

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.

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

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.

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

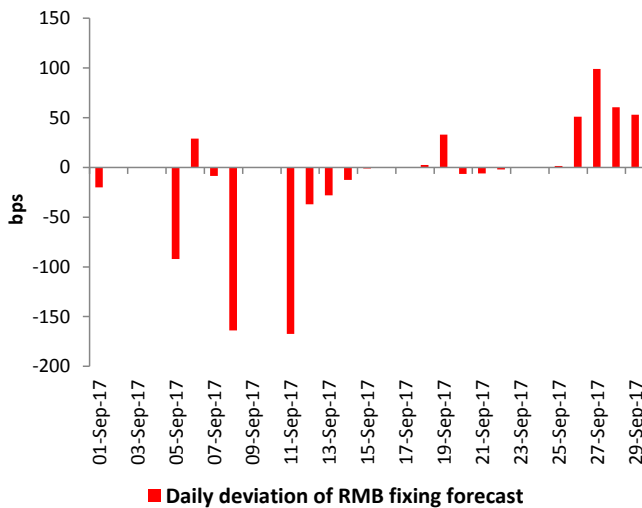
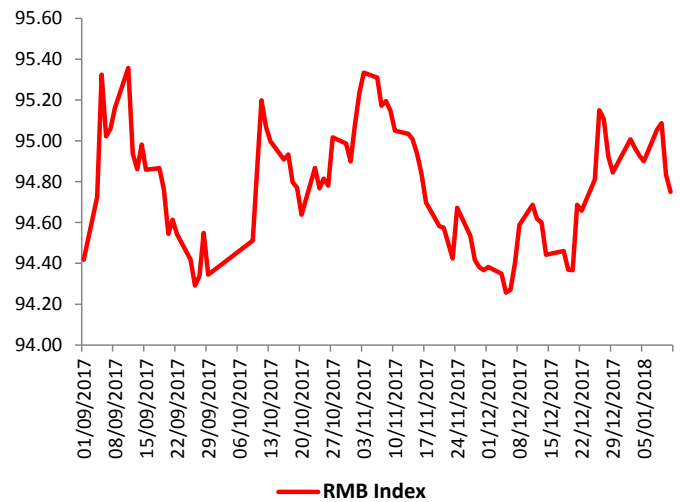


Chart 2: RMB index remained stable at around 95



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.

This publication is solely for information purposes only and may not be published, circulated, reproduced or distributed in whole or in part to any other person without our prior written consent. This publication should not be construed as an offer or solicitation for the subscription, purchase or sale of the securities/instruments mentioned herein. Any forecast on the economy, stock market, bond market and economic trends of the markets provided is not necessarily indicative of the future or likely performance of the securities/instruments. Whilst the information contained herein has been compiled from sources believed to be reliable and we have taken all reasonable care to ensure that the information contained in this publication is not untrue or misleading at the time of publication, we cannot guarantee and we make no representation as to its accuracy or completeness, and you should not act on it without first independently verifying its contents. The securities/instruments mentioned in this publication may not be suitable for investment by all investors. Any opinion or estimate contained in this report is subject to change without notice. We have not given any consideration to and we have not made any investigation of the investment objectives, financial situation or particular needs of the recipient or any class of persons, and accordingly, no warranty whatsoever is given and no liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of the recipient or any class of persons acting on such information or opinion or estimate. This publication may cover a wide range of topics and is not intended to be a comprehensive study or to provide any recommendation or advice on personal investing or financial planning. Accordingly, they should not be relied on or treated as a substitute for specific advice concerning individual situations. Please seek advice from a financial adviser regarding the suitability of any investment product taking into account your specific investment objectives, financial situation or particular needs before you make a commitment to purchase the investment product. OCBC and/or its related and affiliated corporations may at any time make markets in the securities/instruments mentioned in this publication and together with their respective directors and officers, may have or take positions in the securities/instruments mentioned in this publication and may be engaged in purchasing or selling the same for themselves or their clients, and may also perform or seek to perform broking and other investment or securities-related services for the corporations whose securities are mentioned in this publication as well as other parties generally.

Co.Reg.no.:193200032W