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Macro Note

China: PBoC Reintroduced Countercyclical Factor Into Fixing Model

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Countercyclical Factor Back In Action To Offset "Herd Behavior"

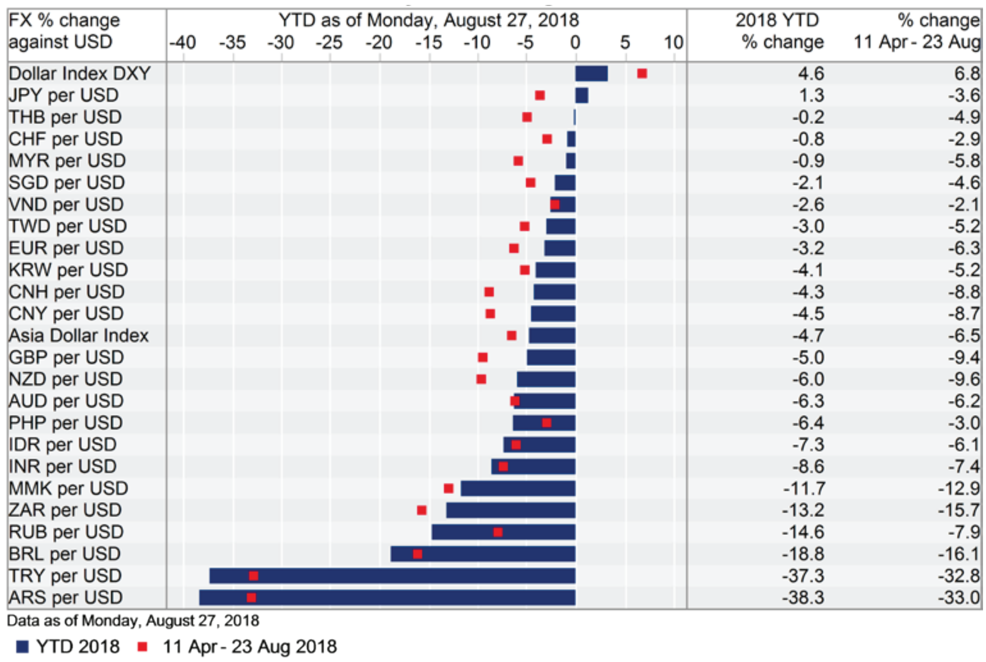
China's PBoC last Friday evening (24 Aug 2018) announced that it has reintroduced countercyclical factor (CCF) into its fixing model, in an effort to counter what the regulators believed is the "herd behavior" in China's currency values especially in recent months. In response to the news release, the offshore USD/CNH pair plummeted by -1.32%, the largest single-day decline for USD since Jan 2016, to close at 6.8024 on Fri (24 Aug). However, on Mon (27 Aug), USD/CNY ended slightly higher at 6.8248, vs. 6.8105 close on Fri, reflecting the firmer USD trend. In the morning, the USD/CNY central parity was set lower predictably, by 0.29% or 202 points to 6.8508 from 6.8710 last Fri. The fixing was largely in-line with our forecast of -234 points.

This "herd mentality" has driven the CNY exchange rate sharply lower especially in comparison to other currencies, in the current environment of strong USD and a backdrop of uncertainty due to US-China trade tensions. It is interesting to note that "herd behavior" in the FX market has been a constant focus of PBoC, and previous actions such as the introduction of required reserves for FX forward transactions could also be traced to such concern (e.g. in China's 2Q 2017 monetary policy report, and our report: "China: PBoC Reiterates Neutral and Prudent Monetary Policy Stance" 14 Aug 2017).

As shown in the table, CNY and CNH have performed relatively poorly against the USD compared to other Asian currencies. Since hitting recent high of around 6.27/USD on 11 Apr, the CNY has tumbled sharply in response to rising trade tensions between the US and China.

Currency Value Changes vs USD

Source: Macrobond, UOB Global Economics & Markets Research



During the period of 11 Apr to 23 Aug (the day prior to announcement of reintroduction of CCF), both the CNY and CNH have fallen by nearly 9% against the USD, vs the 6.5% drop for the Asia dollar index (ADXY) while the USD index (DXY) was up 6.8% in the same period.

This relatively large depreciation of the CNY and CNH has certainly raised regulators' concerns that the market was likely to be positioning against the Chinese currencies while ignoring fundamental economic factors which have yet to result in significant deterioration despite the escalating tensions in US and China trade.

Sharp Declines In CNY And RMB NEER Raised Alarm

The days of CNY on an appreciation or depreciation trend are long gone, and the market should brace for the currency having two-way flexibility going forward. Nevertheless, the rapid declines in the CNY against USD and on a trade-weighted basis (RMB NEER) between Apr and Aug have indeed been more violent than in the past, as shown in the charts.

China: RMB Nominal Effective Exchange Rate (NEER) Index

Source: Macrobond, UOB Global Economics & Markets Research

China: USD/CNY vs. US Dollar Index

Source: Macrobond, UOB Global Economics & Markets Research

This development is likely to have led to the regulators concluding that market has been overly pessimistic against CNY, despite largely balanced fundamentals for China as mentioned earlier.

The reintroduction of the CCF is expected to: 1) enable economic fundamentals to play a role in determining central parity and hence the CNY movements; 2) help shape "rational" market expectations of the currency's future value; and 3) improve the mechanism of the central parity formulation.

Despite CCF, RMB May Still be Subject to Pressure from USD Strength

With the introduction of CCF back into the central parity formulation, there is further flexibility for PBoC to influence the currency value without outright intervention in the FX market. It should be noted the aim of CCF is not to reverse the currency's trend, but rather to "mitigate the pro-cyclical market behaviors and stabilize market expectations", as noted by PBoC in its press release on 24 Aug.

In fact, PBoC noted in the statement that "China's economic performance is stable and turning for the better, supported by the progress in structural adjustment and rapid transformation of growth drivers. Growth has become more resilient. These have created favorable conditions for the RMB exchange rate to remain basically stable at an adaptive and equilibrium level."

As such, it can be interpreted that PBoC sees no major deterioration in domestic fundamentals and believes China's growth outlook is still positive and therefore the RMB should weaken along with a stronger USD, and not more. Therefore, PBoC is inclined to see the recent declines in CNY and CNH to be excessive and unwarranted, and hence reintroduced CCF to dampen this "herd mentality", before a loss of market confidence takes hold.

As noted, the CCF is not meant to reverse the currency's trend. Therefore, if the USD continues to stay supported due to tightening US Fed policy, ongoing US-China trade tensions, relatively loose monetary policy in China, the RMB would stay under pressure all the same. However, with the reintroduction of CCF, perhaps the path of weakening may be less rapid compared to the past months.

Recent Changes In China FX Regime

Date	Event
11 Aug 2015	China's central parity reform
11 Dec 2015	RMB Index introduced, to be considered as part of central parity formula, which is "closing FX price exchange rate movements of a basket of currencies"
27 Jun 2016	FX market self-disciplinary mechanism established
15 Aug 2016	Required reserve for FX forward transactions set at 20%
Feb 2017	Reference hours for central parity reduced from 24 hours to 15 hours of prior to closing
May 2017	Countercyclical factor (CCF) introduced, and central parity model is refined further to include: "closing price + exchange rate movements of a basket of currencies + counter-cyclical factor"
11 Sep 2017	Required reserve for FX forward transactions reduced to 0% from 20% set on 15 Aug 2016
19 Jan 2018	CCF is said to be set to "neutral" by FX market self-disciplinary mechanism, as the cross-border capital flow and supply and demand on the FX market became more balanced
3 Aug 2018	PBoC announced required reserve for FX forward transactions raised to 20% effective 6 Aug 2018, from 0% set on 11 Sep 2017
24 Aug 2018	PBoC announced that CCF have been reintroduced

Source: PBoC, CFETS, media reports, UOB Global Economics & Markets Research

Technical View (By Quek Ser Leang, Quek.SerLeang@uobgroup.com)

USD/CNH: 6.8115

In our update last Tuesday (see FX Insights: USD Asia Weekly on 21 Aug), we held the view that "*USD/CNH has made a short-term top" and "there is scope for a deeper pull-back but expect strong support at 6.8035*". We added, "*the next major support is closer to 6.7400 and his level is likely out of reach for the time being*". USD subsequently rebounded to a high of 6.8958 before staging an outsized decline of -1.32% last Friday (this is the largest 1-day decline since Jan 2016). The sharp drop cracked the 6.8035 support as it hit a low of 6.7989 before extending its decline earlier this morning (low of 6.7818 at the time of writing). The rapid and sharp drop has clearly shifted the focus to the next support at 6.7400. While a move to this support seems likely, the down-move is running too fast, too soon and we still think that this level may not come into the picture so soon, at least not within the next one week or so. All in, USD/CNH is still clearly under pressure and only a break of the 'key resistance' at 6.8700 (minor resistance is at 6.8500) would indicate that a short-term low is in place.

Reference:

RMB/USD Central Parity Rate Quoting Banks Have Reintroduced Counter-Cyclical Factor, PBoC, 24 Aug 2018 http://www.pbc.gov.cn/english/130721/3610729/index.html

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