



## Controlling Capital

In a world in which trillions of dollars move around the globe each day, governments have found it increasingly difficult to implement policies that achieve basic social objectives, such as low unemployment or maintaining a system of public services. Financial markets can punish economies that don't play by their rules. However, there are policies – called [capital controls](#) – that could give governments some flexibility in developing policies that meet important needs.

Capital controls are any policy that regulates, restricts, or influences the movement of investment across international borders. Capital controls can take a number of forms, from outright prohibitions on the movement of capital, to regulatory controls over certain types of investment flows, to taxes on international financial transactions. The central idea remains the same – to control the mobility of investment into and out of an economy.

There are two primary justifications for capital controls: (1) to increase the flexibility in the types of economic policies a government can adopt; and (2) to reduce uncertainty on international markets and the risk of a financial crisis.

Why might unrestricted movement of investment weaken the ability of governments to intervene in the economy? Consider the example of [interest](#)

[rates](#). When investors begin to pull their money out of an economy (a phenomenon called [capital flight](#)), governments often intervene to prevent a crisis. Interest rates can be raised to entice investors to stay by offering them a higher return on their investments. However, high interest rates slow down economic growth by increasing the cost of borrowing and reducing consumer demand. On the flip side, if policymakers were to reduce interest rates to improve the performance of the economy, they risk a rapid outflow of finance and a rapid reduction in the value of the currency.

Instead of bribing investors with high interest rates, capital controls provide an alternative means of influencing financial flows. A government could lower interest rates modestly to improve growth and reduce unemployment without the threat of a financial outflow. As economic performance improves, more long-term investment (often called [foreign direct investment](#)) could flow into the economy.

A second reason why capital controls can be a good idea is that they could reduce the risk of a financial crisis. When short-term or speculative investors panic and pull their money out of a country, the result can be an economic mess – the currency loses value, prices rise, living standards fall, interest



rates often climb, and economic growth grinds to a halt. By limiting the ability of investors to rapidly move financial resources around the world, capital controls can reduce the chances of a financial meltdown.

Capital controls come in a number of different varieties. For example, regulations can simply restrict the movement of investment into or out of an economy. A similar, but slightly more elaborate, approach is a dual [exchange rate](#) system. Here a country maintains two exchange rates – one for trade, interest payments, and other short-term flows and a second, less favorable, rate for movements of investment. Since investors who move their money out of the country do so at an unfavorable exchange rate, they have an incentive not to move their investments.

These types of capital controls are often criticized because they can discourage the inflow of useful, socially productive forms of investment. The real problem, many argue, is the rapid, short-term financial flows, often called [portfolio investment](#). Therefore, capital controls that control the movement of short-term finance without discouraging long-term inflows could be more desirable.

One strategy to slow down short-term investment flows would require foreign investors to keep a fraction of capital inflows in a reserve account for a minimum length of time – for example, several months to a year. The investor would receive no return on this money – therefore, these policies are sometimes called “unremunerated reserve requirements.” The reserve account would act as a “speed bump,” slowing down short-term financial flows and lessening the risk of a financial crisis.

Finally, a low-level tax (sometimes called a [Tobin-tax](#)) could be charged for all foreign exchange transactions. Speculative investors who move their money into and out of a country rapidly would be charged for every transaction. Long-term investors would pay much less since the number of transactions they make would be smaller. Therefore, the tax would discourage rapid turnovers without scaring away stable, productive sources of investment finance.

**Sources:**

Matias Vernengo and Louis-Philippe Rochon. 2000. “Exchange rate regimes and capital controls.” *Challenge*. Nov/Dec.

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