CHINA Insights

OCBC Bank

RMB party to pause for now

Monday, September 11, 2017

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

Highlights:

- **The recent strength of RMB was not only driven by dollar factor but domestic factors as well.**
- **PBoC's boundary for the RMB may have been tested after the recent rapid pace of appreciation.**
- **The unwind of two macro prudential measures on reserve cost for long dollar forward and reserve requirement ratio for RMB deposits placed by offshore participating banks with onshore agent banks, together with weaker than expected RMB fixing for the past two trading days, shows that PBoC wants to slow down the appreciation pace.**
- **We suggest not chasing RMB appreciation aggressively although most factors supporting RMB strength remain intact.**
- **Let's take the cue from the daily fixing in the coming days.**

Since August this year, RMB's strength is no longer a dollar story. RMB has appreciated against the dollar by more than 4% since August while RMB index, RMB's value against its major trading partners, also has gained by more than 2.8%. The recent rally of RMB is clearly driven not only by weaker dollar but by domestic factors as well. In this article, we will first recap the recent drivers behind the stronger dollar and then we would like to suggest investors not to chase recent RMB strength aggressively.

To recap, the recent RMB strength has been driven by three factors. First, as onshore corporates and individuals have hoarded huge amount of dollar for the past two years, the potential unwind of long dollar position due to sentiment change may have led the recent rally. Second, the possible repatriation of proceeds from the unwind of some overseas investments by Chinese conglomerates due to rising political cost may also add momentum. Third, the yield differential as a result of falling US yields due to risk aversion also helped support RMB sentiment.

Those factors are clearly not done yet and may support RMB further. However, the recent rapid pace of appreciation has helped market test PBoC's boundary for the RMB appreciation. The unwind of two macro prudential measures to support RMB for the past two years over the weekend and weaker than expected RMB fixing for the past two trading days show that China may want to slow the pace of RMB appreciation.

Removal of 20% reserve cost for long dollar forward position

Banks are no longer required to set aside 20% reserve cost for long dollar forward position effective from today. Since October 2015, China's central bank has imposed 20% reserve cost on any long dollar forward position to discourage speculation on RMB depreciation via forward position. As a result of higher hedging cost, the contracted value of long dollar forward done by clients have fallen from average monthly US$33.8 billion in the first eight months of 2015 to only single digit amount. Although the new rules help slow RMB's depreciation, it also hurt those companies who have genuine needs to hedge their future dollar payment.

The removal of this reserve cost shows that PBoC is more confident of managing market expectation on RMB. The recent two-way movement of the currency suggested that counter cyclical factor in RMB's fixing mechanism will play a more important role in currency expectation management than unconventional administrative measures such as reserve cost.

Removal of reserve requirement ratio for RMB deposit placed by offshore participating banks

In the past two years, PBoC has intervened RMB in the offshore market via squeezing RMB liquidity to increase cost for CNH short sellers. The reserve requirement ratio imposed on RMB deposits placed by offshore participating banks with onshore agent bank is one of the macro prudential measures to keep RMB liquidity in check in the offshore market.

The removal of RRR is expected to unlock hundreds of billions liquidity in the offshore market, which may lower the RMB funding costs in the offshore market. This may ease costs for investors to short CNH. In the longer run, it may be also supportive to restart the engine of RMB internationalization.

Overall speaking, we think the unwind of those two administrative measures shows that PBoC is more comfortable with the current RMB sentiment. Although it does not mean PBoC wants to create space for market to short RMB, it does signal that PBoC wants to slow the pace of appreciation. As such, we expect RMB to consolidate in the near term before market finds another catalyst. Nevertheless, we think the bias is still for market to sell USDCNY on rally amid weak dollar sentiment.

Co.Reg.no.:193200032W