3. The Case For and Against Capital Controls

3.1. Tobin Tax and Other Proposals for Capital Controls

Macro policy implications of unrestricted capital mobility have persuaded a number of economists to advocate some form of controls on capital movements. A well-known proposal by Tobin makes a case for "throwing sand in the wheels" of international finance by introducing a small but uniform tax on all foreign-exchange transactions.[10]

Another widely-discussed proposal would subject all domestic-currency lending to non-residents subject to deposit requirements in the form of maintaining a proportion of the loan as an interest-free deposit at the central bank.[11] Such restrictions are intended to significantly decrease the payoff from a short-duration round-trip to a foreign market, while imposing a low cost on the profitability of long-term investment. These restrictions could open up significant differentials between short-term interest rates in different countries. For example, a Tobin tax equal to half percent would allow an interest rate differential on three-month loans as high as four percent (at an annual rate) if no change in the exchange rate is expected.

- One advantage claimed for capital controls is that national monetary policy would not be subordinated to foreign conditions.
- By allowing the central bank to set interest rates substantially different than foreign levels, restrictions on capital flows would enable monetary policy to deal with domestic macro-economic conditions.
- It is also argued that capital controls would reduce exchange rate variability

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[10] James Tobin, "A Proposal for International Monetary Reform", **Eastern Economic Journal** 4, 1978, 153-9.

[11] See Barry Eichengreen, James Tobin and Charles Wyplosz, "Two Cases for Sand in the Wheels of International Finance", **Economic Journal**, 105, January 1995, 162-72. Also see Barry Eichengreen and Charles Wyplosz, "The Unstable EMS", **Brookings Papers on Economic Activity** 2, 1993, 51-143, for a similar proposal.