Despite its intuitive appeal, the Tobin tax would not have the desired effects. It is meant to address dealers who trade currencies (and other assets) speculatively through a series of very short term transactions, where profit is made in the form of small percentages on large volumes. However, even a small tax on each transaction (the idea is often associated with a 0.5% tax) could be sufficient to reduce liquidity in financial markets and actually lead to an increase in volatility.[9] In addition, since it would be impossible for tax administrators to target speculators specifically, all market participants would be subject to the tax, including those trying to hedge legitimate business exposures. It is conceivable that the tax, no matter how small, could price hedging instruments beyond the reach of some businesses, and ultimately reduce economic activity. Further, the Tobin tax would need to be introduced globally and at the same rate, or transactions would move offshore to tax-free or lower tax jurisdictions. From a practical perspective, the coordination and cooperation required for the introduction of a global tax would present innumerable, likely insuperable, difficulties.

Rein in Derivatives Markets

The Bank for International Settlements has concluded that, although derivatives do not likely trigger abrupt changes in market sentiment, there are ways in which they can contribute to, and possibly amplify, certain episodes of financial market volatility.[10] That is not to suggest, however, that during a turbulent period it would be desirable to restrict the trading of derivatives beyond the limitations already imposed by most exchanges. Such trading limits based on price movements, which are known as circuit breakers, are meant to reduce the probability of a market overreaction to news, i.e., overshooting, and to reduce volatility in general. Neither the theoretical research nor the empirical evidence is conclusive in demonstrating that price limits can and do reduce volatility driven by more than very short-term overshooting caused, for example, by misinformation. As a result, the effectiveness of price limits remains subject to considerable uncertainty.[11]

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[9] Less liquid markets are considered more volatile since large gaps can open between bid and ask prices resulting in potentially large price movements.

[10] See Bank for International Settlements, *Macroeconomic and Monetary Policy Issues Raised by the Growth of Derivatives Markets*, Basle Switzerland, November 1994, pp. 19-20.

[11] See V.G. France, L. Kodres and J.T. Moser, *op. cit.*, 19-22.