ECONOMIC ANALYSIS

China | Depreciation takes hold after new RMB index set to track EUR and JPY more closely

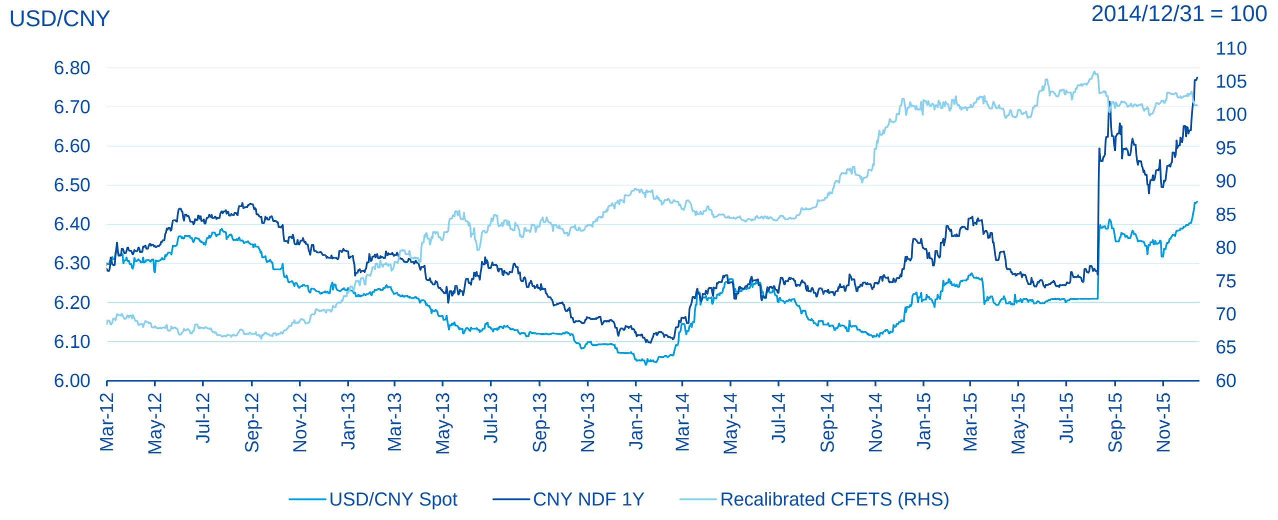
Carlos Casanova / Le Xia

On December 11, the PBOC indicated that the RMB will be loosely pegged to a basket of 13 currencies. Weights for the different currencies were also provided as part of the announcement. Chinese authorities have, for a long time prior to this announcement, claimed that the RMB exchange rate is determined with reference to a basket of currencies, but the composition of this basket has never been disclosed. The move should be seen in the context of China's ongoing quest for capital account liberalization, meaning that basing the mid-point around which the RMB is allowed to fluctuate each day on a broader basket of currencies, as opposed to the USD, should assist China in its transition towards a free-floating exchange rate. In addition, the previous system was regarded as unsustainable, as it led to the appreciation of the RMB in real effective terms, hampering the competitiveness of Chinese exports vis-à-vis other regional competitors. Despite the USD still accounts for the bulk of the index, the latter puts significant weight behind the EUR and JPY. The Fed is expected to start lifting rates later this month, which could lead to some USD strengthening, whereas the ECB and BOJ maintain their easing stance. We have not revised our CNY FX forecasts, though we do identify some upside risks to our end-15 forecast of 6.45 CNY/USD. We maintain our end-16 forecast at 6.8 CNY/USD.

- **PBOC announces new RMB FX index.** Late last Friday, the PBOC announced the CFETS's (China Foreign Exchange Trade System) new RMB index, composed of 13 currencies. The USD accounts for the highest weight amongst all currencies in the basket, or 26.40%, followed by the EUR (21.39%) and the JPY (14.68%)[1]. The move is meant to better reflect the value of the CNY in effective terms, playing down the recent weakening trend versus the USD. Most likely, the PBOC will loosely peg the RMB against this basket of currencies, although the ultimate goal remains to achieve a free-floating exchange rate. The move constitutes a turning point from the previous USD-focused approach, as the EUR and JPY are expected to play a stronger role than in the past.
- **Depreciation versus the USD takes hold.** The PBOC has lowered the CNY's mid-point seven times since the International Monetary Fund (IMF) announced the inclusion of the RMB in the currency basket of the Special Drawing Rights (SDR) on November 30. The recent weakening trend is in line with mounting upside pressure in the FX markets, with the RMB non-deliverable futures (1Y NDF) now factoring in a significant depreciation in a year's time. Following last Friday's announcement, the RMB exchange rate fell to 6.46 CNY/USD on the onshore market, while the offshore CNH reached 6.55 CNH/USD on Monday, extending a 6 day drop to 2%.
- **We maintain our RMB FX forecast, despite upside risks.** The persistently widening differential between the onshore and offshore RMB exchange rates might be signaling that the authorities have started to withdraw from intervening in the offshore RMB market and tolerate a larger magnitude of fluctuations against the USD. Going forward the RMB exchange rate could become more synchronous with the EUR and JPY. That being said, the authorities could intervene in the FX market again if they feel uncomfortable with the level of the exchange rate or its volatility.

[1] USD: 0.2640; EUR: 0.2139; JPY: 0.1468; HKD: 0.0655; AUD: 0.0627; MYR: 0.0467; RUB: 0.0436; GBP: 0.0386; SGD: 0.0382; THB: 0.0333; CAD: 0.0253; CHF: 0.0151; NZD: 0.0065

Figure 1
Under pressure: A weaker RMB based on new CFETS Index



Source: Bloomberg and BBVA Research

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