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Friday, 02 January 2015

Flash Notes

China: SAFE Notice 53 On Changes In Foreign Currency Exchange Net Open Position

- **SAFE Notice 53 announced on 30 December 2014 that FX NOP to be delinked from FX LDR ratios while reporting frequency reduced from daily to weekly. The new rules took effect on 01 January 2015, reversing previous regulation set in place by Notice 20 (dated 05 May 2013).**

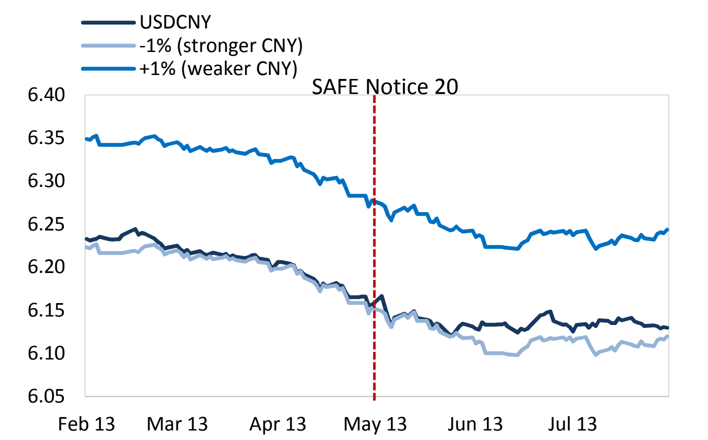
- **On the day of the news release (30 Dec), the USD/CNY pair plunged by >400 pips, but the CNY subsequently pared back some of the appreciation.**

- **Regulatory change not expected to cause reversal in the current USD/CNY uptrend, but may cap the upside and increase downside sensitivities in the near term.**

On 30 December 2014, the State Administration of Foreign Exchange (SAFE) issued Notice 53 (汇发 53 dated 25 Dec 2014) which reverses the linkage between banks' foreign currency loans to deposit ratios (FX LDR) to their net open positions (NOP) and reduced the frequency of reporting from daily to weekly. This change reverses the earlier Notice 20 and was made effective as of 01 January 2015.

Background: SAFE Notice 20
Note that the linkage between commercial banks' FX LDR ratio and NOP was first introduced on 5 May 2013 (Notice 20) where the trigger for NOP floor requirement was set at 75% FX LDR for Chinese banks and 100% FX LDR for foreign banks. This requirement to maintain a positive NOP against FX LDR resulted in an initial short squeeze in the USD/CNY and helped to slow down the pace of appreciation of the Chinese currency. Chart 1 showed that USDCNY had been hugging close to the bottom of the allowed stronger end of the +/-1% trading band, so the introduction of Notice 20 was a countertrend move at the time since it mandated long USD NOP. The USDCNY flat lined for the next 3 months (after the introduction of Notice 20) before heading lower in a stepwise fashion.

Chart 1: CNY was appreciating against USD before Notice 20 started tapping on USD/CNY brakes In 2013



Source: Bloomberg, Global Economics & Markets Research

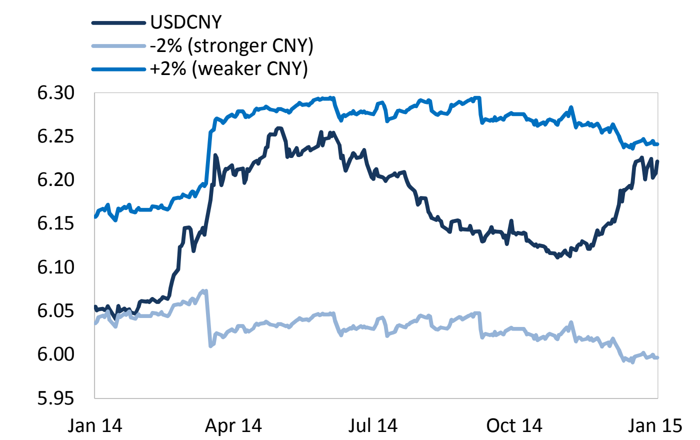
SAFE Delivers "Christmas Gift" To Banks With Notice 53

SAFE's announcement of Notice 53 comes at the time where the recent weakness in the Chinese domestic economy has so far prompted one round of PBOC reference rate cut, and a number of targeted easing measures (including PBoC's easing of loan-to-deposit rules). These developments have weighed negatively on the prospect for CNY appreciation in the near term.

The delinking of NOP to FX LDR and the extension of reporting frequency to a weekly basis (as announced in Notice 53) is meant to encourage further bank lending activity by allowing more flexibility around how banks manage their foreign currency lending books. As seen in Chart 1, the introduction of Notice 20 helped to reduce the rate of appreciation in CNY and thus it is reasonable to expect that the reversal of Notice 20 with the introduction of Notice 53 to have an opposite impact (i.e. supportive of CNY gains). Indeed, this was the case as the USD/CNY slumped by more than 400pips from a high of 6.2351 (on 30 Dec 2014) to a low of 6.1915 (on 31 Dec 2014) when the news was made public on 30 December 2014. Some of the CNY gains subsequently were given back and it closed at 6.2046 in the last onshore trading session of the year 2014. The Chinese markets were closed on 1 and 2 January 2015 and the USD/CNH is currently trading higher at 6.2266 (as of 2 Jan 2015, 2:30pm Singapore time)

The USD/CNY pair shot higher in early 2014 as speculators betting on one-way appreciation in the CNY got flushed out due to a widening in the trading band from 1% to 2% on 17 March 2014. This widening signaled greater tolerance by PBOC for currency volatility. The CNY regained some ground subsequently, before it tumbled again in November 2014 due to the surprise PBOC interest rate cut and has since been drifting higher on expectations of further policy divergence between PBOC and FED. And while the Notice 53 gave a brief reprieve to the CNY weakness, we do not expect Notice 53 to change the dominant trend which at the moment argues for a higher USD/CNY. What we see as a more likely scenario is that Notice 53 may provide some cap on upside moves in USD/CNY. (See Chart 2)

Chart 2: The change in USD/CNY trend in 2014 going Into 2015



Source: Bloomberg, Global Economics & Markets Research

As for the flow argument for lower USD/CNY, we are not expecting an avalanche to hit the market since balance sheet policy changes will likely be deliberate and spread out to minimize price impact. Although Notice 53 is not the game changer in terms of reversing the upward trend for USD/CNY, it may alleviate some of the recent pressure for weaker CNY. And as it is the latest measure coming out from the Chinese authorities, it will be fresh in the market's psyche which means that any downside move in the USD/CNY (i.e. CNY appreciation) might be exacerbated by fears of flows attributed to Notice 53 (long CNY, short USD). An example would be a reversal of the crowded long USD trade due to external factors, in which case USD/CNY may underperform compared to the rest of dollar Asian currency pairs.

Please click on the link to access the Chinese release statements for SAFE Notice 53:

http://www.safe.gov.cn/wps/portal/!ut/p/c5/04_SB8K8xLLM9MSSzPy8xBz9CP0os3gPZxdnX293QwML7zALA09P02Bnr1BvI2c_E_1wkA6zeGd3Rw8Tcx8DAwsTdwMDTxMnfz8P50BDA09jiLwBDuBooO_nkZ-bql-QnZ3m6KioCACk6Xh-/dl3/d3/L2dJQSEvUUt3QS9ZQnZ3LzZfSENEQ01LRzEwODRJQzBJSUpRRUpKSDEySTI!/?WCM_GLOBAL_CONTEXT=/wps/wcm/connect/safe_web_store/safe_web/whxw/ywfb/node_news_ywfb_store/2660298046bd3265a940a97cfb0ecee5