Network Institute for Global Democratisation (NIGD)
Responds to the Arguments Offered in

"COUNTERING VOLATILITY IN INTERNATIONAL FINANCIAL MARKETS: THE TOBIN TAX IS NOT THE ANSWER"

Position Paper by the European Banking Federation

APRIL 8, 2001

The Banking Federation today published a position paper on the Tobin tax proposal. The paper, published as an FBE letter, was discussed and agreed by the members of its Economic and Monetary Affairs Committee (EMAC), which draws together senior economists of European banks and banking associations. The Committee is chaired by Dr Martin Hüfner, Executive Vice- President and Chief Economist at HypoVereinsbank AG.

As Dr. Hüfner said today, in the aftermaths of turmoil in international financial and foreign exchange markets, the idea of introducing a global tax on short-term, 'speculative' financial transactions in foreign exchange markets, the so-called Tobin tax, re-emerges. This has happened after each of the latest financial crises in Mexico (1995), Southeast Asia (1997), Russia (1998), Brazil (1999) and, more recently, Turkey. The aim is twofold: on the one hand, to curb the instability of capital markets by reducing the number of speculative transactions; on the other, to raise revenue for development aid or related causes (such as development projects, or condoning the external debt of LDCs, or financing reconstruction efforts following natural disasters, etc.). According to some estimates, the proceeds of a small tax of 1% would exceed the yearly profits of European, American and Japanese banks taken together.

However, a more detailed analysis of the proposal, as the one carried out in the FBE letter now published, leads us to the following conclusions.

> ***Firstly, the Tobin tax is not feasible in practice: it would have to be introduced simultaneously by all countries in order to avoid diversion of financial activity - the chances of reaching the necessary worldwide consensus for such a concerted move are scarce.***

RESPONSE:
It is true that a universal consensus is unlikely, particularly given the determined resistance of the US in particular and, also, the UK. However, with some modifications, a low-level tax is possible to establish also a non-universal basis.

These modifications include the Spahn model and a tax on domestic currency lending to the outsiders of the tax regime. Any grouping of countries can initiate the system at any time.

> ***But even if it were to happen, it is hard to imagine which supra-national entity would be competent for the allocation of the proceeds of such a***

> ***tax.***

RESPONSE:
There is indeed a problem with the IMF and the BIS. Therefore the idea of the Tobin Tax Organisation, TTO. The TTO can be simultaneously light in bureaucracy and more democratic than any of the existing international organisations. This idea is developed at length in the book 'Democratising Globalisation'.

> ***Moreover, the tax would introduce new complexities into the workings of international financial markets, rendering any control of the system practically impossible and hence difficult to enforce.***

RESPONSE:
To the contrary, the tax can be complemented with regulatory measures simplifying the markets quite considerably, and also stopping practices such off balance-sheet transactions.

> ***In any event, the estimates of the likely revenue derived from a Tobin tax are grossly exaggerated: bearing in mind that the first and utmost aim of the tax is to discourage operators from carrying out short- term forex transactions, the reduction in their volume would considerably reduce the tax proceeds.***

RESPONSE:
The point is to let experience and participants decide the optimal level of taxation, given the two aims of curbing the power of finance and finding new sources of global funding.

> ***Secondly, the tax would have disruptive and frequently unjustified side effects. To start with, the economic rational behind a tax on mere transactions (and not on wealth or capital) is doubtful.***

RESPONSE:
This depends on whether you believe in unrealist neoclassical models of the orthodoxy or more realistic theories of critical finance. Both conceptually and empirically the latter are more sound.

> ***But be that as it may, the fact that it would soon be incorporated into interest rates or into the spread between the buying and selling prices of different currencies is beyond any doubt. Thus, the cost of the Tobin tax would be passed on to all economic agents - not just 'speculators', regardless of how we define the latter. The fairness (and, again, the economic rational) of imposing such a burden on exporters who hedge against the risk of monetary fluctuations, or on savers (big or small), concerned to diversify their investments, is questionable.***

RESPONSE:
The banks and dealers and investment managers are opposing the idea because it would reduce their (sometimes) profitable financial activities. Surely they got a large part of their revenues and profits from forex, and would not like to see the forex markets decrease. If they could pass on a margin of 0.1% or 0.5% to others that easily, they would have done it already.

Moreover, other economic actors could save a lot of money they now have to spend on hedging, should the forex markets be more stable. And that is the aim of the Tobin tax. In other words, even if a portion of the tax burden would be passed on, that would be easily compensated by increased stability.

> ***And thirdly, the Tobin tax would be ineffective in achieving its original aim, i.e. countering the volatility of financial markets and averting financial crisis.***

RESPONSE:
Not true. By reducing the volumes drastically, the power of short-term capital movements would be curbed by the Tobin tax. Its cumulative effect on repeated transactions is drastic. The only real problem is one-shot speculation. The Spahn model can cover this easily.

> ***A careful study of the causes underlying the latest financial crisis which have affected, mostly, developing and newly industrialised countries as well as transition economies, would reveal striking similarities: a too rigid and unsustainable exchange rate policy, a weak domestic financial sector with poor or inexistent supervision, a heavy foreign debt burden, inter alia. It is hard to see in what way a Tobin tax could help offset any of these factors.***

RESPONSE:
This argument is a typical variation of the 'blame the victim' explanations. It brackets the characteristic systemic tendencies of financial markets. As Kindeleberger and other historians have shown, financial crises have been endemic since the 17th century. As Veblen, Keynes, Minsky, Felix, Stiglitz and others have shown, the power and characteristic systemic tendencies of financial markets co-explain economic fluctuations and crises in capitalist market economies more generally. If you are a true believer in the orthodoxy, it is always possible to devise tautological 'blame the victim' explanations after any of the recurring crises. The only problem is that they are at best very partial -- and in their partiality, systematically biased -- explanations, i.e. not true.

> ***In addition, the bulk of international short-term financial transactions (80-90%) take place between industrialised countries and hence they do not pose a threat to the stability of the financial markets of less developed economies; a tax on these transactions would reduce the liquidity of international financial markets, resulting in more rather than less volatility.***

RESPONSE:
The volumes are huge, and even minor parts of these flows can shake economies, even the bigger ones. The most vulnerable components are the markets of the so-called "emerging markets". The industrial economies have bigger states and economies to back the financial markets up; they have a longer history of re-regulation; and the financial actors consider New York, London and other Northern industrial financial centres as the safest places to invest (when there are troubles, the investors transfer their funds to New York and US Treasury bonds etc). This does not mean that financial crises in the North are not possible. To the contrary.

Regarding the liquidity-reduction argument, it all boils down to theoretical disagreements. A brief excerpt from the book may clarify a little:

> However, as a higher tax would curb global financial markets much more effectively, it would also take more liquidity out from the markets. For this reason, Spahn has argued that a high flat rate tax may in fact be an impediment to smoothly functioning markets. This goes against Keynes's point that that the essence of the problem is precisely over liquid investments and the resulting short-termism and speculation. [43] Spahn argues that besides short-term speculation and long-term investments, there is also "liquidity trading", constantly recurring hedging or arbitrage for margins as little as 3 to 5 basis points. He presumes that this has a stabilising function:
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> "A Tobin tax has the enormous disadvantage that it cannot distinguish between liquidity trading and speculation. Sound interbank transactions would thus be affected indiscriminately by the tax although they are non-speculative in nature. This, according to some authors, must lead to thinner markets with less liquidity, which could even increase volatility. The introduction of a Tobin tax could also cause a severe liquidity shock with large disturbances on a global scale." [44]The concepts of "liquidity trading" and "noise trading" are derived from the standard neoclassical equilibrium models. [45] Moreover, these categories are difficult to distinguish, conceptually and empirically. [46] Even if we deemed these categories as clear and existentially plausible, it would not be possible to calculate the ratio of "stabilising liquidity trading" to "noise trading".
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> Rather, in the Keynesian sense, even most forms of hedging and arbitrage are speculative, since they are based on anticipation of the reactions of others within financial markets, not on assessing long-term economic prospects. Nonetheless, cautiousness is in order. In particular, the introduction of a higher rate tax may pose problems. To avoid triggering a sudden reversal of the financial multiplication process, with unpredictable consequences, it may be a good idea to introduce a tax gradually, that is, to start with a lower tax. To also allow for the possibility that decreasing liquidity would have "disturbing effects", it is best to let experience decide. By raising the level of taxation step by step, the contingent real world effects can be taken into account when the tax regime is being developed further.

> ***Sensu contrario, LDCs benefit as much from short-term capital inflows as from long-term flows, which are frequently less forthcoming, so there are no objective reasons why short-term transactions should be penalised with respect to long-term ones.***

RESPONSE:

For the above mentioned and other reasons, this is utterly untrue. Financial market booms have not induced productive investments; but financial crises have tended to lead to an economic depression, also regarding investments.

> ***By means of conclusion the FBE letter released today points at other, first-best means and instruments available to achieve the pursued objectives: both raising resources for international projects and helping the emerging financial markets of LDCs cope with***

their integration in the international financial markets. In any case, the Tobin tax is not the answer.

RESPONSE:

Of course they do not want to be taxed and see their activities curbed. In the democratic world we should not, however, ask them but the citizens.

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