NUS Economists

Will China impose a tax to deter yuan speculation?

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For The Straits Times

Q What might be China’s next move on a Tobin tax (a levy on foreign exchange trades to deter currency speculation)?

A China quietly rattled the financial world by raising the spectre of a Tobin tax last October. After mentioning the need to introduce the tax over a year ago, Mr Yi Gang, chief of the State Administration of Foreign Exchange and a deputy governor of the People’s Bank of China, said again that China should implement a levy on foreign exchange trades to deter currency speculation.

A repeated remark from a top currency regulator which is published in China Finance, an official magazine of the central bank, cannot be taken lightly. In late May last year, central bank governor Zhou Xiaochuan warned about the risk of China’s stock market bubble in the same magazine – and the A-share boom burst in the following month.

Nobody would know for sure whether the Chinese authorities will eventually introduce a Tobin tax. China may use its stated intention to introduce the tax as a bargaining chip to negotiate broader issues with its Western partners.

It seems, however, that a Tobin tax makes some sense and China is equipped with unrivalled capacity to introduce it.

Dr James Tobin, a Nobel laureate in economics, suggested the idea after the collapse of the Bretton Woods system in 1972 and there has hardly been any criticism about its principles since.

Many countries were already adopting financial transaction taxes on equities and bonds. There is no special reason for currency transactions to be an exception. Moreover, the Tobin tax has been proposed at a very low rate – for instance, 0.005 per cent by proponents of sterling stamp duty – to deter short-term speculation.

Despite its rationale, a Tobin tax has not been implemented.

A major reason is that most countries fear they may be stigmatised by introducing the tax: If a country becomes the first to do so, it would be penalised by global investors who would simply take their business somewhere else.

It has therefore been suggested that if a Tobin tax were to be introduced, it should be done globally. But any prospect of a global introduction has been naturally opposed by countries that benefit from currency trading, which is dominated by speculative transactions.

Former United States Treasury Secretary Henry Paulson famously said when he was chairman of investment house Goldman Sachs: “Volatility is our friend... If it wasn’t for volatility, why would you need Goldman Sachs?”

Goldman is Goldman because it is equipped with exceptional capabilities to profit from volatility. But for most companies and financial institutions, especially those in emerging markets, volatility is an enemy, which may trigger a currency war.

They have a strong incentive to dissuade their financial institutions from capital flight, even if China introduces a Tobin tax.

The global financial market is already the largest casino in human history and its size is increasing as rapidly as ever. The real economy is now simply a tiny tail wagged by speculative activities. There would hardly be any harm caused to the global community by reducing the size of the casino – and thereby reducing the expected gains of casino operators and gamblers.

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