

Statement on Financial Transactions Tax

April 15, 2010

John Fullerton
President and Founder, Capital Institute
jfullerton@capitalinstitute.org
www.capitalinstitute.org

Good afternoon. My name is John Fullerton. I am the President and Founder of the Capital Institute, an innovation center focused on sustainable finance. I am also an active private investor and a former Managing Director of JPMorgan where I spent the first eighteen years of my career. My experience includes being Morgan's representative on the Long Term Capital Oversight Committee in 1998-99.

I am here to express my support for a Financial Transaction Tax. I will first explain my reasoning, and then address the principle legitimate concern about the tax from the perspective of a financial practitioner.

Let me first start by saying a FTT is a bad idea if it is conceived in retaliation against certain "bad actors" thought to be at the heart of the financial crisis. Such a tax will be far reaching and affect virtually all participants in the financial system unless explicitly excluded.

I see 3 principle reasons to support the tax:

1. **Combat short-termism:** At the heart of the financial crisis and the ills of our economic system is a malady known as "short-termism". We have lost the distinction between

real investment in the real economy and short-term financial speculation. A FTT should, at the margin, shift investment horizons out to longer holding periods by making high turnover trading strategies marginally less profitable. This would be a uniformly positive outcome in my judgment.

2. Improve Market Resiliency: I believe the FTT should improve financial system *resiliency*, with only minimal cost to efficiency. As systems scientists well understand, there is a *trade-off* between efficiency and resiliency. What policy officials need to do is seek the correct balance between efficiency and resiliency. In its search for ever increasing efficiency, the financial system became too brittle and broke.

Rapid trading strategies are typically low margin strategies, “collecting pennies” on large volumes of trades either via market making activities or short-term speculation, or both. Since they are low margin, they are typically employed with leverage to enhance returns. Such leverage, which can be funded or synthetically imbedded in products such as futures or swaps, reduces system resiliency, at the margin, because in a crisis, leveraged capital tends to be the first to be forced out, augmenting volatility precisely when it matters most. Leveraged positions are “pro-cyclical” and therefore hurt system resiliency. The FTT alone will certainly not control

market leverage, but all else equal, a FTT should reduce overall leverage in the system and improve resiliency in the process.

3. We need the money. Given the massive growth of financial transactions as markets have become more short term and speculative in nature, there is an obvious and attractive source for much needed revenue generation that does not negatively impact the real economy. Given the digital nature of trading, collection mechanics, ideally instituted uniformly across all major financial centers and products, should be relatively straight-forward.

I will now address the principle argument against the FTT: namely **the liquidity argument**. Clear thinking on this issue is lacking in the public debate from what I have seen.

First, I will generalize to say that markets tend to operate in one of two states, what I will call "normal" states and "crisis" states. The impact of the FTT in each state of the market is quite different, and the importance of liquidity and resiliency *is far higher* in crisis markets than in normal markets.

In "normal states" (most of the time), it is true that a transaction tax will have the affect of *widening the "bid-*

offer” spread to take account of the tax. At the margin, this reduces market efficiency, and in the process, we can expect “normal state” liquidity to be reduced, *somewhat*. Recall I stated earlier that anything that improves market resiliency will tend to reduce market efficiency. So we must accept a marginal loss in *market* “efficiency” if we want to improve resiliency.

Note this is different than efficiency in the *economy* as a whole. As I stated up front, I strongly believe *economic efficiency* would be improved if investment decisions were less speculative in nature and more long term oriented. I don’t believe there is any credible argument on this point. A FTT is therefore likely to generate a tradeoff of “normal market” efficiency in favor of economic efficiency, and, in favor of market resiliency, as I will discuss in a moment.

Furthermore, I would argue that the value of liquidity in “normal markets” is vastly overblown. Yes, the largest speculative trading firms care a lot about liquidity. And if asked: is more liquidity better, the answer must be “yes”. But that’s not the right question. The right question is: would you be willing to sacrifice some normal market liquidity at the margin in order to significantly improve market resiliency. This is the question our public officials

should be asking. And to this question, my answer is also a resounding “yes”.

Finally, turning to markets in a “crisis state”, this is where resiliency really counts and a transaction tax will be irrelevant to efficiency. Let me assure you, Warren Buffett’s decision to step in and buy Goldman Sachs stock in the face of the crisis was in no way impacted by the fact that he didn’t need to pay a transactions tax!

Liquidity in a crisis takes on a whole new meaning relative to day to day liquidity in “normal” markets. Liquidity deserts markets in a crisis for many reasons, but one of them must be related to the amount of perceived leverage in the system, leading to “weak hands”. This is why reducing excess leverage in the system is important to building resilience. By curbing, at the margin, high transaction and therefore by definition low margin and high leverage trading strategies, the FTT *helps* build system resiliency.

In summary, The FTT is not a cure all for the financial crisis, but at the margin, it will shift capital allocation away from short-term speculative activities toward longer term investment while improving system resilience and raising much needed revenue in the process.