CHINA Insights

OCBC Bank

RMB: Cost of transparency, drawbacks of Yuan's fixing mechanism

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Highlights:

- **PBoC was active this week trying to talk down RMB depreciation expectation, but market moved to in the other direction.**
- **The divergence is the result of the fact that PBoC has been practicing its new fixing mechanism strictly.**
- **The use of the new fixing mechanism has clearly helped alleviate concerns about another one-off devaluation of RMB.**
- **The drawbacks of the current mechanical fixing system have been more obvious, which may have inadvertently trapped RMB in a gradual depreciation cycle.**
- **There are two major drawbacks include a ripple effect and cost of transparency. RMB's weakness tends to last longer after a big dollar shock under the current fixing mechanism.**
- **There are only two ways out of current trap including waiting for the dollar retreat and intervening in the closing price for USDCNY.**
- **RMB may continue to drift lower.**

Following the unexpected Brexit referendum result released on 24 June, RMB has entered a fresh round of depreciation against both dollar and basket currency with the USDCNY is trading above 6.65 in the onshore spot market and CFETs RMB index dipped below 95 to 94.88 as of writing on 1 July. Since the beginning of this week, PBoC has been active in talking down renewed RMB's depreciation expectation as shown on table below.

	PBoC rhetoric	Market movements
28 June	PBoC said in its social media account that RMB remains stable against basket currency though weakening against the dollar.	CFETs RMB index stabilized around 95.25 for four days post Brexit event but fell again to 95.02 on 30 June and 94.88 on 1 July.
30 June	PBoC denied the media report that PBoC is comfortable with 6.8 for USDCNY, threatening legal action against the media.	RMB fixing weakened to 6.6496 the next day after PBoC's statement and the USDCNY spot broke above 6.6500.

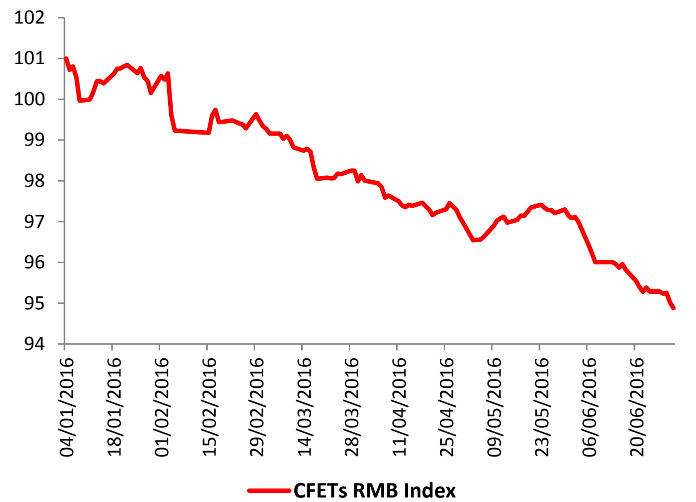
Does the table above shows that PBoC says one thing but actually do another thing? Certainly not. Instead, the divergence is the result of the fact that PBoC has been practicing its market-driven fixing mechanism strictly.

With the exception of the post Brexit Monday, there were no big surprises on the RMB fixing for most of the days this week. As you can see from the table below, the PBoC did not tweak the fixing to artificially keep RMB index above psychological level of 95. This reinforced our belief that PBoC has granted market forces a bigger role to decide the daily fixing regardless of any key level.

Table: No big surprise on RMB fixing despite break of key level s

	OCBC Forecasted fixing	Actual fixing	Difference
29 Jun	6.6340	6.6324	16bp
30 Jun	6.6310	6.6312	2bp
01 Jul	6.6500	6.6496	4bp

Chart 1: CFETs RMB fixing has been falling since the beginning of the year and dipped below 95 on 1 July



Source: Bloomberg, OCBC

The use of the new fixing mechanism has clearly helped alleviate concerns about another one-off devaluation of RMB. However, the drawbacks of the current mechanical fixing system have been more obvious, which may have trapped RMB in a gradual depreciation cycle.

Before we move on, let's recap what China's current fixing mechanism is. The market makers are required to submit their daily fixing based on two parameters including 4:30pm onshore USDCNY spot closing price and the change of three RMB baskets (CFETs, BIS and SDR).

The procedures of daily fixing submit are as below:
Step 1: Calculating the implied USDCNY assuming three basket value (CFETs, BIS and SDR) unchanged over the past 24 hours.
Step 2: Calculating the difference between implied USDCNY and previous day's fixing.
Step 3: Adding the difference calculated in step 2 to previous day's 4:30 closing adjusting for supply and demand factors.

The recent RMB movement demonstrated two key drawbacks of current fixing mechanism including ripple effect and cost of transparency.

Ripple effect

RMB's weakness tends to last longer after the big dollar shock. RMB weakens together with other currencies against the dollar when the dollar strengthened significantly. This is normal. However, a big dollar shock tends to negatively impact the fragile market sentiment. As a result, RMB closing usually ends lower than the fixing. As we can see from the steps above, the closing is the base for next day's fixing. As such, that may create pressure for the fixing to weaken unless dollar weakens overnight. Meanwhile, as shown on chart 2 below, the direction of RMB index has been highly correlated with the difference between fixing and closing since May. When RMB closing is weaker than fixing, there is a good chance that RMB index is likely to go lower next day.

Cost of transparency

PBoC has been transparent about the fixing mechanism. This is good in the sense that it removes uncertainty. However, the transparency may also give institutional investors opportunity to game the system. The Brexit day is a very good example. RMB weakened on the day when GBP and EUR tumbled on 24 June with the 4:30 closing price for USDCNY spiked to 6.6149. However, a simple calculation showed that the USDCNY fixing is likely to touch 6.65 next Monday. As such, the natural reaction is to long USDCNH. This also widened the gap between CNY and CNH, which worsen the depreciation expectation.

Chart 2: High correlation between change of RMB index and diff between daily closing and fixing.

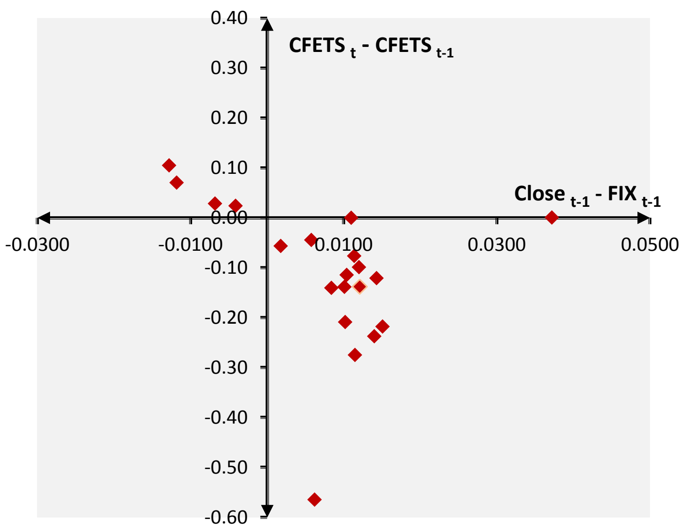
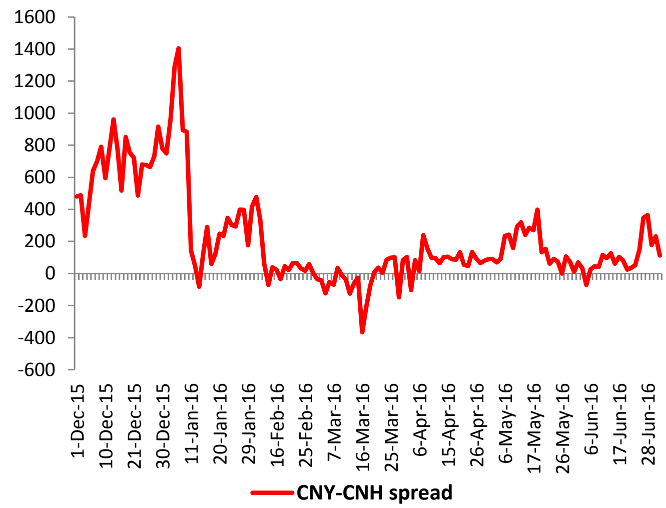


Chart 3: The gap between CNY-CNH spread widened recently



Source: Bloomberg, OCBC

Way out?

The PBoC has demonstrated in the past few trading days that China is following the fixing mechanism strictly. So how can China reverse RMB's recent gradual depreciation trend? We think there is only two possible ways out of the trap. First, PBoC needs to be patient to wait for the significant retreat of the dollar in the global market. Even a seesaw movement of dollar is unlikely to help. Second, PBoC could consider intervening the 4:30 closing prices to bring down the base for next day's fixing calculation.

On the positive note, the first wave of Brexit shock seems to have been contained for now. However, we still need to exercise the caution against any possible event risk such as the second wave of Brexit contagion as well as possible banking stress in the EU area. Any dollar shock may create additional pressure for RMB to weaken against both basket currency and dollar.

Nevertheless, we only expect a mild appreciation of dollar for rest of the year in our baseline given market is dialling back their Fed rate hike expectation. **As there is no easy way for RMB to get out of the current depreciation trap under the current fixing mechanism, we expect RMB to drift lower against the dollar. The USDCNY is expected to reach 6.7 by end of the year and 6.85 by mid-2017.**

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