WHY DOES CHINA FIDDLE AROUND WITH THE YUAN FIXING AGAIN?

Times and conditions change so rapidly that we must keep our aim constantly focused on the future.

Walt Disney

The PBoC adjusted the renminbi (or yuan) fixing mechanism for the second time on 20 February. The first time was in August 2015 when it changed the calculation from using a 10-day moving average of the CNY-USD's closing rates to using the CNY-USD's closing rate of the previous trading day.

There are three parts to the renminbi fixing:

1. The CNY-USD's spot closing rate as of 4:30pm of the previous trading day.
2. The average of the 24-hour daily changes in the USD against the currencies in the CFETS basket, the BIS CNY basket and the IMF SDR basket.
3. A PBoC discretionary adjustment based on its judgement on the FX market's demand and supply conditions, risk appetite and international developments.

In December 2016, the PBoC added 11 new currencies to the CFETS basket (see Table 1), most of them illiquid emerging market currencies. Arguably, their inclusion adds to the volatility of the renminbi trade-weighted index. So this time, by changing the 24-hour reference period in the second part of the fixing to 15 hours (between 4:40pm of the previous trading day and 7:30am of the next day before trading starts in China), the PBoC hopes to reduce the volatility of the renminbi's basket. This is because the currencies traded during the 4:30pm and 7:30am period are mainly liquid developed market currencies.

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Since the PBoC's FX policy is to keep a stable trade-weighted exchange rate (with reference to the currency basket) and use the CNY-USD cross-rate as an adjustment factor to achieve such stability[1], the new shortened reference period should enhance the PBoC's grip over the CNY-USD cross-rate at a lower cost by reducing the volatility of the trade-weighted exchange rate.

This is not a FX policy shift but a fine-tuning of the PBoC's exchange rate management tool. With the PBoC targeting a stable trade-weighted exchange rate, the movement of the USD against other currencies will determine how much the CNY-USD cross-rate will move and in what direction.

Table 1:	Old basket weights (Dec 15)	New basket weights (since Dec 16)	Change
USD	26.40%	22.40%	-4.00%
EUR	21.40%	15.30%	-5.10%
JPY	14.70%	11.50%	-3.20%
KRW	-	10.80%	-
AUD	4.70%	4.40%	-0.30%
HKD	6.60%	4.30%	-2.30%
MYR	2.50%	3.80%	1.20%
SGD	3.90%	3.20%	-0.70%
GBP	6.30%	3.20%	-3.10%
THB	0.70%	2.90%	2.30%
RUB	1.50%	2.60%	1.10%
CAD	3.30%	2.20%	-1.20%
SAR	-	2.00%	-
AED	-	1.90%	-
ZAR	-	1.80%	-
CHF	3.80%	1.70%	-2.10%
MXN	-	1.70%	-
TRY	-	0.80%	-
PLN	-	0.70%	-
SEK	-	0.50%	-
NZD	4.40%	0.40%	-3.90%
DKK	-	0.40%	-
HUF	-	0.30%	-
NOK	-	0.30%	-

Source: PBoC, BNPP IP (Asia)

Indeed, the PBoC has tolerated more decline of the renminbi against the USD than it used to and for good reasons. Pegging the yuan against USD becomes costly when the world turns against the renminbi and capital flows out of China. This is because the resultant loss of FX reserves under a CNY-USD peg creates a passive liquidity drain that hurts China's GDP growth. So allowing the yuan to fall against the USD is more about relaxing this passive liquidity constraint than boosting exports. This is different from a devaluation policy.

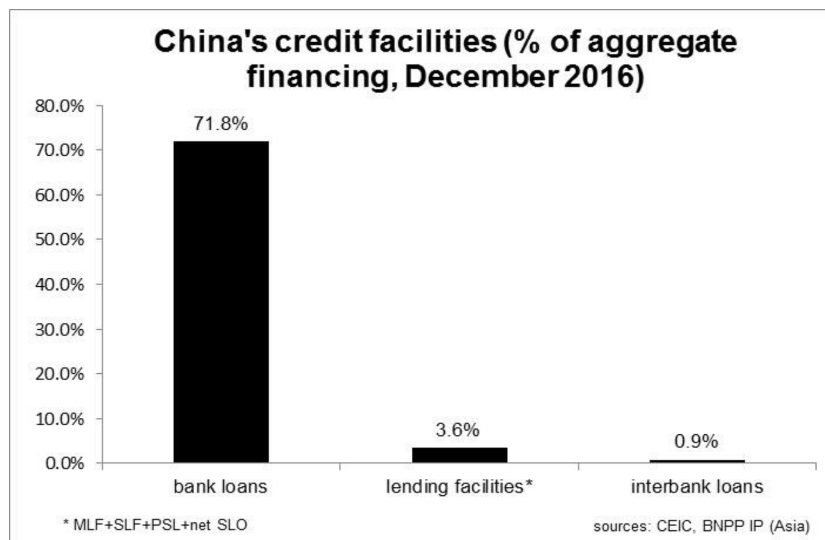
From an Impossible Trinity perspective, persistent renminbi depreciation expectations coupled with the US Fed's interest rate normalisation have prompted the PBoC to re-impose capital controls to stem outflows so that it can regain control on both the interest rate and the exchange rate. The economy is not strong enough to withstand any monetary tightening by the PBoC, which is also mandated to keep a stable exchange rate (among other policy objectives) at this stage. So the authorities have chosen to sacrifice capital account liberalisation in the short-term.

The recent 10-basisi-point "rate hike" by the PBoC is too small to have any impact on reducing the renminbi's depreciation pressures, as the market seems to blindly believe, when the US Fed is raising rates at a pace of 25 basis points at a time. The "rate hike" will also have limited impact on the Chinese system, as the affected lending segments account for less than 5% of total credit facilities[2] (see chart). Furthermore, over 60% of the credit in the Chinese system is still priced off the one-year benchmark lending rate which stands at 4.35%,

[1] See *"Chi Flash: China Hits RMB Speculators Hard,"* 6 January 2017.

[2] See *"Chi Flash: Is the PBoC Tightening or What?"* 3 February 2017.

significantly below the market-driven rates. The small rate hike is a PBoC policy signal to continue forcing debt reduction in China's wholesale funding market, which is increasing financial stress in the small and shadow banking areas[3].



The renminbi may depreciate against the USD by another 3%-4% in the short-term due to capital outflow pressures stemming from both domestic challenges (growth issues, asset diversification etc.) and external ones (US trade policies, European elections this year etc.). China's interest rate policy will focus on domestic needs, assisted by capital controls so that it does not necessarily follow the US rate trajectory. The PBoC is expected to rely more on capital controls in the short-term to manage the renminbi's depreciation, supplemented by FX reserve drawdown and small interest rate adjustments.

Chi Lo
Senior Economist BNPP IP

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[3] See *"Chi on China: Where Does China's Financial Risk Lie?"* 23 November 2016.

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