



International **Economic** Trends



The Tobin Tax

In 1971, Nobel laureate James Tobin suggested that there be a tax levied on foreign currency transactions. In proposing this tax, Tobin was walking in the footsteps of John Maynard Keynes, who had suggested a turnover tax for stock market transactions after the stock market crash of 1929. Keynes' intention was to stem speculative trading by giving investors an incentive to hold their assets for the long run. Unlike a turnover tax in the stock market, the Tobin tax can be implemented only with a coordinated effort of many countries; otherwise, currency transactions would simply move offshore. It is thus of interest to the United States that this summer the French prime minister and the German chancellor put the Tobin tax on the European agenda.

At the time James Tobin suggested a tax on currency transactions, the Bretton Woods system of pegged exchange rates was in shatters. The former Bretton Woods members moved to a regime of floating exchange rates in which arbitrage establishes a close link between cross-country interest rate differentials and expected changes in exchange rates. Tobin suggested that a transaction tax would weaken the arbitrage mechanism, allowing the former member countries to preserve a modicum of monetary autonomy.

Today, proponents of the Tobin tax have little in common with Tobin's proposal, save for the goal of diminishing the trading volume in foreign exchange markets. The transaction tax appeals to many economists and policymakers nowadays because it seems to be a solution to the widely accepted problem of excessive trading in financial markets, brought about by so-called noise traders. Noise is defined as news irrelevant to the intrinsic value of a financial asset. Unlike informed traders, noise traders are unable to distinguish information from noise and consequently are willing to trade frequently.

Clearly, excessive trading in itself is a waste of resources. From this perspective, levying a tax on foreign exchange transactions would improve efficiency. On the other hand, noise traders provide liquidity to financial markets. Noise traders are always available as trading partners because there is a continuous flow of noise in the market place. From this viewpoint, noise traders dampen exchange rate volatility.

In early studies of noise traders, finance scholars assumed that noise traders' erroneous beliefs are idiosyncratic and consequently have no sustained impact on the prices of financial assets. In recent years, motivated by what seemed to be excessive stock market valuations of the late 1990s, finance scholars have devised theoretical models that show that, if noise traders' beliefs are correlated, there might be sustained deviations of prices of financial assets from their intrinsic values. In these models, arbitrageurs, who attempt to bring prices back to fundamentals, are uncertain about the course and the duration of the mispricing and consequently trade less aggressively.

Would the Tobin tax be able to prevent sustained mispricing and excessive swings in valuation in the foreign exchange market? On one hand, the Tobin tax would reduce mispricing by curbing the activity of noise traders. On the other hand, the Tobin tax would make it more costly for arbitrageurs to correct mispricing, should it occur.

At best, the Tobin tax would prevent the world economy from squandering scarce resources on excessive trading. However, such a policy is hardly worth the risk of increased exchange rate volatility, especially because this seems to be what the proponents of the Tobin tax are trying to prevent.

—Frank A. Schmid

