

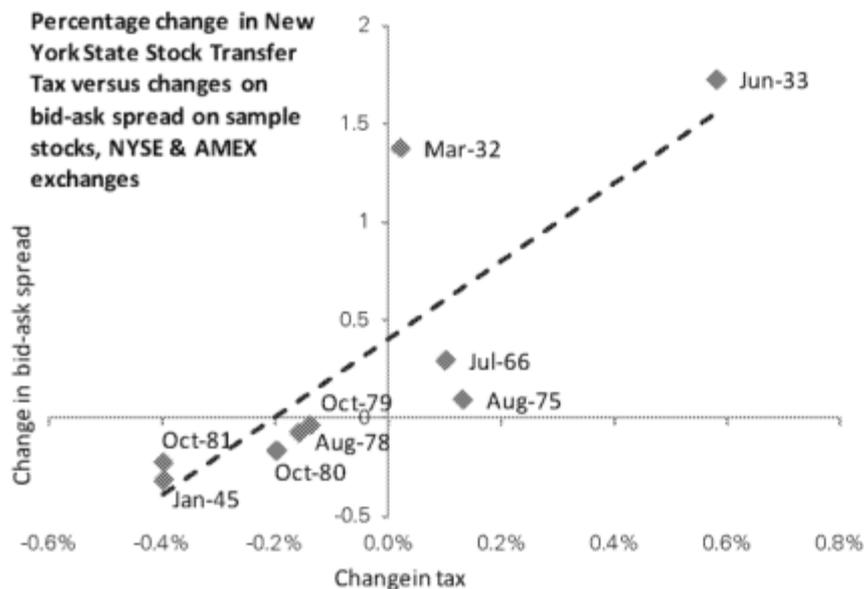


A stated goal of the FTT is to reduce transactions that do not contribute to market efficiency. One aspect of efficient market functioning is the rapid incorporation of news into asset prices, or price discovery. Liu (2007) examined how market efficiency evolved in line with financial transaction taxes in Japan. He measured price discovery using the autocorrelation of returns in the Japanese securities market. In a more efficient market, new information should be incorporated immediately into asset prices. This should, in turn, reduce the autocorrelation of returns. Lui found that reductions in the financial transaction tax in the securities market reduced the autocorrelation of Japanese stock price changes, suggesting that financial transaction taxes diminish price discovery.

A key feature of an efficient financial market is liquidity. This can be briefly summarized as the ability to transact when needed at a reasonable price. The best measure of liquidity is the bid-offer spread. We have already noted how bid-offer spreads would widen by the amount of tax that 'cascades' down the transaction. The FTT may widen bid-offer spreads still further through secondary effects.

Academic evidence suggests that financial transaction taxes result in wider bid offer spreads. Pomeranets and Weaver (2011) study New York State Security Transaction Taxes on the NYSE and AMEX stock markets throughout the 20th century. They found that financial transaction taxes had a strong positive correlation to bid-offer spreads.

Figure 7: Historically, financial transaction taxes have led to wider bid-offer spreads



Source: Pomeranets and Weaver, *Security Transaction Taxes and Market Quality*, Bank of Canada Working Paper, November 2011

Wider bid-offer spreads would result in higher transaction costs for all market participants. In their research, Oliver Wyman estimated that based on a 70% fall in volumes, the most liquid G10 derivative products could see spreads widen by 110%, while in less liquid G10 products spreads could widen by as much as 200%. It is worth noting that under the European Commission's initial impact assessment a fall in derivative trading of 90% in participating countries was anticipated, suggesting that the Oliver Wyman estimates were conservative.