CHINA Insights

OCBC Bank

RMB fixing formula change is not a big deal

Thursday, January 11, 2018

Highlights:

- **The two fixings in the past two days have confirmed that the counter cyclical factor (CCF) has been temporarily dropped from the fixing mechanism.**
- **We think the spike of RMB volatility is due to market misunderstanding of the CCF mechanism.**
- **We don't agree the removal of the CCF is a signal that China is uncomfortable with the current RMB appreciation.**
- **It may mark a nascent step for RMB to be back to the path towards an eventual free floating regime. However, we doubt China will aggressively pursue currency reform in 2018 as the focus is mainly on de-leveraging.**
- **Should the US dollar strengthen significantly in the global market in 2018, we think the CCF may be back to the centre stage again.**

Although China's central bank did not admit directly that it has suggested the RMB fixing submitter not to use the counter cyclical factor (CCF) in its reply to Bloomberg's enquiry on 9 January, the daily fixing in the past two days, which is in line with market forecast without the use of CCF, have confirmed that the CCF has been temporarily dropped from the fixing mechanism.

The RMB volatility spiked following the news as market sentiment was dominated by two popular arguments. First, the PBoC sent a signal to the market that they want to slow down RMB's appreciation via removal of the CCF. Second, the removal of the CCF signalled that China is ready for more currency reform, which may lead to more flexibly.

Although both arguments seem logical, we think market may have overreacted to this event. To have a better understanding about the whole picture, it is important for us to get back to the basic question what the CCF is.

What is the CCF?

The CCF was introduced in late May 2017 as a mathematic solution to solve RMB's asymmetric depreciation problem. Mathematically, the CCF was calculated based on the assumption on the domestic economic condition and change of RMB exchange rate due to market demand and supply. As more parameters involved, the CCF actually helped China take back the discretionary power for the daily fixing in our view.

Corporate FX & Structured Products
Tel: 6349-1888 / 1881

Fixed Income & Structured Products
Tel: 6349-1810

Investments & Structured Product
Tel: 6349-1886

Interest Rate Derivatives
Tel: 6349-1899

Treasury Research & Strategy
Tel: 6530-4887

Tommy Xie Dongming

+(65) 6530 7256

xied@ocbc.com

In theory, the CCF is a balanced tool, which can be used in both direction to stop RMB from excessively appreciation or depreciation. For example, the PBoC successfully stopped RMB from rapid appreciation on 8 September and 11 September via stronger CCF adjustment. In reality, the CCF was mainly designed as a tool with asymmetric bias to mitigate RMB depreciation pressure.

Thanks to the favourable macro backdrop of weaker US dollar in 2017, the introduction of CCF is a big success and it helped China break the vicious cycle of RMB's self-fulfilling depreciation within a short timeframe. Since the last quarter of 2017, the role of the CCF has diminished significantly in the daily fixing. As such, it is the time for the CCF to take a backseat.

The removal of CCF shows China is comfortable with the current market expectation about RMB in our view. However, we doubt it is a message from the PBoC that RMB exchange rate against the dollar is too strong. On trade weighted basis, RMB remains relatively stable against its major trading partners.

Chart 1: CCF has played an important role in September to stop both RMB's rapid appreciation and depreciation

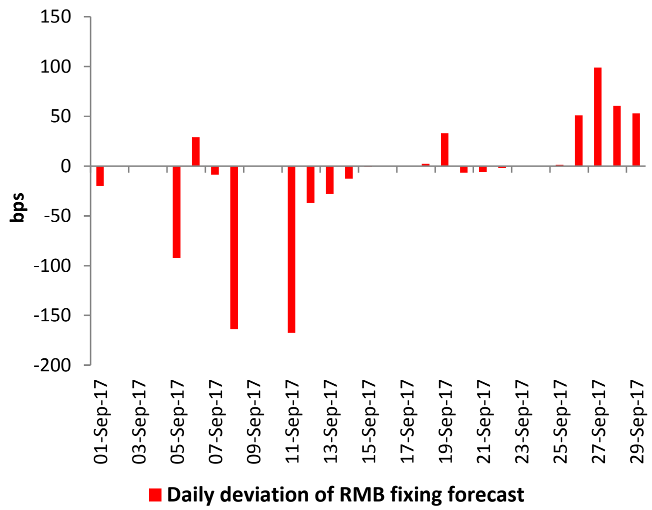
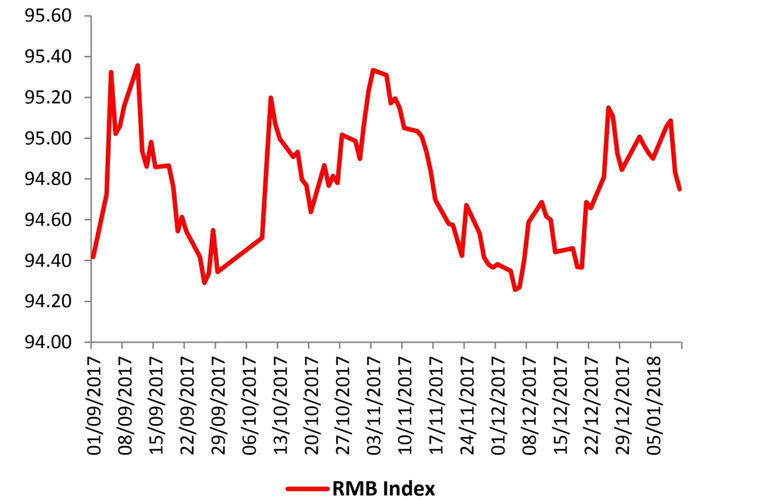


Chart 2: RMB index remained stable at around 95



Source: Bloomberg, OCBC

More currency reforms in 2018?

We agree the introduction of CCF as the emergency measure has derailed RMB's path towards a free floating currency. The removal of the CCF marked a nascent step for RMB to be back to the reform path. However, we doubt currency reform will take a front seat as the aim to balance between de-leverage and containing financial risk will require focus and China may try to avoid fighting on two fronts. As such, we expect low probability of self-engineered RMB volatility in 2018 and China may continue to keep RMB index stable around current range from 94 to 96. The recent market movement is also a reminder that market is still very sensitive to China's policy tweak even a minor one like this.

To conclude, we don't agree the removal of the CCF is a signal that China is uncomfortable with the current RMB appreciation. It may mark nascent step for RMB to be back to the path towards an eventual free floating regime. However, we doubt China will aggressively pursue currency reform in 2018 as the focus is mainly on de-leveraging. Should the US dollar unexpectedly strengthen in the global market in 2018, we think the CCF may be back to the centre stage.

Co.Reg.no.:193200032W