination for surplus capital.

The Limits of Tariffs

Tariffs, in fact, tend to backfire in two ways. First, the threat or imposition of tariffs has historically pushed the dollar even higher, worsening the very competitiveness problem they aim to solve[7]. Secondly, and importantly, attempts to correct trade imbalances through tariffs often miss the underlying financial causes. Donald Trump and his former trade adviser Robert Lighthizer championed tariffs as a way to reduce the trade deficit[8]. However, as Martin Wolf argues, this approach is structurally incoherent: while the administration seeks to reduce trade deficits, it simultaneously runs large fiscal deficits that attract foreign capital inflows, keeping the dollar strong and undermining export competitiveness[9].

Tariffs may shift domestic production from exportables to import substitutes, but they do not reduce the trade deficit if capital inflows remain unaddressed. Instead, they risk creating new distortions without solving the underlying problem.

A Targeted Alternative: Capital Inflow Taxes

That's why some economists and market participants are reviving a long-dormant idea: taxing capital inflows. This echoes the proposal made by Nobel Laureate James Tobin nearly 50 years ago, which called for a small tax on currency transactions to slow down speculative capital movements.

A tax on capital inflows offers a more direct and systemic solution. By discouraging excess foreign lending, such a tax would reduce pressure on the US dollar, limit fiscal dependency on foreign savings, and create space for a more sustainable industrial policy[10]. Martin Wolf, echoing the arguments of economists like Michael Pettis, contends that this approach would address the root cause of external imbalances: the structural flow of surplus savings from abroad into US debt markets.

Stephen Jen, a prominent hedge fund manager, argues that a tax on capital inflows could raise significantly more revenue than tariffs ever could[11]. A minuscule Tobin-style tax on global currency trades—which total around $7.5 trillion per day—could, he notes, generate vast sums without disrupting financial markets. A fractional tax of just 0.0005%, for example, could deliver billions in revenue with almost no visible impact on trading volumes.

Why the Case Against Capital Controls Might Be Flawed

According to the mainstream economic thinking, foreign capital inflows lower interest rates and thus, tax on inflows would raise the cost of capital for American business and raise interest rates for the federal government. The traditional view assumes that capital is scarce, and that inflows ease this scarcity by funding productive investment. But this does not reflect today's reality. American firms are not capital constrained; many sit on vast reserves of cash and face weak domestic demand, not a shortage of funding. Instead of stimulating new investment, foreign inflows often push up the value of the dollar, making imports cheaper and undermining US manufacturing competitiveness.

To prevent trade-driven job losses, the U.S. typically responds with higher household or government borrowing, not more investment but more debt. Thus, inflows do not close a savings-investment gap; rather, they force the US to absorb global imbalances by becoming the "consumer of last resort." The macroeconomic adjustment occurs through a decline in national saving, manifested as increased unemployment, rising household debt, or expanding fiscal deficits.

Mainstream opponents of capital controls or inflow taxes base their argument on the assumption that the US is pulling in capital due to low domestic savings. But in reality, as already mentioned, many inflows are pushed out of surplus economies like China or Germany, where domestic consumption is deliberately suppressed to promote export-led growth. The idea that capital inflows are inherently beneficial ignores the fact that their macroeconomic impact depends on the source and destination of the flows.

America's New Tariff on Money

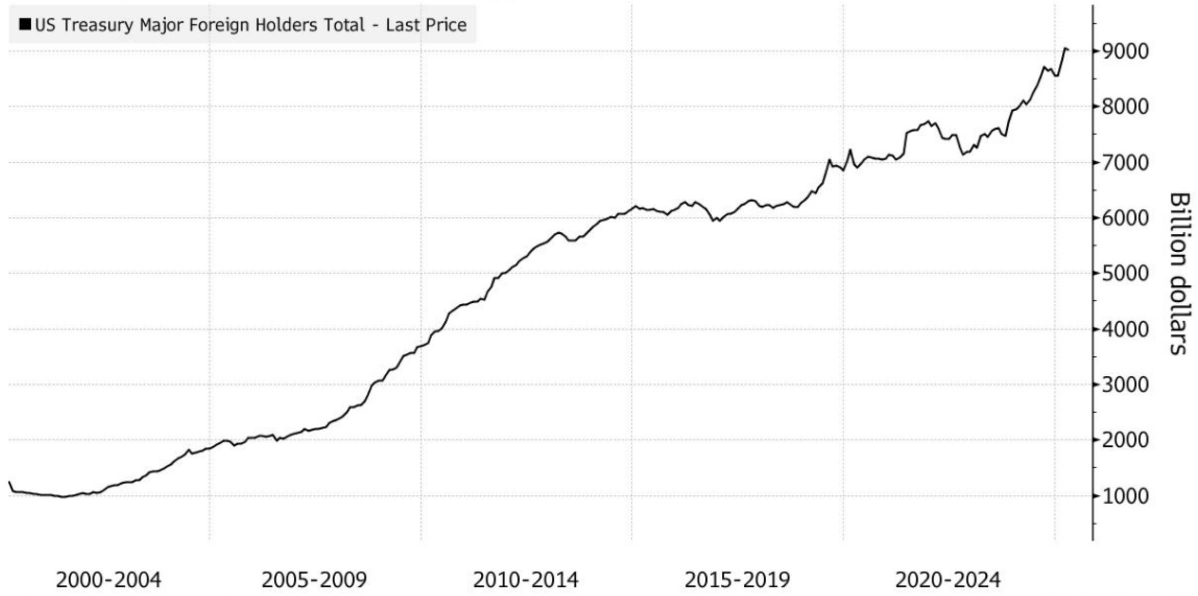
The recognition that persistent capital inflows distort the US economy and global financial order is no longer confined to academic debates. While the Trump administration hasn't formally proposed such measures, figures sympathetic to its economic agenda are openly exploring them. One particular example is the proposed Section 899 of Trump's so-called "big beautiful bill" that would raise US federal income tax rates by 5% to 20% on certain income earned by non-U.S. individuals or entities based in "discriminatory foreign countries" defined as jurisdictions that impose an "unfair foreign tax" under the bill[12]. Framed as retaliation against Europe's digital services taxes, Section 899 effectively ends the decades-long tax exemption that made Treasuries highly attractive to global investors.

Section 899 is prompting a reassessment of global financial responsibilities and capital flows. While the initial industry response focused on the impact to foreign investors and retaliation against OECD tax rules, some analysts argue the proposal signals a deeper ideological shift. European investors, already under pressure to boost defense spending amid US retrenchment, now face the added burden of higher costs to fund US deficits—a contradiction that weakens transatlantic financial ties.

Whether Section 899 passes as proposed remains uncertain. Stephen Miran, downplayed fears that Section 899 of Trump's tax bill would scare off foreign bond investors. He clarified that the provision mainly targets corporate profits, not portfolio flows such as foreign purchases of US Treasuries.

Indeed, as of April, foreign investors' holdings of US Treasuries remained near record highs, despite ongoing financial market volatility triggered by President Trump's plans for historic tariff increases (**Figure 2**). Despite speculation about a foreign exodus from US government bonds, the reality is that overseas investors are unlikely to pull back unless Washington begins taxing capital inflows. The logic is simple: as long as the US trade deficit continues to grow, it must be matched by an equivalent rise in foreign acquisition of US assets, including government debt.

Figure 2: Foreign Treasuries Holdings Remain Near Record High



Source: Bloomberg

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