

A tax on foreign exchange
transactions:
a false solution to the challenges
posed by financial markets

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Executive summary

In the seventies, the American economist James Tobin came up with the idea of imposing a global tax on short-term financial transactions carried out in foreign exchange markets, mainly in order to reduce the instability of the exchange markets. This idea has never been put into practice. However, it has been given a new impetus in the wake of the financial crises that have struck several emerging countries in the recent past. Indeed, some consider this tax to be an instrument which could be used in order to curb speculation and, at the same time, to raise additional resources for specific projects such as development aid.

The question is whether such an instrument *can* be applied and *would* be effective, as well as whether there are any better means of enhancing the stability of the international financial system, reducing the danger of recurrent crises and facilitating the access of less developed countries (LDCs) to foreign capital under favourable conditions.

According to its supporters, the Tobin tax would offer the advantage of allowing to restrain only those capital movements that have a destabilising effect and to make the burden of the tax fall only on the speculators. In fact, however, it is impossible to distinguish between capital movements of a speculative kind and those that are useful for LDCs because of their positive effect on investment, trade, economic growth and technical progress. Moreover, this tax would be levied on transactions and so, the final cost of it would have to be borne by companies, savers and, generally, by the customers of financial intermediaries. Besides, such a tax would affect most of all transactions between industrialised countries, reducing market liquidity, and thus resulting in more, not less, volatility.

Therefore, this instrument would not be effective. But could it be applied at all? The fact that it would be possible to levy such a tax is not sufficient in itself. For it to be operational, **all** countries would have to apply it, for

otherwise there would be a danger of causing substantial relocation of financial activities. Moreover, the system would, technically speaking, prove far more complex, expensive and difficult to administer and control than it seems, in particular because different tax rates would have to be applied to different types of transactions (spot, forward, derivatives, etc.). Finally, it is hard to think of an international authority that would be powerful enough to establish and enforce the criteria for allocating the proceeds of this tax. So the difficulties of implementing it would indeed be considerable, if not insurmountable.

An analysis of the causes which have led to the recent financial crises shows that all of them have some elements in common, notably an excessive foreign debt burden, especially short-term, a too rigid foreign exchange policy, as well as poorly supervised financial markets and intermediaries.

For remedies, therefore, one should rather turn to more robust and better supervised financial systems, more adequate foreign exchange rate policies, greater transparency (faster and more comprehensive information for the financial markets), sounder macro-economic policies (especially regarding public finances and taxation), and a rethinking of the policy of bailing out, which gives lenders the impression that they will not have to bear the consequences of their risky choices.

A massive short-term influx of capital can represent a danger for a country whose economic and financial systems are still too weak to cope with it. In that case, a number of specific temporary measures would be by far preferable to a general and permanent measure such as the Tobin tax.

All this leads us to conclude that, although some of the concerns expressed by those who defend the introduction of a Tobin tax are legitimate and should be paid due attention, the instrument as such is not an efficient means to meet these concerns.

Introduction

In numerous countries, a debate has opened on the subject of a tax on short-term foreign exchange transactions, the so-called Tobin Tax. Against the background of a global world economy, the introduction of this kind of taxation has become a major topic of discussion for a large number of non-governmental organisations, which have been joined by several political groups. This is a matter of direct concern for the banking industry as one of the major players on the foreign exchange markets. So it is only natural for this industry to want to express its point of view on the basis of an objective and rational analysis of the subject.

The historical background of the idea

The idea of a tax on international short-term capital movements was launched by the American economist James Tobin at the beginning of the seventies, at a time when the Bretton Woods international monetary system, which had laid down fixed parities between the most important currencies, was about to break down. The major concern was to curb the instability of capital markets by introducing a tax on speculative financial transactions in foreign exchange markets, which would reduce their volume by making them more expensive. According to Professor Tobin, such a tax would help fight speculation and bring about greater exchange rate stability.

This project has never been put into practice. Recently however, this idea has commanded renewed interest in the wake of the overall liberalisation of capital movements and the monetary crises that have struck several emerging economies (Mexico and Latin-America, Southeast-Asia and Russia).

Consequently, we must look into the purposes of such a tax and try to see whether it would be an effective means to reach them.

The purposes

The supporters of the Tobin tax see it as a means of achieving different, sometimes contradictory aims: reducing volatility of exchange rates, trying to curb speculation, providing the emerging countries with a shelter against financial crises, giving monetary authorities greater autonomy, yielding income for specific purposes, such as development aid. For these Tobin tax advocates, one of the attractive features of this instrument is the ethical dimension they believe it has, i.e., it is meant to achieve a whole series of positive goals, while at the same time it appears to be harmless, since this tax would have to be paid by 'the speculators', a group which is hard to define but enjoys no sympathy whatsoever.

The real situation is more complicated and calls for a closer look. There is no doubt that stabilising the international financial system, reducing the danger of recurrent crises and securing a steady access of emerging countries to the financial markets in order to facilitate their economic and social development are important goals. The question, however, is (i) whether a tax on capital movements would be effective to achieve these goals or whether there are better means to that aim; and (ii) whether it can be applied efficiently, so that its expected benefits outweigh its implementation costs as well as the disturbing effect it would have on the working of the financial markets. These are the questions we turn to below.

An inefficient instrument

The liberalisation of capital movements has been generally positive for the world economy. Most of the emerging economies that opened up to foreign capital and international trade have seen a spectacular increase in growth. The emerging and dynamic economies of developing countries suffer from a structural lack of financial means which older economies with slower growth and a higher savings ratio can help to reduce. The former group of countries

benefit from a steady import of capital, not just long-term but also short-term capital. The volatility of capital movements can sometimes be a real problem. However, the question is whether a tax on capital movements can remedy this situation or, on the contrary, whether it would aggravate it.

As we will see, a Tobin tax could have very unfair consequences. Such tax would not fall on wealth or capital, but on mere transactions. It is however impossible to make a distinction between speculative transactions and those which are useful and necessary. The latter would be affected by this tax to the same extent as the former.

Who would pay this tax? A large part of foreign exchange transactions take place in the field of international trade and investment. A tax on these transactions, to be paid by companies, is unjustifiable from an economic point of view.

Another type of transactions that would be affected are those which are made directly or indirectly by savers concerned to diversify their investments. There is no reason why the head of a family, e.g. based in the euro-zone, having bought an American or Swiss bond should be penalised in comparison with those who buy a French or German one – the former, as an international transaction would be ‘penalised’ with the Tobin tax for the mere fact of involving a forex transaction, whereas the latter would not, as it remains within the euro area. And the same argument applies not just to private investors, but even more so to bigger ones such as an insurance company or a mutual fund – these transactions are not motivated by speculation but by a legitimate wish to diversify one's investment.

A large part of foreign exchange transactions are intended to hedge against the risk of monetary fluctuations, rather than to speculate. Even traders, who are considered to be the biggest speculators, generally help to enhance the liquidity of the markets and hence, reduce their volatility. Any global tax that would reduce short-term capital movements is therefore

unlikely to bring increased stability to the foreign exchange markets, quite the contrary.

Moreover, there is no fundamental reason why short-term transactions should be penalised as compared to long-term transactions, as would indeed be the case if there were some kind of universal and permanent tax on them. Why should an investment with a one month term be penalised with respect to a one year investment? Why should savers or institutional investors be discouraged from modifying the composition of their portfolio if they feel that a particular currency is over-represented? Is there any reason why a trader should be dissuaded from selling a currency if, on the basis of new data, he/she changes his/her opinion about the way this currency will evolve? Short-term capital flows play an important role and are not bad by nature. If they can have some negative side effects, it is mainly as a result of the inefficiency of the financial markets in the recipient country. Consequently, there are many questions marks about the rationality and fairness of a Tobin tax.

In any case, markets tend to neutralise the impact of general and permanent taxes: the tax would soon be incorporated into the interest rate or into the spread between the buying and selling price of the different currencies, and hence the cost would be passed on to all economic agents (not just on to 'speculators').

Last but not least, a global tax on financial transactions would, most of all, hamper short-term capital flows between industrialised countries, which take up by far the major part of these transactions (between 80 and 90% of the total amount).

The real causes of financial crises

There are similarities between the financial crises that struck some emerging economies during the 80s and 90s. They all had some features in

common: a foreign exchange policy which was too rigid, lack of transparency about the economic and financial situation, a chaotic or premature liberalisation of capital movements, badly managed banking and finance systems under poor supervision, and shortcomings in the mechanisms for an orderly solution to financial crises. In each case, the main cause was an excessive debt burden, either on the part of the public sector, the central bank, the private banks, the business sector, or several of these at the same time. In many cases, a too rigid foreign exchange rate policy, contributed to creating an excessive short-term debt in foreign currencies without risk hedging by banks and companies. Together with this foreign indebtedness, these countries also suffered a crisis of confidence, which, in many cases, led to massive capital exports by local people.

There can be no doubt that a Tobin tax would be ineffective as a means of countering this trend, and that the substantial flight of capital, which is sometimes considered to be at the origin of these crises, is in fact a consequence of fundamental disequilibria, not their source.

A remedy which cannot be applied

Even if the Tobin tax would be effective as a means of tackling the causes of financial crises – which is not the case – there is still the question of whether it could be applied. The answer to this question is clearly negative, as we will see.

The first reason is that for this tax to be operational, it would have to be applied by every country (with the possibility of imposing penalties or putting strong pressure on those who refuse), or else there would be a risk of losing transactions and activities, and hence employment, to the financial centres which do not apply this tax. At present, nothing can lead us to expect that a consensus could be reached either within the OECD or the G7, or even at the level of the European Union, for a tax on foreign exchange transactions. The leading financial centres, which account for the major part of the

transactions, have no interest in adopting a measure which would seriously harm their competitiveness. Even if we assume they might be persuaded to take part in the system, the introduction of this tax would cause transactions to shift away from the traditional financial centres towards offshore centres, thus strengthening them, which is certainly not the intended result.

The second reason why the Tobin tax cannot be applied, is that this system would be far more complicated than expected. It would be completely useless to apply this tax only to spot transactions. It would have to apply also to forward transactions as well as to the different types of derivatives that are frequently used in international forex trading. This would entail a system with several tax rates and a very complicated control system.

Since the Tobin tax would be detrimental to a large number of short-term transactions that are fully justified and even indispensable for the smooth functioning of commercial and financial markets, some alternative solutions have been elaborated. The best known among these is that proposed by Bernd Spahn in 1996, i.e. a system of double taxation with a very low tax rate for common foreign exchange transactions within a fluctuation margin that is considered to be normal, and a very high rate for transactions beyond this margin. The margin would consist of a percentage above or below a mobile average exchange rate. The high tax rate would apply only if fluctuations become excessive, whereas normal fluctuations would hardly be affected. This may seem tempting, but it would make the foreign exchange markets considerably more complex. Indeed, there would be a constant need to calculate a mobile average for thousands of bilateral exchange rates and to lay down elaborate procedures in order to make sure that transactions exceeding the authorized margin were effectively penalised. It would however be simple to evade this tax, e.g. by passing through a succession of different currencies without ever going beyond the bilateral authorized margins. This means that a complex and expensive

control system would have to be created in order to ensure the efficiency of a Tobin tax, as adjusted by Spahn.

An aspect that is often forgotten is the allocation of the tax proceeds. These would mainly come from a handful of big international financial centres. What would be the criteria for the distribution and which supranational authority would be responsible for supervising and enforcing these criteria? The enormous difficulties in trying to reach a consensus on a very modest degree of harmonisation of the taxation of interest income within the European Union give an idea of the huge problems related to the allocation of the yield generated by a tax on foreign exchange transactions at world level. A consensus in this respect would imply a degree of international co-operation that, at present, is nothing but an illusion.

According to the most optimistic supporters of the Tobin tax, the proceeds would exceed the global yearly profits made by the European, American and Japanese banks taken together. However, these estimates do not seem to take into account the fact that this tax first and foremost aims at bringing stability to the foreign exchange markets by deterring a large number of short-term capital movements. Assuming that the Tobin tax would prove efficient in achieving this aim, it would automatically make a substantial part of the tax base disappear – so maybe the proceeds would not be that large any more.

If, on the contrary, the aim is not to curb speculation but to collect more financial resources to help less developed countries, it would be far more efficient to increase slightly the income tax rate in wealthy countries or to open up the Western markets to a greater extent to the exports of less developed countries. Unfortunately, there is as yet no democratic consensus for taking such measures, especially in an internationally coordinated way.

Real solutions do exist

Although the arguments stated above may point towards a negative and pessimistic conclusion, there are several ways in which countries can avoid financial crises like the ones we have witnessed in the last few years:

- pursuing a sound macroeconomic policy aimed at preventing excessive indebtedness by states, banks or companies and at fostering domestic savings rates.
- creating a sound, adequately supervised banking and financial system. Several crises could have been prevented if the banks in some countries of Asia and Latin America had been subject to prudential rules supervising foreign exchange positions and the transformation of maturities.
- an adequate foreign exchange policy is an essential element of stability. A stable exchange rate is not an aim in itself. The exchange rate is a price which must adapt to the evolution of the fundamentals of the economy. Unrealistic exchange rates foster speculation and destabilising capital movements.
- the liberalisation of capital movements must be an orderly and progressive process which takes into account the degree of development of the economy and the maturity of its financial markets. For example, there is a serious risk in compensating the lack of domestic savings or the impossibility of collecting a certain amount of tax revenue by taking on massive short-term debt abroad.
- transparency is one of the best remedies against speculative capital movements. Timely and accurate information about the actual economic and financial situation of a country would prevent massive and unforeseen adjusting capital movements.
- where there are borrowers, there are also lenders, and the latter must accept the consequences of their incautious choices. The hope that

there will be an implicit State guarantee or a bailing out by the international institutions makes private borrowers overconfident and less critical. The use of measures that cause this 'moral hazard' should therefore be minimised.

- finally, specific and temporary measures, more than general and permanent ones, can effectively curb destabilising capital movements. It may be risky to import too much capital in proportion to the absorption capacity of the economy. In this case, a temporary curb on capital inflows may be useful. Such a brake can be imposed in several ways; one of them could be a tax introduced individually and provisionally by the country concerned.

The measures explained above clearly show that there are indeed effective means of reducing the risk of an international financial crisis. However, a universal and permanent tax on short-term foreign exchange transactions is not one of them.

This edition of the Letter is written by the FBE's Economic and Monetary Affairs Committee, which has the following members: M. Georges MARTIN – Association Belge des Banques (Belgium), Helge J. PEDERSEN – Unibank (Denmark), Martin W. HÜFNER – HypoVereinsbank AG (Germany), Karl KNAPPE – Bundesverband deutscher Banken (Germany), Dimitrios MALLIAROPULOS – National Bank of Greece (Greece), Juan BASURTO – Asociación Española de Banca (Spain), Marie-Hélène FORTÉSA – Association Française des Banques (France), Anton BRENDER - Compagnie Parisienne de Réescompte (France), Pat McARDLE – Ulster Bank Group (Ireland), Massimo ROCCIA – Associazione Bancaria Italiana (Italy), Paul M. FEENSTRA – Nederlandse Vereniging van Banken (Netherlands), Robert A.R. VAN DEN BOSCH – ABN Amro Bank N.V. (Netherlands), Alf A. HAGELER – Finansnaeringens Hovedorganisasjon (Norway), Josef CHRISTL – Creditanstalt AG (Austria), Kaija ERJANTI – Finnish Bankers' Association (Finland), Stefan HOFFMANN – Association Suisse des Banquiers (Switzerland), Klas EKLUND – Skandinaviska Enskilda Banken (Sweden), William MASON – British Bankers' Association (United Kingdom).

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