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RMB: a way to reduce volatility in the daily fixing

Wednesday, February 22, 2017

Highlights:

- China has fine-tuned its RMB fixing mechanism. The new regime will dilute the impact of global market volatility on the daily fixing.
- It will help reduce volatility in the daily fixing. Yesterday's price movement has clearly demonstrated it.
- The most important impact of the new fixing mechanism in our view is that it will partially offset the impact of stronger dollar on next day's RMB fixing.
- This may help partially break RMB's self-fulfilling depreciation pressure faced in 2016.
- We will continue to observe whether the new regime will improve price continuation for daily fixing.

Reuters reported on Monday that PBoC has fine-tuned the daily RMB fixing mechanism effective from 20 Feb. Although there is no official confirmation yet, we think this news is credible as RMB market makers have started to submit the daily fixing using the new method from Monday.

Since February 2016, China has launched the market-based fixing mechanism. The market makers are required to submit the daily fixing based on two parameters including 4:30pm onshore USDCNY spot closing to reflect the change of dollar supply and demand and the change of three currency baskets (CFETS, SDR and BIS) over the past 24 hours to reflect the global non-dollar movement.

The newly revised fixing mechanism shortens the calculation of the change of currency baskets to 15 hours from 24 hours. In other words, the reference point to calculate the daily change of currency basket will change from 9:15am to 4:30pm. According to Reuters quoting source that the key purpose of the change is to avoid the double counting on the impact of global currency market on RMB. We agree.

Implications

The new fixing mechanism seems to be a small technical adjustment. However, we see two possible impacts on RMB. First, the new mechanism will help reduce volatility in the daily fixing. Second, it will also dilute the impact of global market volatility on the daily fixing. The daily will better reflect the onshore dollar supply and demand matrix, which is likely to improve price continuation for daily fixing. This means that the gap between daily fixing and previous day's closing is likely to be narrowed.

Yesterday's price movement clearly demonstrated how the new fixing mechanism helped reduced volatility in today's fixing. Dollar strengthened during Asian hours on 21 Feb with the dollar index rose from 101.1 in early morning to above 101.30 at 4:30pm. As a result of stronger dollar, RMB weakened against the dollar during the intra-day trading, however, RMB index rose to 94.13 at 4:30pm from 93.96 at 9:15am tracking the stronger dollar index. As such, today's fixing calculated with the new method based on 4:30pm RMB basket value is stronger than that with the old method based on 9:15am RMB basket value. On the relative basis, today's fixing is also closer to previous closing at 4:30pm.

	Actual RMB fixing	OCBC Estimated fixing based on new regime	OCBC Estimated fixing based on old regime
22Feb2017	6.8830	6.8847	6.8878

Based on the observation above, one conclusion we can draw here is that when RMB index appreciates from 9:30am to 4:30pm, RMB fixing will be stronger under new model compared with that under old model and vice versa. So what are the factors affecting RMB index? Those include the change of RMB's value against the dollar as well as non-dollar currencies' movement. Historical relationship shows that RMB index gains when dollar index appreciates even though RMB may weaken against the dollar.

Therefore, the relationship will be

If Dollar Strengthens in Asian time	RMB Index will be likely to strengthen, as such, RMB fixing will be stronger under the new regime as compared to old regime.
If Dollar weakens in Asian time	RMB index may fall, as such, RMB fixing will be weaker under the new regime as compared to old regime.

From the observation above, the most important impact of the new fixing mechanism in our view is that it will partially offset the impact of stronger dollar on next day's RMB fixing. Although it will not change the direction in absolute term, on the relative basis, RMB index will be stronger under the new mechanism should dollar strengthen. This may help partially break RMB's self-fulfilling depreciation pressure faced in 2016.

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