

Economic Analysis

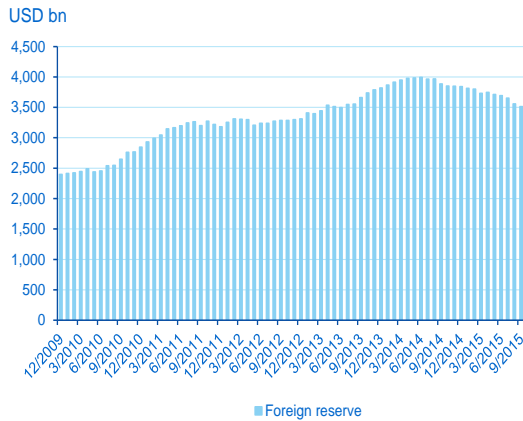
Tobin tax could be introduced to stem capital outflows

Le Xia

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.

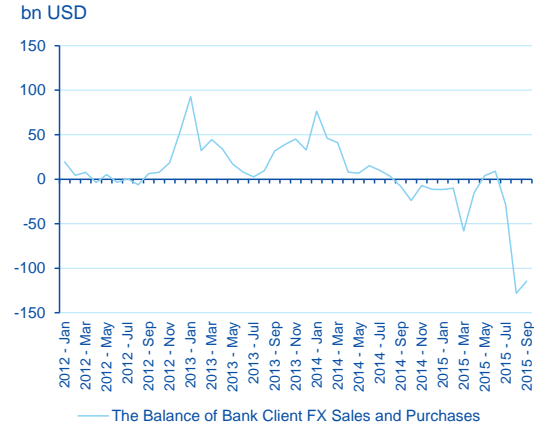
- **Among the indicators announced today, the Balance of Bank Client FX Sales and Purchases is the most informative.** The Balance is defined as the gap between the amount of client FX sales to banks and that of client FX purchases from banks. Its deficit means bank clients purchase more FX than they 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



Source: CEIC and BBVA Research

DISCLAIMER

This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. It is forbidden its reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process, except in cases where it is legally permitted or expressly authorized by BBVA.