Economic Analysis

Tobin tax could be introduced to stem capital outflows

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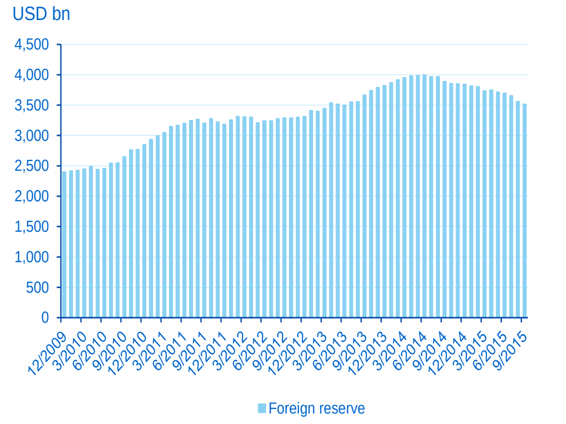
Today's released FX market indicators confirm a further stabilization in September after the unexpected RMB devaluation in early August caused violent movements in financial markets. Nevertheless, the pressure of capital outflows remains large as domestic firms and individuals, fuelled by expectations of further RMB depreciation, scrambled to exchange for the USD. In today's press conference, the officials from the State Administration of Foreign Exchanges (SAFE) reemphasized the solid fundamentals of the RMB and its bright outlook in the long run. However, they also indicated that Tobin tax could be introduced to FX trades in a bid to stem capital outflows.

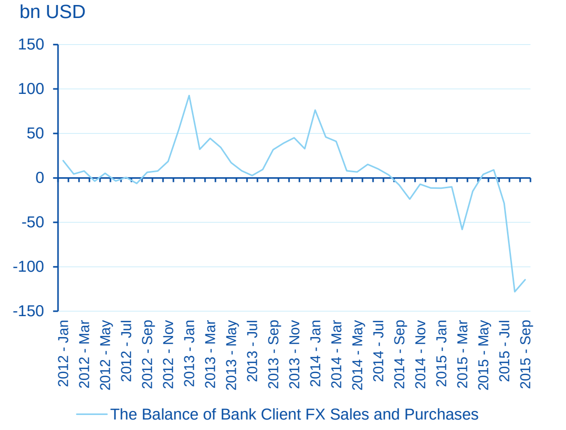
- **Among the indicators announced today, the Balance of Bank Client FX Sales and Purchases is the most informative.** The Balance is defined as the gap between the amount of client FX sales to banks and that of client FX purchases from banks. Its deficit means bank clients purchase more FX than they sell and surplus vice versa. Previously, the Balance moved broadly in parallel with the changes of foreign reserves. However, in the aftermath of the August devaluation, the authorities could have been leveraging banks' balance sheets to intervene into the FX market and stabilize the RMB exchange rate, which, as a consequence, might artificially boost the amount of foreign reserves than otherwise.
- **Financial tension has been eased but the pressure on China's BOP remains large.** The Balance in September registered a deficit of RMB -730 billion (equivalent to USD -115 billion), compared to RMB -807 billion (USD 127 billion) in August. Taking into account the fact that the devaluation of the RMB occurred in August 11th, domestic demand for the USD has somewhat eased in September on a daily basis. It is mainly due to the authorities' efforts to stabilize the RMB exchange rate and the Fed's decision in its September meeting to postpone the first interest rate hike. Nevertheless, the pressure on China's BOP remains large as the Balance in September still hovers around its historical low. (Figure 1)
- **Tobin tax might be a good option for China.** Named after James Tobin, a great economist and Nobel laureate, the tax is aimed to discourage investors' speculation by levying on financial transactions. It seems a perfect fit for China's authorities who are painstakingly seeking to avert a vicious circle of currency depreciation and capital outflows in the process of increasing its exchange rate flexibility. However, Tobin tax could carry high costs. For instance, it could reduce the market liquidity by squeezing out speculative investors out of the market. Moreover, when investors are aware that their future transactions will be subject to such a tax, they could scramble to trade ahead of the tax imposition and therefore amplify the volatility of the exchange rate for the short run. The authorities need to comprehensively assess all related risks before reaching their conclusion.

Figure 1
Foreign reserves only registered a much smaller decline in September than the previous month…



Source: CEIC and BBVA Research

Figure 2
… while the Balance of FX Sales and Purchases showed that the pressure on BOP remains large



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