



involve very large notional amounts. The FX market is also intermediated, with several potential stages between client and ultimate liquidity provider.

We are concerned that the FTT would result in higher costs for end users of FX markets. Transactions between non-financial entities (e.g. corporate clients) and their dealers are not exempt from the FTT and higher transaction costs incurred by liquidity providers may have to be passed down. While non-financial entities are not primarily liable for payment, where the FTT goes unpaid both counterparties are jointly and severally liable, potentially introducing a new risk to corporate hedging decisions where none previously existed. A less liquid FX market would also mean non-financial entities have access to poorer pricing, as academic research suggests that financial transaction taxes lead to wider bid-offer spreads.⁷

Since the stated purpose of policymakers in introducing the FTT is to increase the tax contribution of the financial sector in the interests of a level playing field with the non-financial sector, we think it is surprising that the proposal contains no exemption for transactions involving non-financial entities. As well as being counter to the goal of the proposal, this risks reducing the competitiveness of European companies. We calculate below that the FTT would impose a direct cost of between EUR 1 to 2.4bn per year on German exporters and importers. The FTT would, therefore, involve a significant direct cost for the real economy.

We believe the European Commission's proposal poses significant risk to liquidity and efficiency in the foreign exchange market. Historical examples of financial transaction taxes show significant declines in deal volume shortly after their introduction, while academic literature suggests that they impair market efficiency and liquidity.

We are also concerned that the proposal may offer market participants economic incentives that run counter to post-2008 international efforts at financial reform. By discouraging financial intermediation, the FTT flies in the face of mandatory clearing rules introduced in the wake of the 2008 financial crisis. Were the FTT to apply to the exchange of margin, it would discourage some market participants from collateralizing trades, hindering efforts to reduce counterparty credit risk.

An understanding of how the FTT will apply to FX transactions is the key to determining the impact on the FX market. We therefore begin our discussion with an outline of the current proposal.

How the Financial Transaction Tax Will Work

The FTT would be charged on all security transactions at a rate of 10bp and all derivative transactions at a rate of 1bp. FX products which are eligible for taxation are FX forwards and swaps, NDFs and FX options. FX spot is excluded. The European Commission had previously noted that a 'Tobin Tax,' on FX spot transactions could run counter to EU law by restricting the free movement of capital.⁸ The Commission appears not to have extended this consideration to FX swaps and forwards although there are questions as to whether they also represent 'capital flows.'

⁷ Pomeranets and Weaver, *Security Transaction Taxes and Market Quality*, Bank of Canada Working Paper, November 2011

⁸ European Commission, Staff Working Document, *Innovative Financing at a Global Level*, 1st April 2010