

China: CFETS Upgrades Its RMB Index Basket

China Adjusts RMB Index Components And Weights

China's Foreign Exchange Trade System (CFETS) announced on Thur (29 Dec) that it will revise the components and weights of its CFETS RMB index to "version 1.1", by adding 11 new currencies into the basket (to bring to 24 in total), effective 1 Jan 2017. The CFETS basket was first unveiled on 11 Dec 2015 with 13 currencies, 3 months to the day the PBoC reformed its USD/CNY central parity mechanism that rattled the global financial markets.

For the new basket, the base year of the index remains the same as before, at 100 on 31 Dec 2014. Also, beginning 2017 the currency basket will be revised on an annual basis at end of the year, with the changes taking effect on the first day of the following year, unless there are other special circumstances, according to the statement from CFETS. The pace of revision is mirrored in the title of its statement as "version 1.1", from "version 1.0" that was released a year ago in 2015.

CFETS RMB Index (Component Weights, in percent)					
%	Currency	New (Effective 1 Jan 2017)	Old		Change (Percentage points)
1	USD	22.40%	26.40%	↓	-4.00%
2	EUR	16.34%	21.39%	↓	-5.05%
3	JPY	11.53%	14.68%	↓	-3.15%
4	KRW*	10.77%	-	↑	10.77%
5	AUD	4.40%	6.27%	↓	-1.87%
6	HKD	4.28%	6.55%	↓	-2.27%
7	MYR	3.75%	4.67%	↓	-0.92%
8	SGD	3.21%	3.82%	↓	-0.61%
9	GBP	3.16%	3.86%	↓	-0.70%
10	THB	2.91%	3.33%	↓	-0.42%
11	RUB	2.63%	4.36%	↓	-1.73%
12	CAD	2.15%	2.53%	↓	-0.38%
13	SAR*	1.99%	-	↑	1.99%
14	AED*	1.87%	-	↑	1.87%
15	ZAR*	1.78%	-	↑	1.78%
16	CHF	1.71%	1.51%	↑	0.20%
17	MXN*	1.69%	-	↑	1.69%
18	TRY*	0.83%	-	↑	0.83%
19	PLN*	0.66%	-	↑	0.66%
20	SEK*	0.52%	-	↑	0.52%
21	NZD	0.44%	0.65%	↓	-0.21%
22	DKK*	0.40%	-	↑	0.40%
23	HUF*	0.31%	-	↑	0.31%
24	NOK*	0.27%	-	↑	0.27%
	Sum	100.0%	100.0%		0.0%

* = Part of the 11 new components effective 1 Jan 2017, which account for 21.09% of the weights
 Source: www.chinamoney.com.cn, UOB Global Economics & Markets Research

Lower US Dollar's Weight Leads The Changes

With the near doubling of its basket components, the most noteworthy changes in this round include (see table):

- 1) the reduction of the US dollar's weights from 26.40% to 22.40%,
- 2) deep cuts for EUR, JPY and HKD weights,
- 3) the introduction of Korean won into the basket, at a hefty 10.77% weight, and
- 4) 11 new additions are emerging markets currencies, except for the 3 Nordic units (Denmark, Sweden, and Norway)

While the USD's weight has been reduced by 4% points to 22.40%, it remains a substantial part of the index. Together with HKD, which is pegged to the USD, the combined weight is still heavy at 27%, but down from 33% previously. While the US dollar would continue to be a swing factor in the RMB index, this is offset by reductions in weights for the EUR (5% point lower) and JPY (3% point lower) and increased weights of EM currencies, which could help make the CFETS RMB index somewhat more sensitive towards non-USD moves. The 11 newly added currencies (including Mexican peso, South African rand, Turkish lira) contribute about 21% of the weightage, half of which is attributed to the Korean won. This is what CFETS intended, to strengthen the "representativeness" of the index by enlarging the currency components.

The addition of Korean won should not come as a surprise, as it was actually a puzzle that it did not make it in the first round in 2015, given the size of external trade between the two countries. Since 2013, South Korea has been China's largest source of imports, accounting for 10.3% share of China's imports in 2015, followed by US' 9% share. South Korea was China's fourth largest exports market in 2015, with about 4% share of China's exports, which has been holding steady at this size over the past several years.

With the changes to the RMB index and addition of a number of EM currencies into the mix together with the lowered of USD weights, it does not mean that the RMB would be subjected to less depreciation pressure against the USD as it still boils down to confidence and fundamentals. As long as the pressure for capital outflows and/or perceptions of weak domestic fundamentals remain, the RMB would still be biased weaker vs. the USD regardless of the weights in the RMB index.

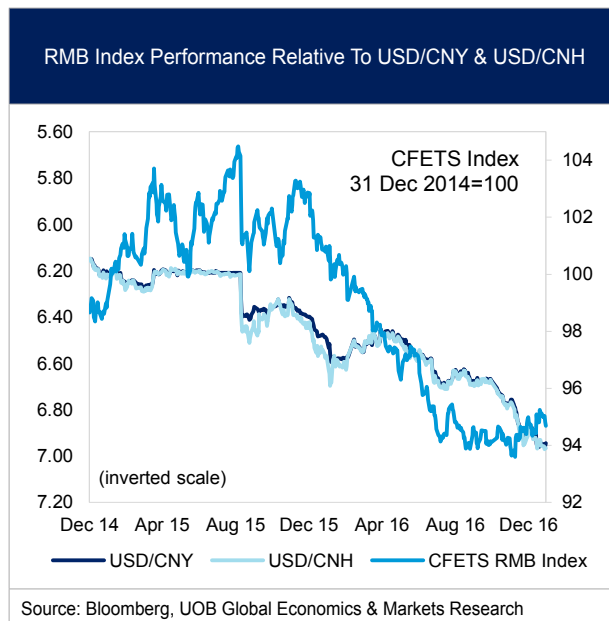
A More Stable RMB Index Ahead?

With the change, the top 5 currencies in the upcoming basket account for 65.4% of the basket weights, lower compared to 75.3% previously. Meanwhile, the top 10 currencies account for 82.8% share of the basket, down from 95.3% previously. These changes with a more diversified basket could favour a more stable RMB index in 2017. Nonetheless, a sharply stronger USD could still put the RMB under pressure, though the extent would likely be less than was the case before.

As for the outlook of the RMB, we continue to see a weak bias for the currency near term given the domestic concerns of debt and growth slowdown and resurgent US sentiment, even though the recalibration of the CFETS RMB index could help steer towards a more market-determined (and less USD-focus) exchange rate mechanism over the longer term. Note that CFETS also references two additional currency baskets in its FX policy, i.e. the 40-currency BIS Currency Basket and the RMB Index based on SDR Currency Basket (4 currency pairs). From China's perspective, the CFETS version likely warrants the most consideration among the three indices.

However, so far the performance of the CFETS RMB index has not been entirely consistent with official stance of a "stable" currency. This is reflected in its 6% decline since the end of 2015, which is close to the 6.6% drop in the onshore CNY against the USD in the same period. Ideally, the RMB index should be relatively more stable compared to the individual components, especially the USD. It remains to be seen whether the upcoming changes could address this issue.

Over the next 3-6 months, the USD/CNY could breach the 7.00 level earlier than our mid-2017 estimation, and the offshore USD/CNH already trading precariously close to that level. Our end-2017 for USD/CNY is at 7.16. One key event to note is the 20 Jan inauguration of US President-elect Donald Trump, who has vowed to declare China a "currency manipulator" on his first day in office.



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