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China: PBOC tweaks model guiding Yuan fix to underpin financial stability

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On May 26th, the People's Bank of China (PBOC) announced that, henceforth, it would add a 'counter-cyclical adjustment factor' to its model guiding daily USDCNY midpoint fixing, on top of two key factors in the previous model: the previous day's official closing price and changes in a basket of currencies. The tweak aims to reduce excess Yuan volatility and curb one-way bets by easing 'herd behaviour' which could stem from the escalating pressure in domestic financial markets surrounding the ongoing deleveraging campaign (Refer to our recent watch on China's Financial Deleveraging).With memories of Yuan sell-off post August 2015, when China's original CNY fixing mechanism was first introduced, still fresh, we expect PBOC to lean towards a stronger CNY fixing in the near term in order to pre-empt any market uncertainty about the new mechanism. On the other hand, the tweak could defacto backpedal the Yuan exchange rate regime to the one prior to the reform in August 2015, which was a soft peg against the USD under the name of benchmarking to a currency basket whose composition had never been announced to the public. That said, its medium to longer term implications for USDCNY are hard to determine, especially given the opaqueness of the new adjustment factor.

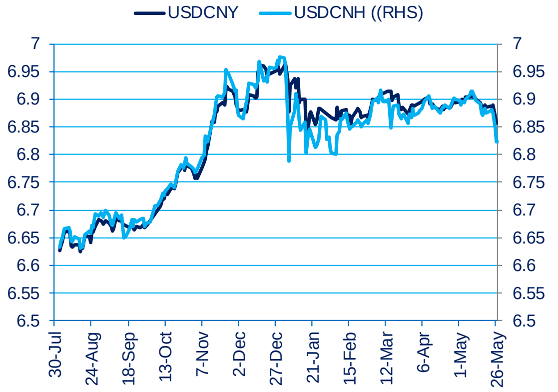
Ensuring currency stability in a year marked by key economic and political changes

PBOC's new fixing mechanism and its emphasis on currency stability should be understood against the backdrop of ongoing economic and political development in China. An accommodative monetary and fiscal policy stance helped support China's real GDP growth at relatively robust pace last year, although, at the cost of a continued rise in economy-wide debt, which in turn has weighed on potential growth and fueled financial stability risks – a key reason cited by Moody's in its downgrade of China's rating by one notch to A1 Stable last week. Reassuringly, a number of China's regulators have stepped up their efforts to curb shadow banking activities since last December. Meanwhile, PBoC has shifted its policy stance to "prudent", tightened interbank liquidity, introduced Macro Prudential Assessment (MPA) and stepped up capital controls to curb speculative currency outflows. Through the tweak of pricing model, the authorities are seeking to reinforce investors' confidence in the Yuan strength and therefore prevent the contagion from domestically originated financial turmoil to the FX market. It is all the more so when the US Federal Reserve's prospective interest rate hike in June is likely to initiate another round of surge in the USD. Policy urgency to ensure financial stability is accentuated further by the upcoming top leadership reshuffle planned at the 19th Party Congress this autumn, which also marks President Xi's second five-year term at party-state's helm. In this context, Beijing would also ensure avoiding conflict with Mr. Trump on currency manipulation charges, at least in the run-up to the Party's Congress.

Despite RMB appreciating 1.2% against the US dollar so far in 2017, compared to 6.5% depreciation in 2016, policy constraints continue to risk triggering capital outflows from China. In this context, the 'counter-cyclical adjustment factor' does give PBOC more discretion in fixing the Yuan midpoint rate. On the flip side, the change undermines transperancy in Yuan fixing mechanism and the recently established credibility of China's exchange rate policy. Moreover, it is also unsustainable for the authorities to artificially maintain a currency value which appears too high for the market. China's domestic capital might have a stronger incentive to flow out of the country when they feel that the currency is overvalued. As a response, the authorities are unlikely to relax the existing restrictions under the capital account in near term.

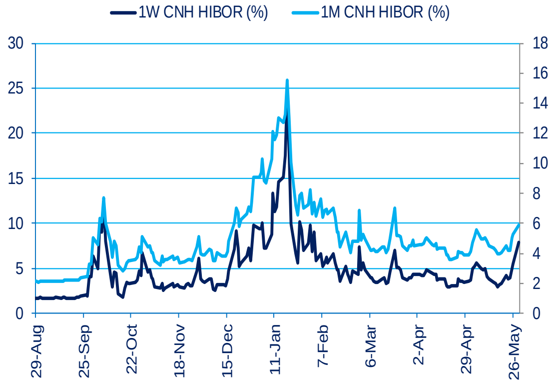
All in all, the tweak of the Yuan fixing model could be indispendable to the deployment of China's deleveraging campaign. Meanwhile, the authorities have actualy raised their stakes on the deleveraging campaign. If they fail, the backfire effects of maintaining an overvalued exchange rate in the FX market will be fiercest.

Figure 1. Recent CNY fixings have been stronger



Source: BBVA Research, CEIC

Figure 2. Upside pressure on CNH HIBOR rates



Source: BBVA Research, CEIC

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