Financial Crises, Capital Controls and the Tobin Tax: Answers to Globalisation of Financial Markets

Abstract:

This paper analyses capital controls with a focus on conversion taxes as proposed by Tobin and Spahn. To understand the problems associated with these models, it first offers a description of the foreign exchange markets and their decentralized, concentrated form of organization. In a second part, the paper turns to financial crises, their causes and their costs both domestic and international. Central issues here are suboptimal allocation of resources, loss of information in the banking sector and contagion. In a third part, the paper analyses capital control models as preventive measures to such events, with a focus on conversion taxes. The paper shows possible advantages of capital controls in general (a more independent monetary policy) and of conversion taxes in special (systemic stability and tax payoffs). It then turns to counterarguments to conversion taxes. A Tobin tax would punish all short-term investors indiscriminately. It would rise hedging costs. There is a tax evasion problem not to be easily overcome. The paper ends with a simple, qualitative model where a Tobin tax increases volatility contrary to expectations.

As a conclusion, Spahn's proposal shows most promise, if the remaining issues, mainly related to hedging costs, can be overcome.

Capital controls have some worthwhile points, especially in reducing hedging costs, which would facilitate trade. However, international capital market take a central role in allocating both capital and risk in a Pareto efficient manner most of the time. Any interference with market forces at work has to be thoroughly weight up, as it not only potentially reduces the markets' ability in creating such Pareto efficient outcomes, but also reduces the disciplining power of the market.

Should policy makers and economists reach the conclusion that such interference is necessary, Spahn's conversion tax approach appears to be the best available choice. Spahn's proposal solves the dilemma of Tobin's model, and still has the benefit of funding national or international organisations with its payoffs. Some issues still remain, though. And one has to realize that in drastic cases, even a conversion tax will not be able to avert crises. The only possible way to avert crisis is following sound, well-balanced policies (both fiscal and monetary) and to support well functioning, reliable market infrastructure.

Core references:

Bank for International Settlements. "Triennial Central Bank Survey. Foreign exchange and derivatives market activity in 2001." Basel: Bank for International Settlements, March 2002.

Felix, David and Sau, Ranjit. "On the Revenue Potential and Phasing in of the Tobin Tax." in Mahbub ul Haq, Inge Kaul and Isabelle Grunberg, eds.: *The Tobin Tax. Coping with Financial Volatility.* New York and Oxford: Oxford University Press, 1996, pp. 223 – 254.

Frankel, Jeffrey. "How Well Do Foreign Exchange Markets Work: Might a Tobin Tax Help?" in Mahbub ul Haq, Inge Kaul and Isabelle Grunberg, eds.: *The Tobin Tax. Coping with Financial Volatility.* New York and Oxford: Oxford University Press, 1996, pp. 41 – 81.

Spahn, Paul Bernd. "The Tobin Tax and Exchange Rate Stability." *Finance and Development,* June 1996, 33(2), pp. 24 – 27.

Tobin, James. "A Proposal for International Monetary Reform." *Eastern Economic Journal,* July / October 1978, 4(3-4), pp. 153 – 159.

Daniel Frank
daniel_frank@gmx.ch