

RMB's two anchors

Monday, May 09, 2016

Highlights:

- RMB policy may have entered a new era, which may switch between dollar anchor and basket anchor depending on the dollar movement in the global market.
- A dollar anchor is more likely when dollar weakened against the global currency while a basket anchor may be switched on should dollar regain the strength in the global market.
- However, it does not change our call for RMB's mild depreciation against dollar to the range of 6.60-6.70 this year.

In its latest monetary policy report published on Friday, PBoC reiterated the important role of RMB basket currency in setting the daily fixing and specified that the daily fixing will depend on two parameters including previous closing price at 4:30pm and the move of RMB basket currency.

The report came out at the right time, partially addressing market's confusion about China's RMB policy which heightened last week after RMB index unexpectedly broke 97. The fact that China continued to guide RMB weaker against its basket currency flagged the warning signal that China may prefer a weaker basket currency. The almost one-way depreciation of RMB Index since the beginning of the year has shown deviation from China's earlier commitment to maintain its currency relatively stable against the basket. This also raised the concern that Yuan may have to depreciate faster against the dollar should the dollar regain strength in the global market.

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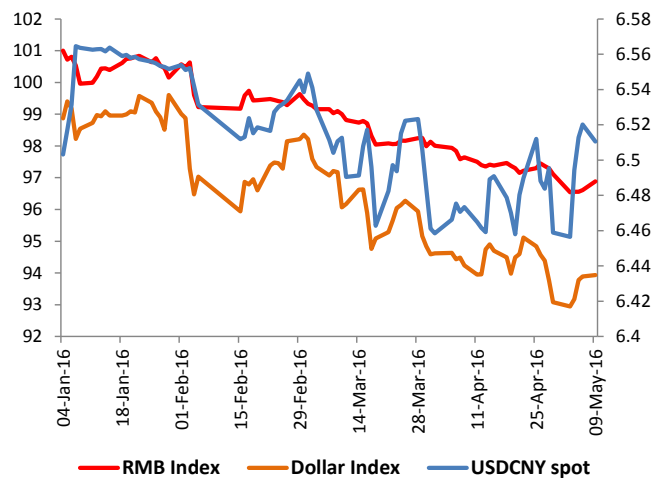
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Source: Bloomberg, OCBC

Based on last Friday's PBoC report, we think RMB may be referencing to both dollar anchor and basket anchor going forwards depending on the movement of broad dollar. Let's elaborate in the following two different scenarios.

Scenario one: weaker dollar

To maintain RMB index stable when a weak dollar dominates the global market may lead to RMB's passive appreciation against the dollar. This may not be the ideal scenario for PBoC. As such, switching to the dollar anchor is in China's favour as the relative stable USDCNY creates room for China to adjust the RMB index lower without injecting additional fear into the market.

Scenario two: stronger dollar

Should dollar regain strength globally, China may consider switching to the basket anchor to maintain RMB index relatively stable. The benefit of the basket anchor amid the strong dollar is that it may help contain the volatility. The basket anchor will not change the depreciation trend of RMB against the dollar should dollar surge but it will create the scenario of orderly depreciation. As such, the disorderly selling off of RMB seen in early January is unlikely to be repeated.

The rebound of RMB index this morning to 96.89 from 96.61 last Friday seems to confirm that China may switch from the dollar anchor to basket anchor amid the recovery of broad dollar.

To conclude, we think RMB policy may have entered a new era. Instead of a pure dollar anchor or basket anchor policy, RMB policy may switch between dollar anchor and basket anchor depending on the dollar movement in the global market. A dollar anchor is more likely when dollar weakened against the global currency while a basket anchor may be switched on should dollar regain the strength in the global market. The new regime is likely to contain the volatility in the USDCNY. As such, the probability of RMB's sharp depreciation against the dollar is low. However, it does not change our call for RMB's mild depreciation against dollar to the range of 6.60-6.70 this year. RMB is likely to follow its global counterparty to weaken against the dollar, in an orderly manner, based on the assumption of dollar strength.

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