Macro Roundup Artcile

Headline: The Dangers of a US Capital Inflow Tax

Article Link: https://www.project-syndicate.org/commentary/capital-inflow-tax-to-cut-us-trade-deficit-would-be-a-disaster-by-maurice-obstfeld-2024-06

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Tweet: Maurice Obstfeld argues that attempting to address America's chronic trade deficits via a levy on foreign purchases of US assets would lead to higher interest rates and risk undermining the liquidity of US financial markets.

Summary: A capital inflow tax big enough to balance US trade would inflict economic damage at home and abroad in several ways, but the most notable effect would be a steep rise in US real interest rates. The capital inflow tax would, of course, raise the cost of foreign borrowing by the amount of the tax. But perhaps less obviously, it would also raise the interest rate paid by every US borrower on every loan, whether the funding source was domestic or foreign. After all, some foreign funding is necessary in the face of a trade deficit, however small; but nobody would be willing to borrow from abroad unless domestically sourced and foreign funding were equally costly. This rise in interest rates points to the key mechanism through which a capital inflow tax reduces the trade deficit. A country's borrowing from foreigners must also equal the amount of its investment in excess of what it can cover out of national savings. Thus, the trade deficit (or, more precisely, the current-account deficit) equals investment minus saving. The rise in interest rates may compress the trade deficit through some increase in saving, but its main effect would most likely be a fall in investment, leading to reduced demand, lower growth, and less innovation. Worse, all these repercussions would be magnified if, as seems likely, the inflow tax undermined global confidence in the safety of the US dollar and the liquidity of US financial markets. The implications for monetary and fiscal policy are also worrying. On monetary policy, the capital inflow tax would raise the neutral real interest rate and introduce the risk of runaway inflation if the Fed did not raise its policy rate commensurately. And on fiscal policy, it would raise borrowing costs for the Treasury. The sustainability of US public-sector debt is already a problem, and while the tax would generate revenue, its net effect could be to make the fiscal situation even worse.

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