

# [Financial transaction tax 1782](https://assignbuster.com/financial-transaction-tax-1782/)

The soaring volume of international finance and increased interdependence in

recent decades has increased concerns about volatility and threats of a financial crisis.

This has led many to investigate and analyze the origins, transmission, effects and policies

aimed to impede financial instability. This paper argues that financial liberalization and

speculation are the most reflective explanations for instability in financial markets and that

financial instability is likely to be transmitted globally with far reaching implications on real

sector performance. I conclude the paper with the argument that a global transaction tax

would be the most effective policy to curb financial instability and that other proposed

policies, such as target zones and the creation of a supranational institution, are either

unfeasible or unattainable.

INSTABILITY IN FINANCIAL MARKETS

In this section I examine four interpretations of how financial instability arises.

The first interpretation deals with speculation and the subsequent “ bandwagoning” in

financial markets. The second is a political interpretation dealing with the declining status

of a hegemonic anchor of the financial system. The question of whether regulation causes

or mitigates financial instability is raised by the third interpretation; while the fourth view

deals with the “ trigger point” phenomena.

To fully comprehend these interpretations we must first understand and

differentiate between a “ currency” and “ contagion” crisis. A currency crisis refers to a

situation is which a loss of confidence in a country” s currency provokes capital flight.

Conversely, a contagion crisis refers to a loss of confidence in the assets denominated in a

particular currency and the subsequent global transmission of this shock.

One of the more paramount readings of financial instability pertains to speculation.

Speculation is exhibited in a situation where a government monetary or fiscal policy (or

action) leads investors to believe that the currency of that particular nation will either

appreciate or depreciate in terms relative to those of other countries. Closely associated

with these speculative attacks is what is coined the “ bandwagon” effect. Say for

example, that a country” s central bank decides to undertake an expansionary monetary

policy. A neoclassical interpretation tells us that this will lower the domestic interest

rates, thus lowering the rate of return in the foreign exchange market and bringing about a

currency depreciation. As investors foresee this happening they will likely pull out before

the perceived depreciation. “ Efforts to get out would accelerate the loss of reserves,

provoking an earlier collapse, speculators would therefore try to get out still earlier, and

so on” (Krugman, 1991: 93). This “ herding” or “ bandwagon” effect naturally cause wild

swings in exchange rates and volatility in markets.

Another argument for the evolution of financial market instability is closely related

to hegemonic stability theory. This political explanation predicts a circumstance (i. e. a

decline of a hegemon” s status) in which a loss of confidence in a particular countries

currency may lead to capital flight away from that currency. This flight in turn not only

depreciates the currency of the former hegemon but more importantly undermines its role

as the international financial anchor and is said to ultimately lead to instability.

The trigger point phenomena may also be used as an instrument to explain financial

instability. Similar to the speculative cycles described above, this refers to a situation

where a group of investors commits to buy or sell a currency when that currency reaches a

certain price level. If that particular currency were to rise or fall to that specified level,

whether by real or speculative reasons, the precommited investors buy or sell that

currency or assets. This results in a cascade effect that, like speculative cycles, increases

or decreases the value of the currency to remarkably higher or lower levels.

Country after country has deregulated its financial markets and institutions. The

neoclassical interpretation asserts that regulation is thought to create incentives for risk

taking and hence instability. It is said to bring about what are called “ moral hazards.”

Proponents of deregulation argue that when people are insured, they are more apt to take

greater risks with their investments in financial markets. The riskier the investment

activity, the more volatile the markets tend to be.

A closer look suggests that perhaps only two of these explanations are valid when

thinking about the origins of financial instability. The trigger point explanation seems to

be a misreading of the origins of instability. It is unlikely that a large number of investors

would have the incentive or operational ability in order to simultaneously coordinate the

buying or selling of a currency or assets denominated in that currency. If even there is

such unlikely coordination, the “ existence of even a very large group of investors with

trigger points need not create a crisis if other investors know they are there” (Krugman,

1991: 96).

The theory of hegemonic stability also overlooks a number of factors that can

provide useful insights in explaining the emergence of financial instability. Historical

precedence supports this assertion. For instance, Britains role as international economic

manager was very minor in the stability experienced under the gold standard. The success

of the standard can be attributed to endogenous factors such as the self adjusting market

mechanism and the informal discipline maintained by its rules. The destabilization of the

gold standard can be attributed to the extreme domestic economic and financial pressures

brought on nation states by World War I, and not solely on the industrial and economic

demise of Britain.

A valid explanation for the origins of financial instability are the speculative attacks

brought on by investors. Although similar in function to trigger points, these speculative

cycles cannot be mitigated simply by pure recognition. Rather than acting on the value of

the currency itself, speculators act on occurrences or policies that will alter the value of

the currency. Instability arises from the fact that these speculative cycles induce capital

flight and therefore a change in the value of that particular currency, whether or not the

decisions of these investors are based on market “ fundamentals.” Futures, options, swaps

and other financial instruments “ have given investors and speculators an unheard of

capacity to leverage financial markets. The greater the leverage, the greater the

instability” (McCallum, 1995: 12).

If we examine the deregulatory process closely, it becomes clear that there is a

perverse relationship between deregulation and financial stability. Say for example,

investors suffer from a profit squeeze. This causes the investors to lobby politicians for

deregulation. The resulting wave of deregulation fosters instability and wide swings in

exchange rates which in turn cause loan defaults and subsequent banking crisis. The

resulting financial instability thus begs calls regulation, likely placing the investors in the

original position with an unsolved problem. We can see that the dialectic of the regulatory

process undermines anticipated stability and will eventually lead to financial instability and

collapse. In this environment, there arises calls for new forms of financial regulation.

These policies and proposals are of critical importance and will therefore be discussed

later in the paper.

THE TRANSMISSION AND EFFECTS OF FINANCIAL INSTABILITY

There are three contending albeit interrelated views on how financial instability

may be transmitted globally. These include equity markets, multiplier effects and

monetary reverberations.

Say for example, a movement of stock prices generates a recession in one country.

This is turn leads to a reduce in imports from abroad. The lower aggregate demand for

foreign imports will generate a contraction in other country” s output markets. The

resulting contraction in the foreign countries will then induce a contraction in the

originating country. As seen, the multiplier effect begins to take place that in turn leads

to a global recession.

If an asset crash leads to a monetary crises, the money crisis could be transmitted

worldwide. The Mundell-Flemming model assumes that under a fixed exchange rate

system, such as that under the gold standard, a worldwide monetary contraction will result

from a contraction in any one particular country because “ a monetary contraction in one

country, which raises interest rates in that country, must be matched by an equal rise in

rates elsewhere” (Krugman, 1991: 103). However, under a flexible exchange rate system,

such as the one in operation today, the model predicts that monetary shocks will be

transmitted perversely, that is, a monetary contraction in one country will produce

expansion elsewhere. Herring and Litan (1995) advance this argument by concluding that

the transmission of crisis creates a “ systemic risk.” This view states that continuous

losses in financial markets has adverse effects on the real economy because “ significant

losses can occur if there is a significant disruption in the payments system or the

mechanism through which transactions for goods, services, and assets are cleared”

(Herring and Litan, 1995: 51) .

While it may be accepted that financial crises can be transmitted globally, there is

debate on its ramifications on the real sector of the economy. Krugman (1991: 97) states

that a currency depreciation “ will produce an improvement in competitiveness that will

increase net exports and thus have an expansionary effect on the domestic economy.” He

also asserts that policy responses may help to curb real sectors effects. When currencies

depreciate, government officials and central bankers raise interest rates to discourage

capital flight. The recessionary effects of tight monetary and fiscal policies, it is argued,

dilute the inflationary repercussions of the currency crisis. Citing historical evidence of the

US stock market crash, Kapstein (1996: 6) goes so far as to say that the real economy is

“ shockproof” from transmission of financial instability and even in the face of financial

crisis “ continues to function normally.”

The assumption that swings in financial markets do not influence real sector

performance is inattentive to many factors. Advocates of this view use what is percieved

as relatively small repercussions felt worldwide after the US stock market crash in 1929

where “ in general the slump was mild” (Krugman 1991: 91). The empirical data of the

slump underscores this argument. Between December 1929 and December 1932, for

example, Germany experienced a 30.% percent stock market decline, France 38. 5 percent

and Canada 37. 5% (Kindleberger, 1973). If we keep in mind that the percentage swing in

the US stock during that same period was 37. 3 percent, we see that the slump was only

slightly “ milder” but by no means “ mild.” The real sector ramifications were just as

remarkable. Germany saw a 58 percent decline in industrial production, France 74 percent

and Canada 68 percent, all comparably higher declines than in the United States (Yeager,

1976).

It is obvious that financial crises do have global spillover effects and consequences

on real sector performance. However, recognition of these adverse effects does not solve

the problem. In the next section I present contending policies and proposals designed to

curb international financial instability and its repugnant ramifications.

CONTENDING VIEWS AND POLICY PROPOSALS

Three main policies have been introduced to curb international financial instability.

A global transaction tax, which is a tax on short term financial investments, a target zone

approach, where nations exchange rates would be allowed to fluctuate within a specific

band and a supranational or regional institution aimed at coordinating global financial

reform.

Proposed by economists and Nobel Laureate James Tobin in 1978, a global

transaction tax (STT) would act to “ throw some sand in the well greased wheels of the

global financial markets.” The STT is predicted to slow the short term financial

excursions into other currencies, yet at the same time it would have a lighter impact on

trade and long-term investments with higher percentage yields. Speculators, now carrying

the burden of a tax woul therefore have less “ leverage” with which to exploit exchange

volatility while long-term investment would be encouraged. Another benefit of the tax is

that it would reduce wasted financial resources and increase government revenues.

While proponents of the STT say the policy will reduce wasted financial resources,

others argue that there would be an adjustment problem because of the fact that “ goods

and the price of labor moved in response to international price signals much more

sluggishly than fluid funds, and prices in goods and labor markets moved more sluggishly

than prices of financial assets.”(McCallum, 1995: 16) Others attack the view that excess

volatility would be eliminated because “ deciding whether volatility is excessive is

complicated by difficulty of determining the fundamental value of a security” (Hakkio,

1994: 22). Opponents of the tax argue that it could be avoided by product substitution and

regulatory arbitrage and that the government revenue created would be overestimated

because “ the tax base would decline as security prices and the volume of trading decline”

(Hakkio 1994: 26).

Advocates of the “ efficient market hypothesis” argue that if financial markets are

allowed to freely operate, there will be a revaluation of asset values that will produce the

most accurate price signals on which to base long-term resource allocations. They say that

a STT would be detrimental to less developed countries so reliant on short term

investment.

Another highly noted policy aimed at curbing international financial instability is

the adoption of a targeted exchange rate system. A sort of “ hybrid” regime, target zones

allows currencies to fluctuate within predetermined and set bands, thus allowing a “ float”

but at the same time keeping a “ fix.” Since “ the main sources of conflict have been the

unpredictability of exchange rates” (Frenkel, 1990: 318) a target zone approach would in

theory alleviate this unpredictability, while keeping the appealing attributes of a floating

system. Seen to be the optimal answer for coordinated exchange rate stabilization, “ target

zones would involve the determination of an international consensus regarding an

appropriate and globally feasible range around which currency values could fluctuate”

(Grabel, 1993: 77).

The adoption of a target zone system would not be universally beneficial.

Naturally, the size, status and sector of the economy play an important role in its

desirability. Government officials and central bankers will likely oppose the adoption of a

targeted exchange rate due to the fact that it would hurt their ability to change the value of

their currency in the face of high capital mobility. With a targeted exchange rate, it is

argued that there is limited room for fluctuation which infringes on the effectiveness of

domestic policies. On the other hand, the fixity of the target zone would in theory stabilize

purchasing power of wage earners in both developed and less developed.

The overriding problem of the adoption of a target zone regime is that there is no

clear way in which target zones could be calculated. If they were to be calculated what

would be the ramifications if a country was to fluctuate out of the specific bands? Would

the target zones be global or regional? If global, how could the less developed countries

be able to stay in the same bands as the developed countries? If a target zone was adopted,

what is to say the maldistribution of wealth would not remain idle? There seems to be

little, if any, evidence that a fixed, stabilized exchange rate leads to higher or lower interest

rates. If the value of a currency is not able to adapt to high tendencies of capital mobility,

then it is only rational to say that the developed countries would continue to sap the

wealth of less developed countries.

The last major policy aimed at quelling financial instability is the creation of a

supranational institution aimed at coordinating financial reform and adopting a system of

“ regulatory supervision.” Processing along the lines of a Bretton Woods architecture, this

would in a sense institutionalize the role of a hegemon with “ a creation of a common

currency for all of the industrial democracies” and “ a joint Bank of Issue to determine

monetary [and financial] policies” (Cooper, 1984: 166). This policy proposal endorses the

adoption of an global financial institution managing the operation of coordinated

supervision.

Experience shows us that coordinated supervision is not possible in international

financial markets. For instance, the Basel Concordant was never able to reach

organizational level to properly respond to a crisis. Additionally, “ the BCCI affair

demonstrated the limitations of international bank supervision when confronted by

unscrupulous operators intent on exploiting the gaps in national bank supervisory systems”

(Herring and Litan, 1995: 105).

Proponents of re-creating a Bretton Woods-type system are unaware of the lessons

to be learned from that period. The theoretical brethren of hegemonic stability advocates,

proponents of this policy seek too place “ the direction of world monetary policy in the

hands of a single country” or institution that would have “ great influence over the

economic destiny of others” (Williamson, 1977: 37). As seen under the Bretton Woods

system the “ destiny” of others was in the hands of a country that was unable to maintain

stability. It is yet to be demonstrated how an institutional framework would sidestep the

same faultlines and management problems experienced by the United States under the

Bretton Woods regime.

The organizational barriers to creating such cooperation and coordination would

be insurmountable. Secondly, whose view would most likely be presented in the

supranational forum? Experience in international organizations shows us that it will

probably be the powerful, industrialized nations. The voice and needs of the less

developed countries is likely to be marginalized and situations such as the Latin American

debt crisis would continue to occur.

When looking at the progress of the European Monetary Union we see that the

completion of a single market is far too radical for today” s international financial climate.

Just as “ the costs of qualifying for the EMU has become too high” it becomes “ unrealistic

to hope that the major industrial countries can make comparable strides toward political

[much less financial] unification in our lifetime” (Eichengreen and Tobin, 1995: 170).

Ideally, the best policy for stemming financial instability and spillover effects would

be one that extinguishes the problem at its roots. If deregulation in itself causes instability

in financial markets, then regulation would be appealing. “ Even when the benefits of

financial deregulation are apparent, there is a role for regulatory policy” that would “ leave

the world economy less vulnerable to financial collapse” (Eichengreen and Portes,

1987: 51). . If we also hold true the conclusion that the best explanation for financial

instability is speculation, then a global securities transaction tax such as the one proposed

by Tobin would be optimal. The discouragement of short term speculative excursions and

the endorsement of long-term investment will eliminate the problem of volatility based on

speculative attacks that so often stray from market “ fundamentals.” Critics are quite

correct when they argue that the tax could induce financial arbitrage and substitution.

However this problem would be solved as long as the tax was globally adopted.

Secondly, the tax would be applied to goods, services, and financial instruments that had

few or no substitutes. The view that the creation of new government revenues is

overestimated and that Third World countries would carry the financial burden is nullified

when we see that “ a . 5 percent tax on exchange transaction would augment government

revenues globally by as much as $300 to $400 billion per anum” and “ devoting merely

10-20 percent of that revenue to a revolving fund for long-term lending to Third World

countries would be a healthy substitute for the hot money on which some have become

disastrously overdependent” (McCallum, 1995: 16).

The recognition and ceasing of financial instability and its global transmission is

becoming more and more universally endorsed. To decide on a prudent and practical

policy will prove to be a major hurdle of international financial leaders around the world.

However, if we look closely, we will find the locus of instability in financial markets to be

deregulation and speculative attacks. Government and central bankers can no longer

adopt an attitude of “ benign neglect” toward international financial instability as it

becomes increasingly apparent that there are far reaching consequences on real sectors.

We can see that there is one policy that supersedes the rest. If the world financial system

hopes to curb these real sector ramifications of speculative attacks and financial

liberalization, then it becomes indisputable that the STT is an idea whose time has come.

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