

The Tobin Tax as Fund for Financial Stability

As globalization challenges national borders, governments are discovering that their ability to conduct their public business is eroding. This lesson struck sharply in southeast Asia in 1997 and 1998 when financial capital, which had entered in a burst of euphoria, left in a rush to the exits, leaving in its wake financial devastation akin to a typhoon that blasts onto a land mass from across the oceans and departs into some mysterious ether. Speculative movements of liquid finance is the technical term used to describe this. The history of the modern era has seen this before, summarized admirably in Charles Mackay's title of his 1841 book as »Extraordinary Popular Delusions and the Madness of Crowds«. What globalization brings to this is a new dimension of speed, mass, and reach over extended space, threatening the sovereignty and policy-making capacities of the nation state.

To deal with this problem of hot money stinging its holders, a proposal has been resurrected from the early 1970s, the Tobin Tax, named after its originator, the Nobel Prize winning economist James Tobin of Yale. He proposed levying a small tax on foreign exchange transactions. Each time a Deutsche mark would be sold for a dollar, for example, or vice-versa, a tax would be charged. As with all taxes its intent is to reduce the volume of such exchanges without interfering with the necessary function of buying and selling currencies in order to allow trade, travel, and financial transactions to take place. If the tax is calibrated carefully enough only a portion of pure speculation would be reduced, leaving intact the important and necessary requirements for financial liquidity on global markets. Tobin describes this as throwing »some sand in the well-greased wheels« of financial speculation to restrain financial markets from deviating too much from fundamental values.

He was writing at a particular historical moment and his scheme was designed to address the problems in financial markets of the late 1970s:

currency instability following on the collapse of the Bretton Woods system, the OPEC oil price shock, a collapsing dollar, intense speculation in other currencies and gold, and a difficult after-birth for the system of privatized flexible exchange rates that replaced a market that had been operating as more of a publicly controlled market since 1946. Speculation in financial markets further destabilized what was already a fragile balance in financial markets. Such a tax he thought would restore a degree of lost control over monetary policy for central banks, particularly during financial crises.

His idea became current once again after the Asian financial crisis of 1997–98. Starting in 1993 short term money poured into these markets at a rate that eclipsed previous inflows. Dubbed emerging markets to make them attractive for financial speculators and to distinguish them from their former characterization of less-developed-countries, this followed the classic speculative script identified in 1841 by Mackay: naming something valuable when it may not be (like Tulips in the 1634–35 Dutch Tulip crisis), attracting investors on the basis of flimsy research and analysis, and finding a willing host who would be foolish to turn away from such largesse. The key modifying adjective in all this is »short-term«. Financial flows into Asia were not about long-term investment in anything tangible that would produce wealth. To provide some sense of its dimension, from 1988–1992 the typical size of these inflows amounted to about 7–10 percent of Gross Domestic Product (GDP) of the receiving country. From 1993 to 1995 they grew by a third for some countries and nearly doubled for others to 13 percent of GDP, and 86 percent of this was of the short-term variety.

Starting in Thailand the speculative bubble burst and then circulated to most of the countries in Southeast Asia, spreading beyond this region like a contagious virus as far as Russia, Brazil, and Argentina. It was the financial equivalent of hoof

and mouth disease. Supporters of the Tobin Tax and Tobin himself pulled his idea off the shelf and re-tooled it. Circumstances were vastly different from the 1970s. At that time about 150 billion dollars traveled the globe daily in foreign exchange transactions. Today it is about one trillion dollars a day, moved in trading rooms in Tokyo, London, and New York on a 24-hour, 7-day clock. Most transactions in the 1970s were called spot transactions, the sort you engage in when you change money from your own into another. You pass your national currency through a window and receive the currency of the country you want. The markets today, however, are dominated by futures transactions where a contract is created to deliver a specified amount of currency at some future date and at a price which deviates from the current spot price. What if you were planning a trip a year from now and believed the price of the currency you needed was going to increase. You would simply find a dealer who would agree to deliver the currency to you a year from now at a price which you thought was better than the actual spot price would be at that moment a year hence when you needed the money. These elaborate dealings are subsumed under the term »derivatives,« risky financial ventures that can produce large speculative thrusts one way or another. In the Asian crisis they became the equivalent of tulips. The Tobin Tax is designed to quell the fever and prevent contagion by making foreign exchange transactions more expensive in the first instance and collecting the tax revenues into a fund that can be used to intervene into financial markets when the frenzy appears.

A small tax of 0.1 percent on foreign exchange transactions accumulates in one year about 225 billion dollars. This rate of taxation is deemed not so onerous that the appropriate functions of foreign exchange trading will be truncated and not so small that it would do nothing to lop off the top end of excessive speculative activity, what the American Federal Reserve Chairman, Alan Greenspan, calls »irrational exuberance«. To make the tax comprehensive it must be levied on both spot and futures transactions, those derivatives that are the most chancy and highly leveraged in that they are based on small down payments and heavy borrowing against an uncertain future.

The tax would best be introduced simultaneously by the three countries that account for

virtually all of the daily foreign exchange trading, the U.S., U.K., and Japan. However, it is not out of the question for the United States to go it alone since it accounts for about two-thirds of all foreign exchange activity. As to the criticism that foreign exchange activity would simply move offshore to places that do not impose a Tobin Tax, that would be unlikely to happen for several reasons. These transactions require a very sophisticated and reliable technology infrastructure of communications systems that do not fail and the human resources to run them. It is an industry that directly employs thousands and indirectly a like number. This could not be replicated offshore. And if it were feasible, why haven't these activities moved offshore where lower salaries and cheaper land is available, compared to some of the highest price real estate in the world in the City of London, Wall Street, and the Tokyo financial district.

This aspect of the Tobin Tax addresses speculation directly. A second benefit derives from the monies collected and the uses to which they can be put. The United Nations Conference on Trade and Development (UNCTAD) wants to use the funds for economic development in the Third World, and this has been taken up in the Tobin Tax campaigns in less-developed-countries. The funds can also be used for the purposes for which they are intended, namely reduction of destabilizing financial speculation. This leads to my proposal for a Financial Stability Fund, a perpetually replenishable stabilization fund that can be mobilized in the event of another crisis of capital exiting fragile markets. The very existence of the stabilization fund and its size may be a deterrent to speculation and reduce risk in the system without it being used frequently. However, in extremis it can be mobilized effectively to stabilize global financial flows. It is self-financing in that the tax is extracted from the source of the potential problem and used to mitigate the consequences of instability deriving from the activity that is taxed. The tax is small on each transaction but raises sufficient resources to make the stabilization fund credible.

Direct transfers that emerge from the UNCTAD proposal are not the only way to assist emerging economies. Greater financial stability and the avoidance of speculation in emerging economies can also accomplish this. One only needs to be

reminded of the devastating impact on the poor wrought by the gale forces of financial speculation in the aftermath of the 1997–1998 crisis. One feasible solution between using the funds for UNCTAD-type purposes and for a financial stability fund is to apportion them according to the proportions of transactions located in emerging markets and in other markets, or some such formula.

In the midst of a financial crisis managers need to »buy time«, the conventional phrase used to convey the essence of the problem. Globalization reduces time and makes it more difficult for managers to calm the furies of speculation. In terms economists use, the supply of time has become scarcer due to the speed and scope of capital movements: the computer which permits instant moves of money by the nano-second push of a button and the rapidity with which this information travels the globe. If time is in short supply its »price« increases precisely at that moment when the demand for more time is placed on the stability of the system, further increasing its »price«. So the cost of time is higher precisely when it needs to be lower. But how does one buy more time without increasing its cost? This is the dilemma in which crisis managers find themselves when a financial implosion starts. The speed at which the crisis builds on itself exceeds the time-resources available to managers of the crisis. Enter the Tobin Tax and the twin virtues of mitigating the problem in the first instance and allowing managers to buy time at a lower cost in the midst of crisis.

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