



China's Economic and Financial Outlook

Annual Report 2015 (Issue 21)

December 2, 2014

Highlights

- China's economy continued to slow in 2014 under the downward pressure from a deceleration in growth, painful economic restructuring and the hangover of previous stimulus policies. China's GDP is expected to grow at around 7.4% in 2014 on an annualized basis, significantly lower than the annual average of 9.9% since the country launched its economic reform and opening-up policy in 1978. Overall, the Chinese economy remains within a reasonable range, accompanied by some positive changes in trend terms.
- China's economy is shifting into a "new normal" with new engines of growth taking shape. In 2015, China's economy will move ahead steadily backed by the stable external environment with an uptrend, further release of reform dividends and emerging engines of growth, yet still under a downward pressure from the growth engine switchover, industrial capacity cuts, property market corrections and elevated debt ratios. China's GDP is estimated to grow at about 7.2% and CPI to increase by approximately 2.4% in 2015 on an annualized basis, still showing a combination of slow growth and low inflation.
- Against such a backdrop, macroeconomic policy easing is expected. China's fiscal policy will be more proactive, focused on optimizing structure and accelerating the fiscal system reform to promote inclusive growth. China's monetary policy will be more flexible and pertinent while remaining prudent, with interest rates and reserve requirements expected to be lowered and RMB exchange rate to fluctuate more widely in both directions.

China Macro-economic Climate Index

Indicator	2013		2014										
	11	12	1	2	3	4	5	6	7	8	9	10	
1 .Fiscal expenditure	●	●	●	●	●	●	●	●	●	●	●	●	●
2 .M1	●	●	●	●	●	●	●	●	●	●	●	●	●
3 .Electric power output	●	●	●	●	●	●	●	●	●	●	●	●	●
4 .Completed urban fixed-asset investment	●	●	●	●	●	●	●	●	●	●	●	●	●
5 .y-o-y growth rate of industrial value added	●	●	●	●	●	●	●	●	●	●	●	●	●
6 .Total retail sales of consumer goods	●	●	●	●	●	●	●	●	●	●	●	●	●
7 .CPI	●	●	●	●	●	●	●	●	●	●	●	●	●
8 .Fiscal revenue	●	●	●	●	●	●	●	●	●	●	●	●	●
9 .Balance of loans by FIs	●	●	●	●	●	●	●	●	●	●	●	●	●
10 Total imports/exports	●	●	●	●	●	●	●	●	●	●	●	●	●
Overall judgment	23	23	21	22	21	22	21	19	18	17	14	13	

Source: Institute of International Finance, BOC

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Explore New Growth Engines for the “New Normal” Economy

-- China's Economic and Financial Outlook (2015)

China's economy continues to slow down in 2014 under the downward pressure from a deceleration in growth, painful economic restructuring and the hangover of previous stimulus policies. China's GDP is expected to grow at around 7.4% in 2014 on an annualized basis, significantly lower than the annual average of 9.9% since the country launched the economic reform and opening-up policy in 1978. Generally speaking, however, the Chinese economy remains within a reasonable range, and shows some positive trends. The tertiary industry, principally service sectors, is growing swiftly and has a bigger proportion in the economy. Emerging industries like E-commerce and mobile Internet are speeding development. Employment and energy conservation indicators have beaten expectations. In 2015, China's economy will move ahead steadily backed by a stable and upbeat external environment, further release of reform dividends and emerging engines of growth, yet still under a downward pressure from growth engine change over policies, industrial capacity cuts, property market corrections and elevated debt ratios. In 2015, China's GDP is estimated to grow at about 7.2% and CPI to increase by approximately 2.4% on an annualized basis, still showing a combination of slow growth and low inflation. China's economy will embrace further optimized structure, higher efficiency and stronger sustainability of development.

I. Economic Review and Outlook

I.1 Steady growth amid the switchover of growth engines, prices to remain at low levels

I.1.1 With growth “slow but improving”, GDP to grow by about 7.2% in 2015

In 2014, China's economy has continued to slow, under the downward pressure from a deceleration in growth, painful economic restructuring and the hangover of previous economic stimulus policies, coupled by weakening demand, industrial overcapacity and property market adjustment. China's GDP is expected to grow at around 7.4% in 2014 on an annualized basis, significantly lower than the annual average of 9.9% since the country launched its economic reform and opening-up policy in 1978, and the lowest since 1990.

Firstly, why growth is slowing? The root cause for China's economic deceleration in recent years lies in the ongoing changes in its external environment and internal conditions. Globally, the faltering global recovery, the long and bumpy road to rebalancing and the notable slowdown of global market expansion suggest an increasingly tighter environment for China's economic development. Locally, China sees economic and financial risks gathering and increasing amid the rising costs of production factors, heavier pressure on resources and environments, diminishing comparative advantages, huge industrial overcapacity, elevated leverage ratio and weakening profitability of enterprises. According to international experience, an economy will slow down notably when its GDP per capita is in the range of USD4000 – USD12,500, falling into the so-called “middle income trap”. China's GDP per capita will break the USD7000 this year, staying in a critical stage of getting away from the trap. The current deceleration and “gear shift” of the Chinese economy are partially due to weakening demand and policy adjustments, and also the combined effect of structural and long-term factors.

Figure 1: China’s Quarterly GDP Growth

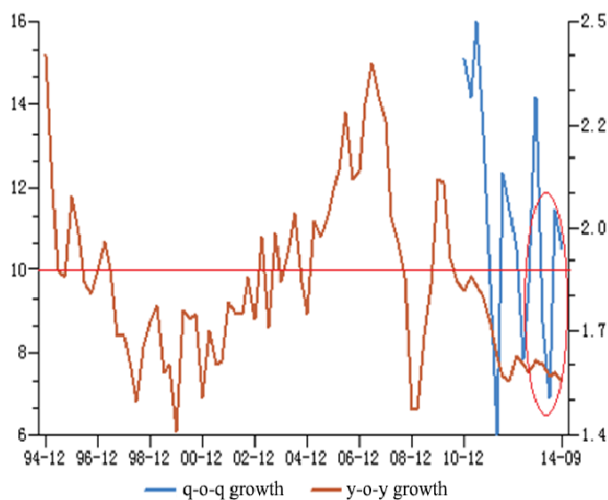


Figure 2: China Macro-economic Climate Index

Indicator	2013		2014										
	11	12	1	2	3	4	5	6	7	8	9	10	
1 .Fiscal expenditure	●	●	●	●	●	●	●	●	●	●	●	●	●
2 .M1	●	●	●	●	●	●	●	●	●	●	●	●	●
3 .Electric power output	●	●	●	●	●	●	●	●	●	●	●	●	●
4 .Completed urban fixed-asset investment	●	●	●	●	●	●	●	●	●	●	●	●	●
5 .y-o-y growth rate of industrial value added	●	●	●	●	●	●	●	●	●	●	●	●	●
6 .Total retail sales of consumer goods	●	●	●	●	●	●	●	●	●	●	●	●	●
7 .CPI	●	●	●	●	●	●	●	●	●	●	●	●	●
8 .Fiscal revenue	●	●	●	●	●	●	●	●	●	●	●	●	●
9 .Balance of loans by FIs	●	●	●	●	●	●	●	●	●	●	●	●	●
10 Total imports/exports	●	●	●	●	●	●	●	●	●	●	●	●	●
Overall judgment	23	23	21	22	21	22	21	19	18	17	14	13	

Source: Wind; Institute of International Finance, BOC

Secondly, is structure optimized? In addition to the improved employment as analyzed in the last quarter report, the economic bright spots in 2014 include notable structural optimization showing continuous improvements in sustainability and balance of growth. Firstly, consumption contributes markedly more to economic growth. In the first three quarters, final consumption contributed to 48.5% of economic growth, up 2.6 percentage points year-on-year, compared with 41.3% for capital formation, down 14.5 percentage points from a year ago. Secondly, the tertiary industry is growing more swiftly and gaining substantial weight, standing as a stronger pillar for economic growth and employment. In the first three quarters, tertiary industry grew by 7.9%, 0.5 percentage points higher than the GDP growth rate in the same period, and also 0.5 percentage points higher than the growth rate of value added in secondary industries. Thirdly, emerging industries and new business models are developing rapidly, with fast growth seen in such sectors as major technologies and equipment, Internet, robots, e-commerce, energy conservation and environmental protection (please see Special Analysis I). Those facts indicate that China is shifting its primary growth engine from export-led manufacturing and infrastructure development to consumption and innovation, shifting into a new normal of moderate growth, optimized structure and better quality.

Looking into 2015, the world economy will continue to struggle, mired in the recovery process with still-weak engines of growth. Major economies will continue to vary in performance and become further divergent in monetary policy, posing greater uncertainties to the global economy. China is embracing a new normal featuring a change of growth engines and transformation of its development model, with risks, challenges and opportunities coexisting. In 2015, China’s GDP is expected to grow by about 7.2% as industrial overcapacity, high leverage ratio and ongoing shift to new growth engines will further weigh on growth. We expect the government to set the target GDP growth rate at about 7% for 2015, down 0.5 percentage point from 2014. Meanwhile, the tertiary industry will account for about 48% of GDP, expected to contribute more to growth stabilization and job creation. Consumption will contribute to about 50% of growth, 1 percentage point higher than in 2014, with hot spots continuing. Central and western areas will remain the primary regional engines of growth. In particular, the “One Belt and One Road” and Beijing-Tianjin-Hebei integration will bring good development opportunities to provinces, municipalities and regions involved. The sprouting of a new round of technological revolutions, including new energy revolution, new-generation mobile Internet, robots and Big Data, will shape a new trend of low-cost, smart and IT-driven growth.

It should be pointed out that China's economy is gathering strength for the next boom cycle as the new growth engines are beginning to take up and reform dividends are gradually released. Probably 2015 will be near or at the bottom of China's ongoing downturn.

1.1.2 CPI to rise by about 2.4% under mild inflation pressure

In 2014, prices have mainly showed the following three characteristics: Firstly, inflation is mild. CPI rose by 2.1% cumulatively in the first ten months, down 0.5 percentage points from a year ago, representing the lowest year-on-year growth since 2009. Secondly, price movements are irregular and reverse-U shaped (high in the middle and low on ends) on an annualized basis, partially attributable to the carryover effect of CPI growth in 2014. The carryover effect was 1.06, 1.51, 1.0 and 0.17 in the first to fourth quarters of 2014, respectively. Third, PPI growth was negative for 32 consecutive months. PPI declined by 1.7% cumulatively in the first ten months of 2014, with quarter-on-quarter growth negative for ten consecutive months. The negative PPI growth was mainly due to cheaper capital goods and zero price growth of consumption goods. In capital goods price decline was seen in the mining industry (-5.4%), raw material industry (-2.5%) and processing industry (-1.7%). As for consumption goods, except consumer durables (-0.9%), foods, clothing and daily necessities saw price inflation. In 2014, the slower CPI growth and the negative PPI growth bore close relations to economic downturn, weakening demand and industrial overcapacity.

Figure 3: Reverse U-Shaped CPI Curve

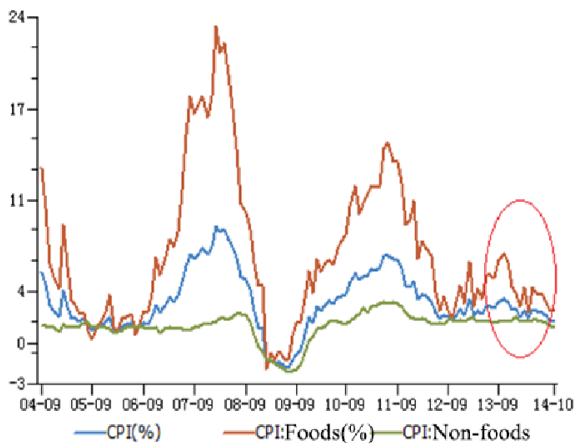
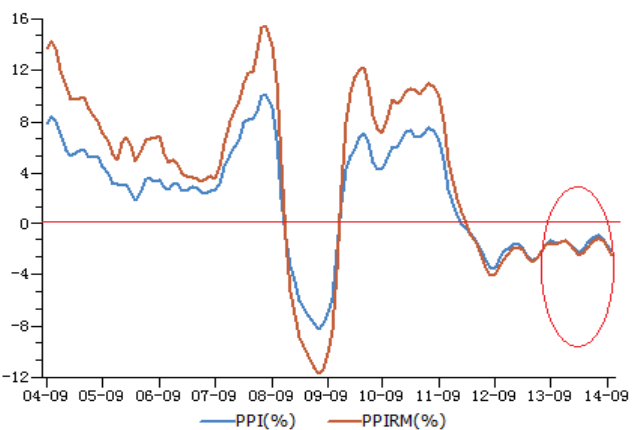


Figure 4: PPI Negative for 32 Consecutive Months



Source: Wind; Institute of International Finance, BOC

In 2015, prices will remain at low levels. Firstly, economic growth will slow down further. The overall supply-demand relationship will pull inflation low. We expect GDP to grow by about 7.2%, slightly down 0.2 percentage points from 2014. Secondly, food and housing prices will not rise sharply. The two categories of consumer goods together have a weight of about 50% in the CPI basket, coming as the biggest contributor to price movements. Thirdly, prices of crude oil and other international commodities will remain at low levels amid mild global growth and US energy revolution. Crude oil prices are estimated to be USD80 to USD90 in 2015. Fourthly, the overall money and credit environment will be stable. Fifthly, industrial overcapacity will remain a serious problem and it is difficult for PPI to turn positive in the short term. However, the price reform of public utilities and population structure changes will lead to price inflation in some service sectors and likely drive up the CPI.

According to a preliminary estimation, the CPI will be about 2.4% in 2015, up 0.4 percentage

points from 2014; PPI will drop 0.5%, representing an improvement of 1.3 percentage points compared with this year.

I.2 Demand structure to be further optimized, consumption to contribute more

I.2.1 Infrastructure projects continues to grow fast as the major stabilizer of investment

In 2014, investment growth was gradually slowing as investment incentive weakened. In the first ten months, fixed asset investment grew cumulatively by 15.9% from a year ago, down 4.2 percentage points year on year and the lowest since 2001. There are two main reasons for investment slowdown: Firstly, real estate investment growth was 6.8 percentage points slower than last year; secondly, manufacturing investment growth was 5.6 percentage points slower than a year ago. Despite a slight slowdown, infrastructure investment still maintained a high growth rate of above 20%.

Figure 5: Investment Slowdown Continues

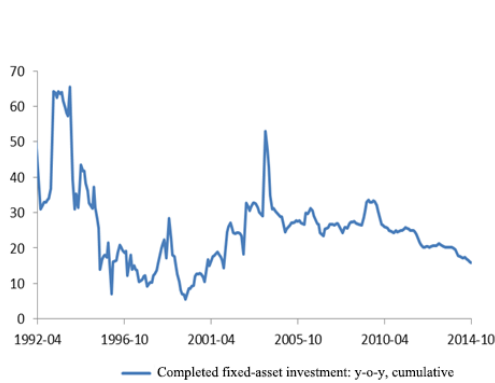
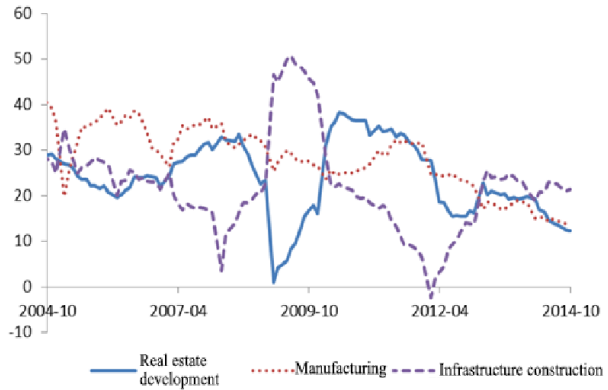


Figure 6: Weak Investment in Real Estate and Manufacturing



Source: Wind; Institute of International Finance, BOC

In 2015, real estate investment is expected to stabilize at lows, mainly backed by the regulatory policies adjustment in the second half of 2014, including easing the restrictions on housing purchases and credit limits and the central government’s decision to stabilize housing consumption. Housing sales have been increasing recently. Manufacturing investment may further decline, as overcapacity that remains unsolved in some industries places a big pressure on de-stocking and capacity cuts and banks are more wary of lending, coupled by relatively high risk-free interest rates and rising risk premiums. Infrastructure investment with a focus on affordable housing, railway, roads and water conservancy projects is likely to remain fast tracked as the primary stabilizer of investment. In 2015, fixed asset investment is expected to grow by approximately 15%, down about 1 percentage point from 2014.

Figure 7: Property Sales Start to Pick Up

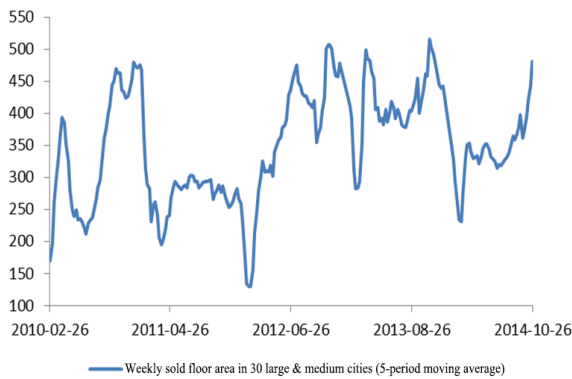
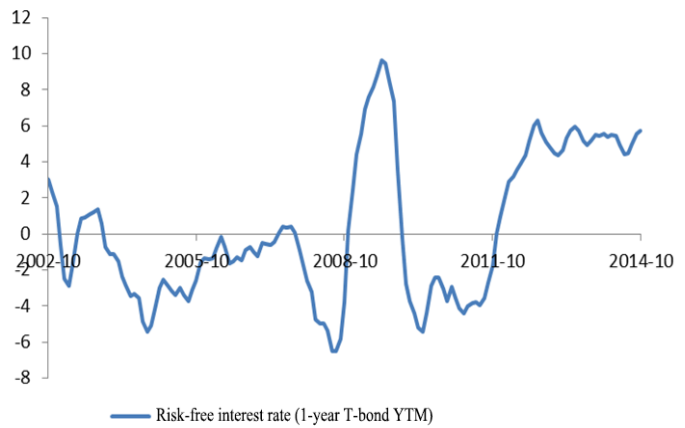


Figure 8: Risk-free Interest Rates Remain High



Source: Wind; Institute of International Finance, BOC

I.2.2 Consumption growth remains stable, but hard to pick up notably

Overall consumption growth has been stable in 2014. In the first ten months, total retail sales of consumer goods grew by 12% year-on-year cumulatively, 1 percentage point slower than a year ago. Furthermore, it is also stable after adjusting for inflation. Consumption growth slowed slightly, mainly due to sluggish growth in food, beverage and tobacco, automobile, petroleum and its products as well as household appliances and audio-visual equipment. The rapid growth of telecoms equipment and furniture and building and decoration materials offset some of the consumption downturn.

Figure 9: Stepwise Decline in Consumption Growth

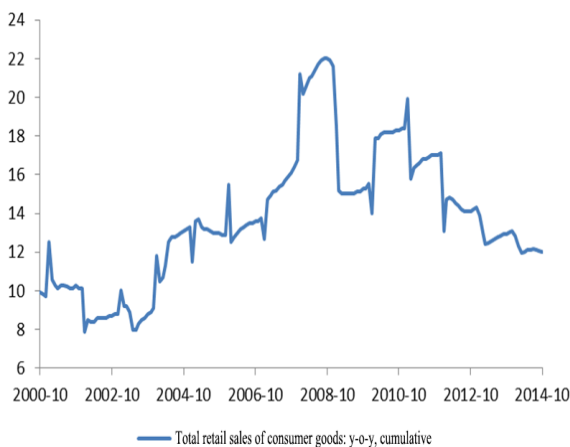
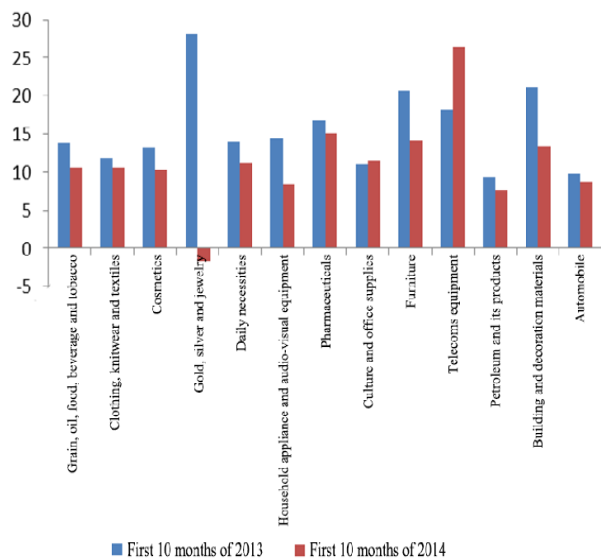


Figure 10: Consumption Growth by Sub-sectors



Source: Wind; Institute of International Finance, BOC

In the first nine months of 2014, urban per-capita disposable income and rural per-capita cash income grew by 6.9% and 9.7% cumulatively, both up 0.1 percentage points year-on-year. Consumers are upbeat about future income and consumption prospects, which is also a strong stabilizer of consumption growth. The Consumer Confidence Index for September 2014 was 105.4, higher than 100 for the ten consecutive month and representing a half-year high. With respect to government policy, the central government clearly stated to increase residents' income, improve

the social security system and improve the consumption environment so that residents, either rural or urban, are able, bold and willing to spend. The State Council discussed and launched six consumption stimulus measures late in October. In 2015, total retail sales of consumer goods are estimated to grow by about 11.5%.

Figure 11: Stable Growth in Urban and Rural Residents' Income

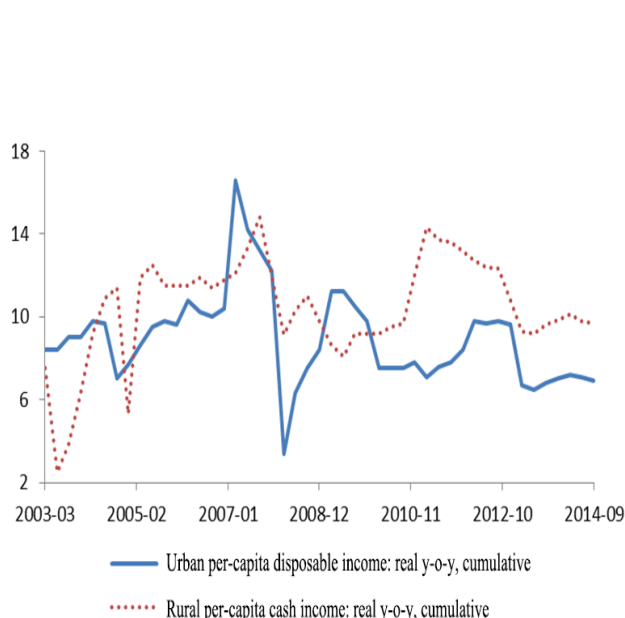
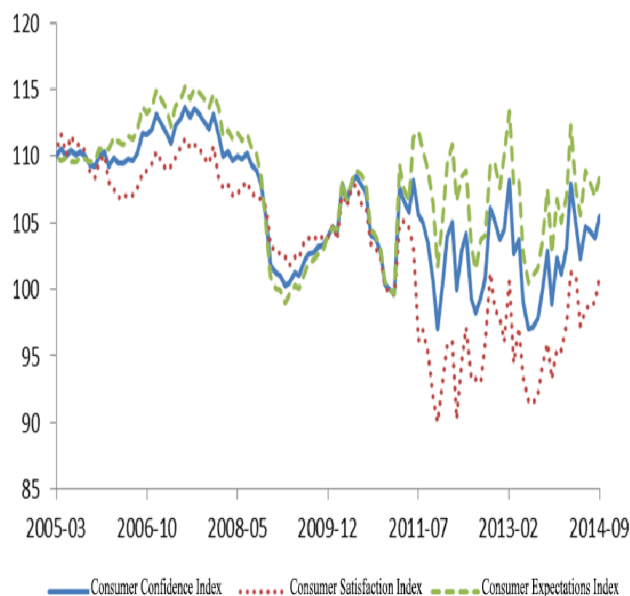


Figure 12: Consumers Sentiment Upbeat



Source: Wind; Institute of International Finance, BOC

1.2.3 Foreign trade growth likely to pick up, trade surplus to further expand

Exports grew in 2014, gathering increased momentum over time, at -3.5%, 5% and 13% in the first, second and third quarters respectively. Import growth decelerated slowly, down to 1.6%, 1.5% and 1.2% in the first, second and third quarters respectively. Exports were fueled mainly by US and European recovery as well as China's foreign trade stabilization moves, while the export slowdown was mainly due to China's economic downturn and weakening demand. Improving exports and stagnant imports are widening the trade surplus, which rose from USD17.1 billion in 1Q to USD86.4 billion in 2Q, and further to a record high of USD128.1 billion in 3Q. With the trade surplus widening, net exports contributed increasingly more to economic growth. In 3Q 2014, net exports' contribution to economic growth turned positive, becoming the second engine of growth in addition to final consumption.

Figure 13: Better Exports & Bigger Surplus

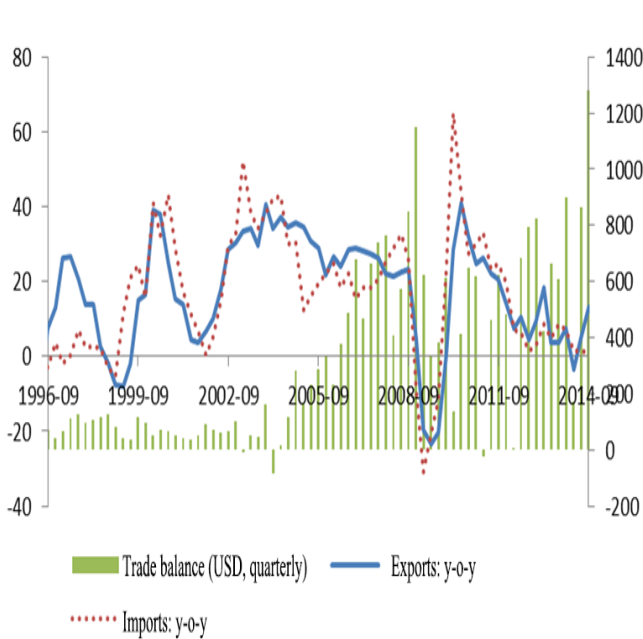
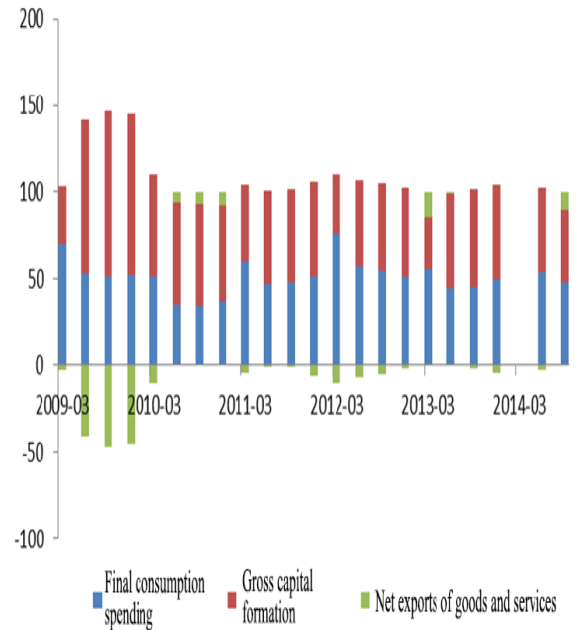


Figure 14: Changes in Contributors to Economic Growth



Source: Wind; Institute of International Finance, BOC

In 2015, the US economy is expected to continue a strong recovery, while the euro zone will continue its monetary easing and maintain a growing demand for exports from China. Driven by the setup of China-South Korea Free Trade Area (FTA), the upgrade of China-ASEAN FTA and the further implementation of the “One Belt and One Road” strategy, China will see rapid growth in its exports to South Korea, ASEAN, India and Russia. Also, the central government’s policies to strengthen imports and encourage importing of cutting-edge technologies and equipment as well as critical parts and components will increase the level of trade facilitation. In 2015, exports are estimated to grow by about 8%, up 2 percentage points from 2014, imports to grow by about 5%, up 2 percentage points from 2014 and trade surplus to exceed USD390 billion, an increase of more than USD60 billion when compared with 2014.

Figure 15: US, Europe and Japan Manufacturing PMI

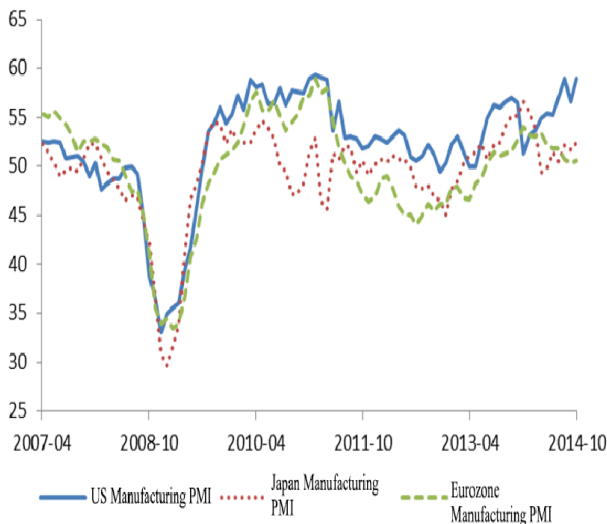
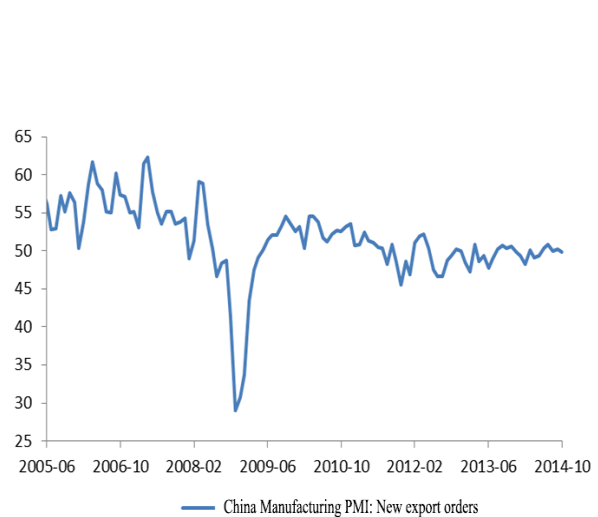


Figure 16: China Manufacturing PMI – New Export Orders



Source: Wind; Institute of International Finance, BOC

I.3 Industrial production slows markedly and will further weaken in the future

Industrial production has slowed down in 2014 due to weak demand, overcapacity and higher costs. In the first ten months of 2014, industrial value added increased by 8.4% cumulatively, down 1.3 percentage points from a year ago. 32 of the 41 industries saw year-on-year deceleration in cumulative growth of industrial value added. In annualized terms, industrial value added is expected to fall to about 8.5% in 2014. In the first three quarters, industrial activities pulled GDP growth by 2.7 percentage points, and contributed 37.4% of GDP growth, the second lowest ever (only second to 2009).

Figure 17: Growth in Industrial Value Added.

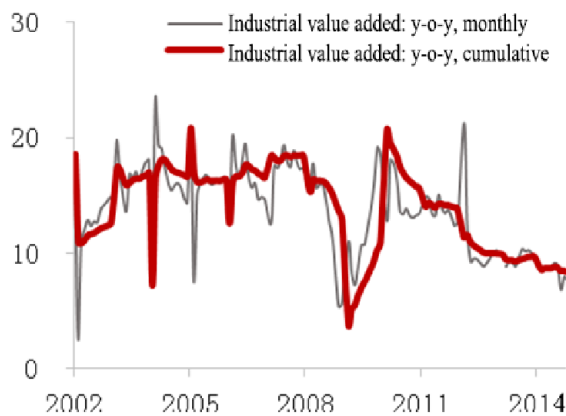
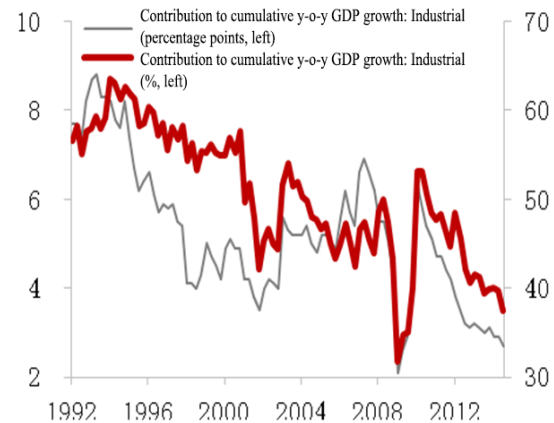


Figure 18: Industry's Contribution to GDP Growth



Source: Wind; Institute of International Finance, BOC

Specifically speaking, the industrial sector of the economy showed the following characteristics in 2014:

I.3.1 Enterprises face high costs and heavy pressure to make profit

Financial and interest expenses of industrial enterprises are gaining a larger weight in industrial value added, the cost per RMB100 of prime operating revenue continues to rise and enterprises face relatively high funding and operating costs. Enterprises' income and profit growth remain slow amid weakening demand, industrial overcapacity and elevated costs. In the first three quarters, 36 sectors saw slower growth in income from principal activities, 33 industries (including all mining industries and most light and heavy industries) seeing a sharp decline in profit growth. Industrial profit growth was even negative in August. Ratio of profit from principal activities also decreased when compared with the previous year.

Figure 19: Changes in Costs of Enterprises

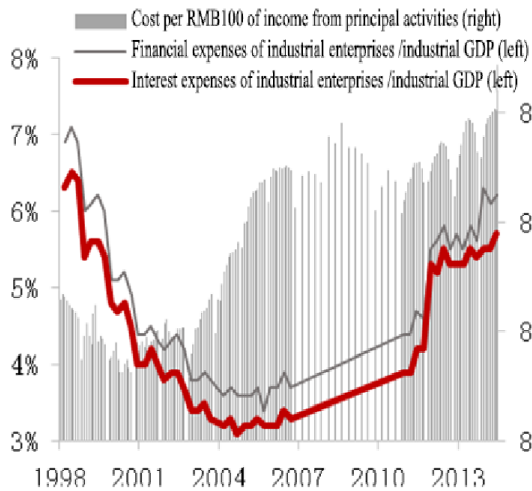
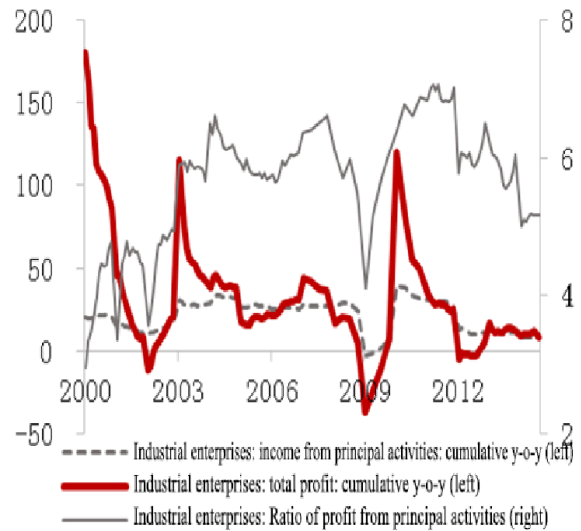


Figure 20: Income and Profit Curves of Enterprises



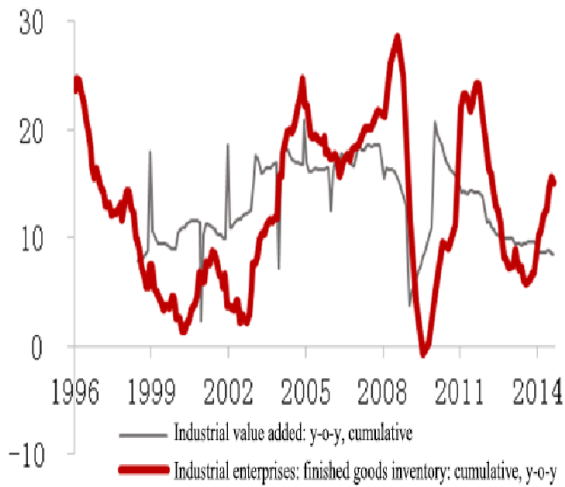
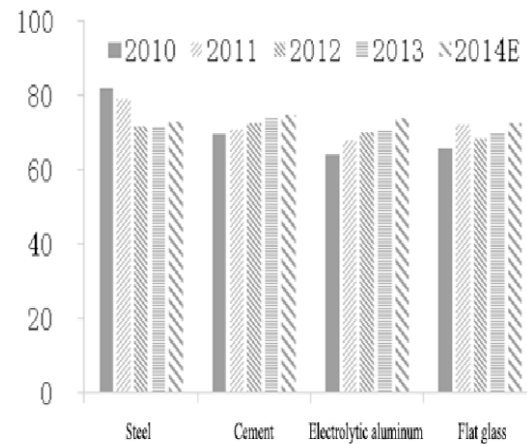
Source: Wind; Institute of International Finance, BOC

I.3.2. Most sectors are in the stage of passive restocking

In 2014, industrial value added declined continuously year-on-year, but inventory showed substantial cumulative growth year-on-year. Industrial sectors were in the stage of passive restocking. By sectors, in the first three quarters, ten sectors (i.e. petroleum and natural gas extraction, tobacco products, textile and apparel, manufacture of furniture, manufacture of general-purpose equipment, manufacture of special-purpose equipment, manufacture of railway and other transport equipment, manufacture of communication equipment, computers and other electronic equipment, gas production and supply and other manufacturing) were in the stage of active restocking characterized by increase in industrial value added and increase in inventory. Four sectors (i.e. nonferrous metals mining and dressing, manufacture of alcohol, beverages and refined tea, manufacture of cultural, educational and sports goods and manufacture of chemical fibers) are in the stage of active de-stocking characterized by a decline in industrial value added and increase in inventory, two sectors (e.g. reuse of waste resources and water production and supply) were in the stage of passive de-stocking characterized by an increase in industrial value added and decline in inventory, and the other 25 sectors (including most mining and heavy industries) were in the stage of passive restocking characterized by a decline in industrial value added and an increase in inventory.

I.3.3 Industrial overcapacity is eased, but de-capacity remains challenging

Due to weak demand and industrial over capacities, the production of steel, electrolytic aluminum, cement and flat glass fell year-on-year; in particular, steel, cement and flat glass dropped substantially. Industrial value added, income and ratio of profit from principal activities in relevant industries declined year-on-year. Since 2012, driven by the government policy to step up overcapacity cuts, fixed asset investment in relevant industries has fallen significantly, the objective of outdated capacity elimination has been met to schedule and the capacity utilization ratio has been increased for steel, cement, electrolytic aluminum and flat glass. Taking into consideration the fact that most industries are experiencing passive restocking and over capacities are still building up, “de-capacity” remains a significant challenge.

Figure 21: Inventory of Industrial Enterprises**Figure 22: Capacity Utilization Rate of Industries with Overcapacities**

Source: Wind; Institute of International Finance, BOC

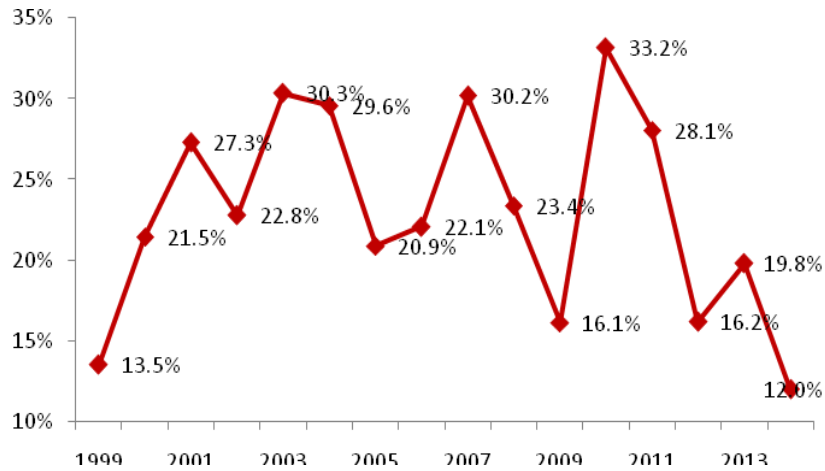
In 2015, contributors to industrial production growth will include the following: Firstly, the gradual recovery of the global economy, in particular the US economy, the ongoing regional economic integration, the interconnections with Asian Pacific, European and other neighboring nations that are turning from plan to reality. In addition, China's deepening economic and financial cooperation with neighboring countries will increase exports and fuel industrial production, especially, the growth in infrastructure, telecommunications and equipment manufacturing. Secondly, China's expanding investment in urban infrastructure, railways in central and western parts of the country, and dilapidated shantytown redevelopment will drive up relevant industrial production.

Meanwhile, barriers to industrial production growth include the following: macro-economy is under heavy downward pressure and domestic demand is weakening; industries with over capacities have a low capacity utilization rate and will adjust continuously in the "new normal" economy. Enterprises' profitability is weakening due to rising costs of labor, land, environment and funds; industrial enterprises are much less willing to invest, which means less potential of industrial capacity in the future. Based on the above analysis, industrial value added is estimated to grow by about 8.3% in 2015.

I.4 Property market

I.4.1 Real estate investment to see the biggest decline ever

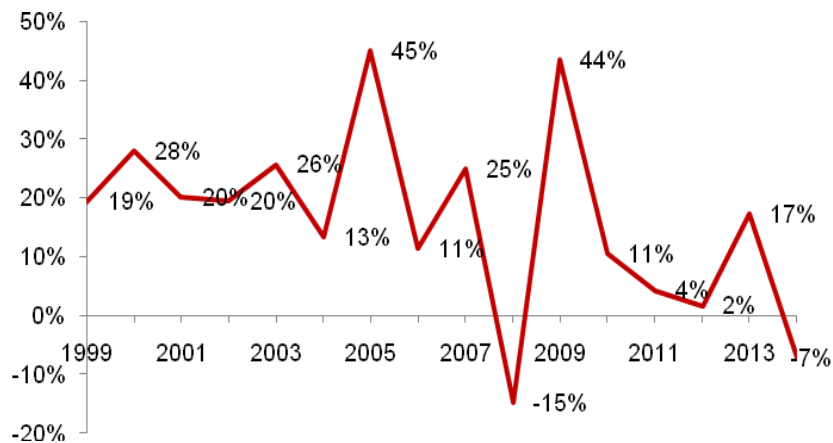
Real estate investment continues a downturn movement amid weak investor confidence, sluggish sales and tight financing environment. In the first ten months of 2014, real estate investment stood at RMB7.7 trillion cumulatively, representing a year-on-year growth of 12.4%, 6.8 percentage points slower than a year ago. Real estate investment is estimated to expand by 12% in 2014 in annualized terms, the lowest since the housing reform started in 1998. In 2015, real estate investment is likely to bottom out as new construction areas expand continuously, availability of funding sources increases and confidence gets stronger on both demand and supply sides.

Figure 23: Real Estate Investment Growth Hits All-time Low

Source: Wind; Institute of International Finance, BOC

I.4.2 Decline in property sales continued but moderated

In the first ten months of 2014, the commercial housing sales area nationwide stood at 880 million m², down 7.8%, compared with a 21.8% increase a year ago. In 2014, property sales are estimated to drop by 7% year-on-year in annualized terms, a decline only second to the biggest one recorded in 2008. In spite of continuous negative growth in property sales, the property market has been improving in 4Q. The rate of property sales in the first ten months indicated a decline of 0.8 percentage points less than in the first three quarters.

Figure 24: Sold Floor Area on the Decline

Source: Wind; Institute of International Finance, BOC

Decline in property prices continued but moderated. In October, residential housing prices in 100 monitored cities dipped 0.4% quarter-on-quarter, representing a decline for the sixth consecutive month, but 0.52 percentage points less than the first three quarters. Residential housing prices in tier-one cities fell the least, by only 0.07% quarter-on-quarter, 0.81% percentage points less than the first three quarters. In addition, a smaller number of cities saw property price falls. In October, 73 of the 100 monitored cities recorded a quarter-on-quarter decline in residential property prices, six fewer than the first three quarters.

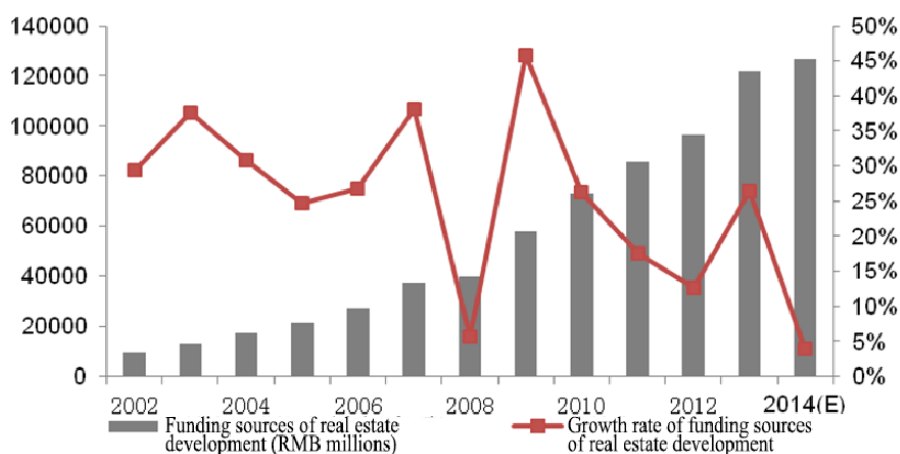
Table 1: Housing Price Changes in 100 Cities in 2014 (y-o-y and q-o-q, %)

Month		1	2	3	4	5	6	7	8	9	10
y-o-y (%)	Nationwide	11.1	10.8	10	9.1	7.8	6.5	4.7	3.15	1.12	-0.52
	Tier 1	22.1	21.5	20.3	18.5	16.6	14.3	11.3	8.98	5.4	2.94
	Tier 2	9.8	9.2	8.5	7.5	6.4	4.6	2.8	1.13	-0.36	-1.75
	Tier 3	5.2	4.6	3.9	3.1	1.9	0.8	-0.35	-1.28	-2.81	-3.84
q-o-q (%)	Nationwide	0.63	0.54	0.38	0.1	-0.32	-0.5	-0.81	-0.59	-0.92	-0.4
	Tier 1	1.15	1.2	0.71	0.32	-0.15	-0.61	-0.99	-0.29	-0.88	-0.07
	Tier 2	0.05	0.22	0.44	-0.03	-0.35	-0.78	-0.78	-0.92	-0.75	-0.54
	Tier 3	0.2	-0.13	-0.04	-0.07	-0.52	-0.66	-0.71	-0.56	-0.87	-0.76

Source: Wind; Institute of International Finance, BOC

I.4.3 Funding of real estate development hit historical low, yet improving recently

In the first ten months, funding made available to property developers grew by only 3.1%, 24.1 percentage points lower than a year ago. In 2014, funding made available to property developers is estimated to grow by 4% year-on-year in annualized terms, the lowest since 1998. The contributors to insufficiency of real estate development funding include; property developers' lack of investment confidence, sluggish sales, slow cash recovery and tight financing environment. It is noteworthy that this indicator has been showing improvement since the 4Q. In October, funding of real estate development accelerated by 0.8 percentage points when compared with the first three quarters.

Figure 25: Funding Available to Property Developers Hit All-time Low

Source: Wind; Institute of International Finance, BOC

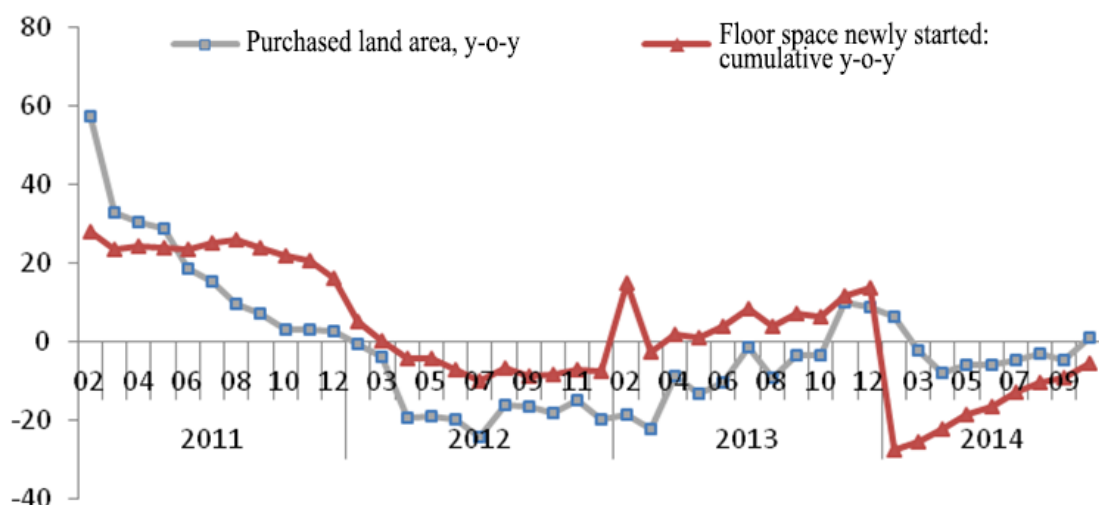
I.4.4. Some leading indicators including land purchases continue improving

Since the 4Q, property developers have had their investment confidence restored as local governments lifted restrictions on housing purchases and lending, providing stronger tax supports and real estate credits which became more available. In the first ten months, purchased land area expanded by 1.2% cumulatively year on year, putting an end to seven-month run of negative growth. New construction areas fell by 5.5% cumulatively, 3.8 percentage points less than the first three quarters; floor space under development grew by 12.3%, 0.8 percentage points higher than the first three quarters.

I.4.5 Real estate policy is more counter-cyclical and market-based

As the property market started adjustments nationwide, the central and local governments modified property curb policy in the 2H 2014. Firstly, such administrative measures as restrictions on housing purchases and lending were lifted. Currently only a few tier-one cities, including Beijing and Shanghai, maintain purchase and lending restrictions. Secondly, strong credit supports have been provided for home purchases. PBOC and other authorities issued policies to expedite housing loan approval, relax the standard for identification of first housing buyers and lower interest rate of housing loans in May and September. Thirdly, tax cuts relating to housing purchase were introduced and more subsidies were granted to home buyers. Such policies have played a positive role in steadily releasing housing demand and stabilizing the property market.

Figure 26: Moderating Declines in Purchased Land Area and Floor Space Newly Started



Source: Wind; Institute of International Finance, BOC

In 2015, some large cities will take the lead in property market recovery and drive the entire property market to bottom out, as local governments further relax housing purchases and strengthen personal mortgage supports. However, this round of property market adjustments will continue, for such adjustments are triggered more by fundamental factors, including the speed and focus of macroeconomic growth, changes in the demand-supply relationship of property market and aging population. Overall, China's property market will bottom out in 2015, albeit modestly.

Specifically speaking, firstly, real estate investment will see a modest decline while maintaining overall stability. Real estate investment is estimated to grow by approximately 10% year-on-year in 2015. Secondly, property sales will fall before starting an upturn in the second half of the year. As local governments' easing policies further take effect, housing loans become available more easily, the decline in property sales will moderate gradually, and property sales are expected to record a positive year-on-year growth in 2H 2015. Thirdly, property prices will become divergent again. Tier-three and tier-four cities will continue to see property price adjustment due to excessive stock, while some regions like tier-one cities (Beijing, Shanghai, Guangzhou and Shenzhen) will be the first to see a mild pickup in property prices as sales improve. Most cities will likely find their property prices flat with the current level.

II. Financial Review and Outlook

In 2014, the financial market maintained overall stability, money supply and RMB credits grew moderately, the expansion of aggregate financing to the real economy slowed down,

off-balance-sheet financing shrank, the stock market recovered and the RMB exchange rate fluctuated notably in both directions. In 2015, we expect M2 and RMB loans to remain on track for stable growth, direct financing to further gain a bigger weight, market liquidity to be eased moderately, capital market to continue recovery and RMB exchange rate to fluctuate more widely.

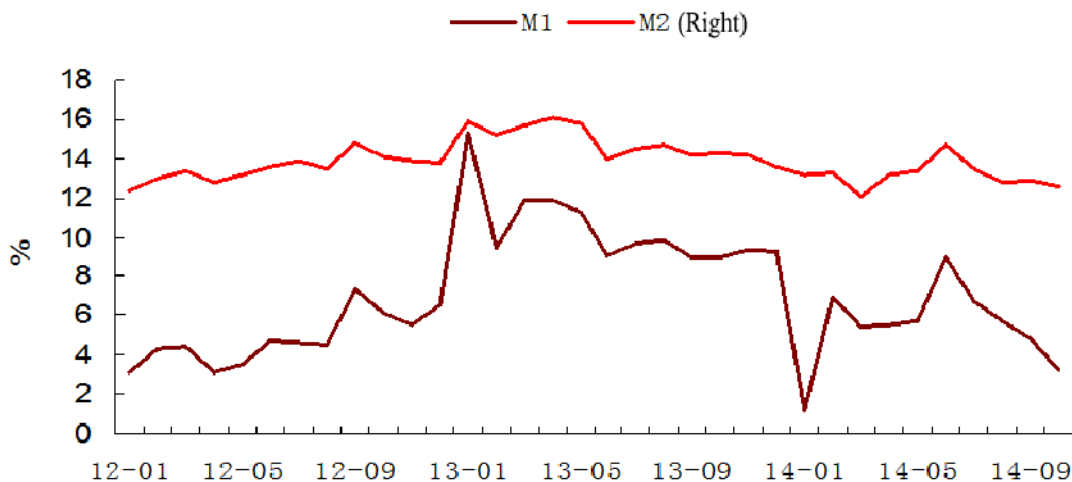
II.1 Money and credit: stable growth in a sound overall situation

II.1.1 Money supply growth moderated, but still within the expected range

As at the end of October 2014, the balance of broad money supply (M2) was RMB119.92 trillion, representing a year-on-year increase of 12.6%, 1 percentage points lower when compared with the end of the prior year. The balance of narrow money supply (M1) stood at RMB32.96 trillion, representing a year-on-year increase of 3.2%, 6.1 percentage points lower when compared with the end of prior year. The deceleration of M2 growth is attributable mainly to economic restructuring and tightening regulatory measures. M1 growth has hit a low in recent years, reflecting enterprises' current weak business activities and unwillingness to hold too many demand deposits with banks. M2 is expected to grow by about 13% in 2014.

In 2015, M2 is estimated to grow by around 12.5% as economic growth moderates, inflation remains low and money supply declines.

Figure 27: Moderating Growth in Money Supply



Source: Wind; Institute of International Finance, BOC

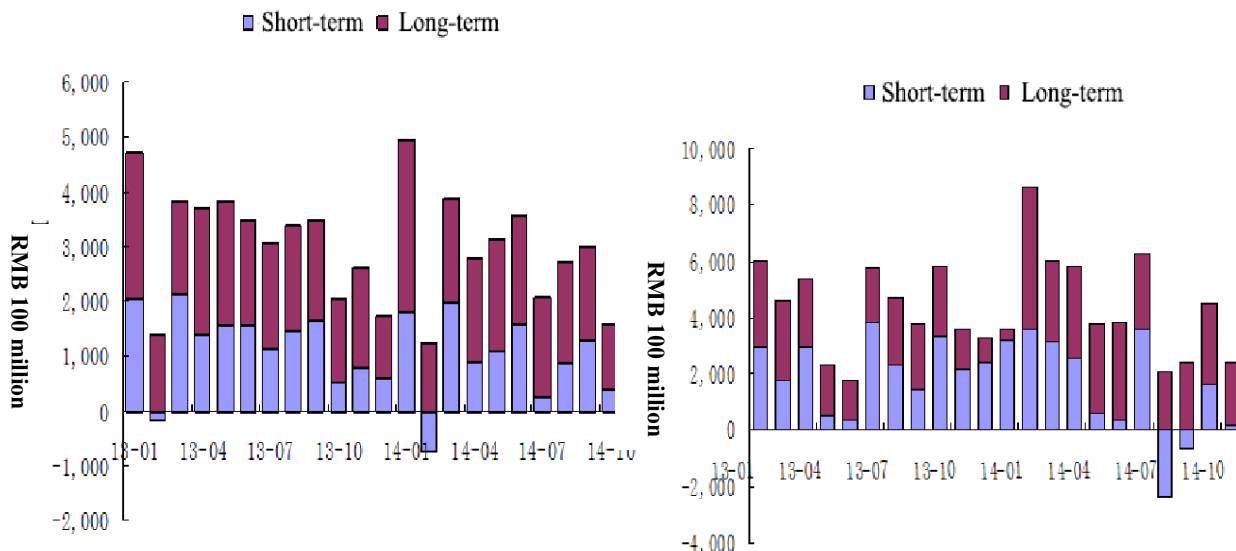
II.1.2 Overall credit growth was stable, medium- and long-term loans growing faster

New RMB lending by financial institutions was RMB8.23 trillion in the first ten months of 2014, an increase of 5.8% year-on-year. In October, RMB loans added by RMB548.3 billion, RMB42.3 billion more than a year ago. Except notes financing, loans to all sectors in October showed declines, yet varying in degree. In October, short-term and long-term loans to residents dropped by RMB12.4 billion and RMB34 billion respectively year-on-year, both continuing a downtrend through the year and suggesting still-weak demand for consumption and home purchases. In October, short-term loans to enterprises only added by RMB17.9 billion, RMB196.9 billion less than a year ago, representing a six-month year-on-year decline in a row and suggesting weak business activities of enterprises. Medium- and long-term loans to enterprises rose by RMB79.2 billion, continuing year-on-year growth through the year and reflecting the supports of monetary easing for medium- and long-term financing. New RMB loans are expected to be about RMB9

trillion in 2014.

In 2015, as the economic growth objective is lowered and restructuring continues, new RMB loans are estimated to stand at around RMB9 trillion.

Figure 28: New RMB Loans to Residents **Figure 29: New RMB Loans to Enterprises**



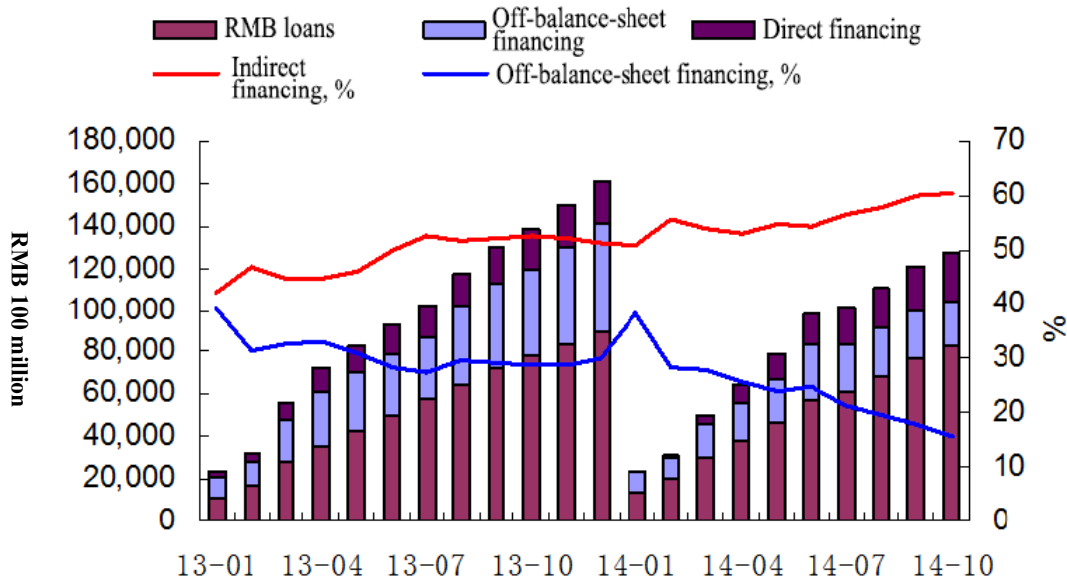
Source: Wind; Institute of International Finance, BOC

II.1.3 Aggregate financing growth moderated, off-balance-sheet activities shrinking

In the first ten months of 2014, aggregate financing to the real economy increased by RMB13.5 trillion cumulatively, down 8.94% from a year ago. By structure of financing, off-balance-sheet financing shrank in 2014. Entrusted loans, trust loans and undiscounted bank acceptances fell year-on-year by RMB78.6 billion, RMB1,290 billion and RMB724.1 billion respectively, representing a combined decrease of RMB2,092.7 billion. Off-balance-sheet financing totaled RMB2,141 billion in the first ten months. The decline of off-balance-sheet activities is partially due to the weak financing environment, and also attributable to tightened regulation of shadow banking and inter-bank activities. Off-balance-sheet financing as a percentage of aggregate financing fell to 15.75%, down 14 percentage points from a year ago. By contrast, on-balance-sheet financing gained a bigger weight of 60.6% in aggregate financing since 2014, up 9 percentage points from the end of prior year.

In 2015, against the backdrop of tightening regulatory environment and weakening financing demand in the business sector, off-balance-sheet financing will not expand significantly. Aggregate financing is expected to grow steadily by about RMB18 trillion in 2015.

Figure 30: Composition of Aggregate Financing (Cumulative)



Source: Wind; Institute of International Finance, BOC

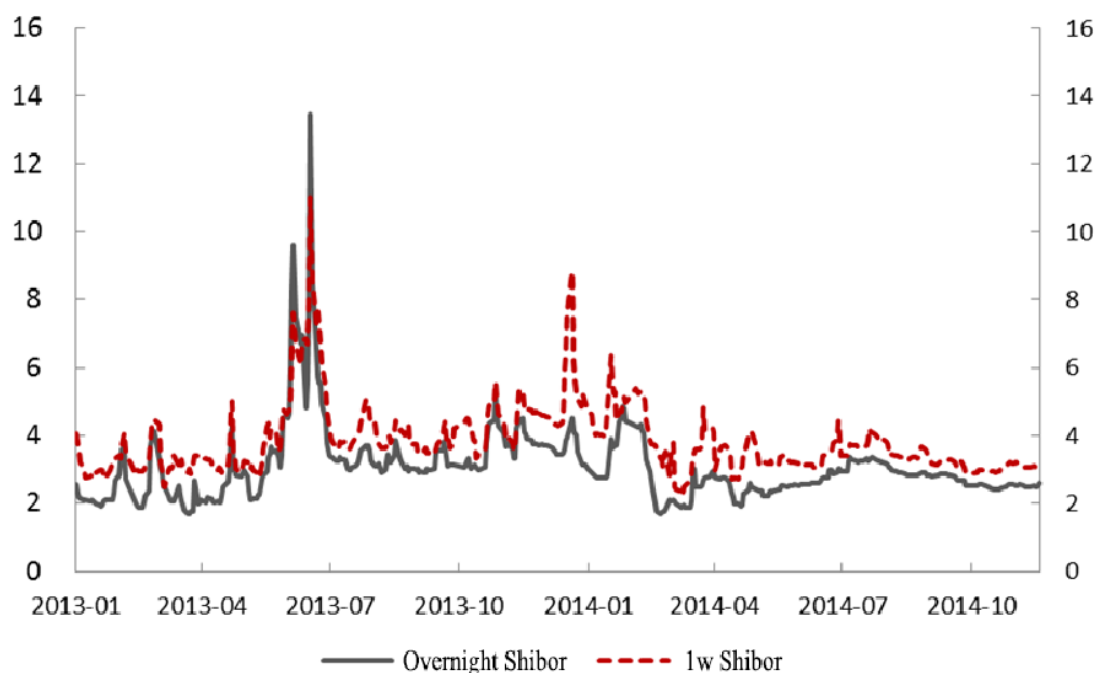
II.2 Financial markets: money market is generally stable, stock market still upbeat

II.2.1 Money market shows overall stability and moderately eased liquidity

The money market was generally stable in 2014, with market interest rates on the decline. On the one hand, trading volume picked up notably in the money market. In October, transactions (call borrowing, spot bonds and bond repo) in the inter-bank RMB market totaled RMB29.18 trillion, averaging RMB1.54 trillion a day, up 78.7% and 107.4% from January respectively. On the other hand, market interest rates showed an overall decline. At the end of October, overnight Shibor and one-week Shibor were 2.56% and 3.2% respectively, down 57 and 178 bps from the beginning of 2014. PBOC lowered the 14-day repo rate in July, September and October, which is 3.4% at present, down 40 bps from the beginning of 2014.

In 2015, the overall market liquidity is expected to be moderately easy. PBOC will replenish liquidity in time in the forms of open market operations, re-lending, re-discounting, SLO, SLF, MLF and PSL according to economic and financial conditions and financial innovations. Shibor is estimated to fall while maintaining overall stability.

Figure 31: Shibor Movements



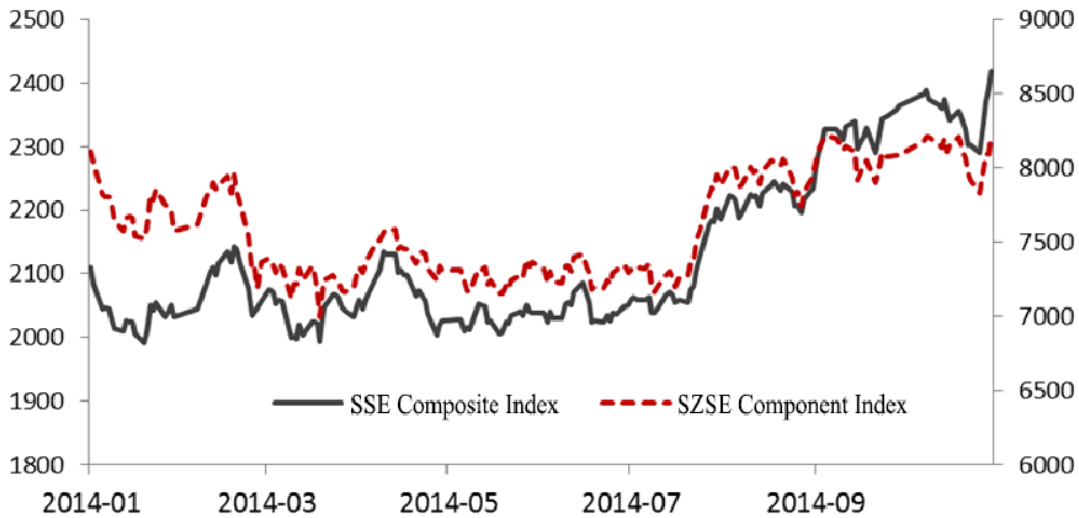
Source: Wind; Institute of International Finance, BOC

II.2.2 Shanghai-Hong Kong Stock Connect further liberalizes capital market, stock market still upbeat

The stock market is in an uptrend in 2014. The Shanghai Stock Exchange (SSE) Composite Index closed at 2533 in November 24, up 20.1% from 2109 in the beginning of the year. Meanwhile, both SSE and Shenzhen Stock Exchange (SZSE) saw a substantial increase in trading volume, in particular in 3Q when daily trades averaged RMB293.3 billion, up 39.5% from RMB210.2 billion in 1Q. The overall stock upturn is attributable to foreign capital influx, moderate liquidity easing and the Shanghai-Hong Kong Stock Connect scheme.

In 2015, the stock market will be driven by the government's stronger effort in reform and innovation and acceleration of the multi-level capital market drive. However, the capital market faces uncertainties posed by the weak global economy, geopolitical risk on the rise and China's economy still under downside pressure. The acceleration of cross-border capital flows may also make the stock market more volatile.

Figure 32: Movements of SSE and SZSE Stock Indices



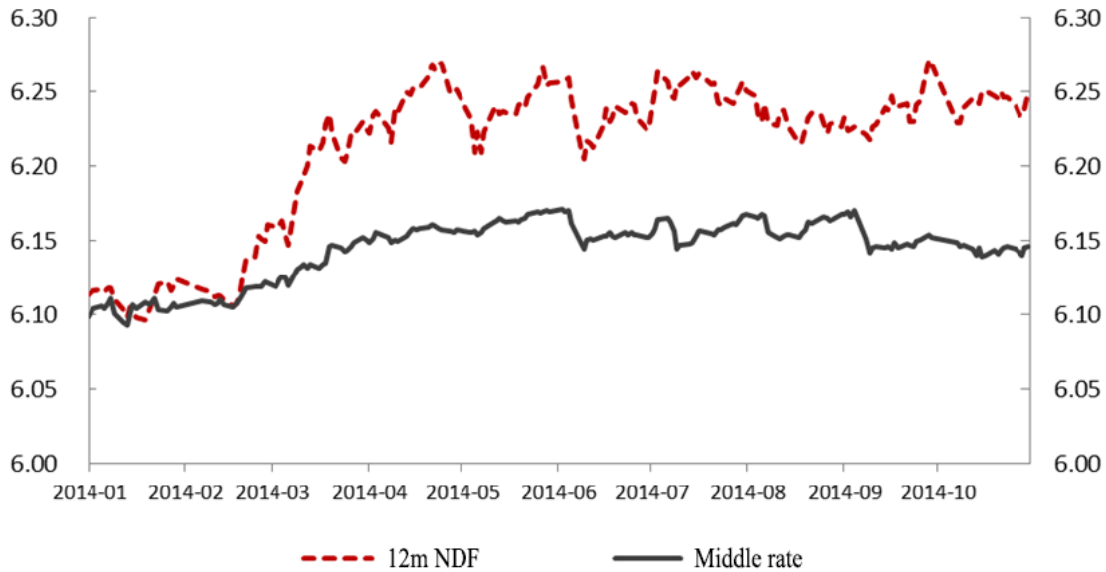
Source: Wind; Institute of International Finance, BOC

II.2.3 RMB exchange rate likely to pick up slightly, swinging more widely in both directions

Up to the end of October 2014, the middle exchange rate of RMB against USD was 6.1461, representing a mild depreciation of 0.77% when compared with the beginning of 2014. Overall, RMB exchange rate against USD experienced two phases in 2014: The first phase was the period from January through May when the RMB fell in value continuously against USD, by 1.16% cumulatively. The second phase started from June, featuring an overall increase and notable two-way fluctuations of RMB exchange rate against USD. At the end of October, the middle exchange rate of RMB against USD rose slightly by 0.38% from the end of May.

In 2015, RMB exchange rate against USD is estimated to further rise slightly while fluctuating more widely in both directions. At present, China's relatively high growth rate, coupled by expanding trade surplus and attractiveness to global capital, will push the RMB to appreciate slightly. Also, the RMB exchange rate is backed by the acceleration of China's financial reform and RMB internationalization. On the other hand, the two-way movement of RMB exchange rate against USD will be more notable: Firstly, China's current account surplus as a percentage of GDP fell from the 2007 peak of 10% to 2.1% in 2013. As the current account balance is moving increasingly closer to zero, RMB exchange rate is near its equilibrium level and unlikely to rise or fall continuously. Secondly, the trading range of the RMB against the USD widened from 1% to 2% on March 17, 2014, and is expected to further expand in the future. Thirdly, the US Federal Reserve officially announced the end of QE in late October, expected to start rate rises in 2015, and PBOC announced rate cuts on November 21. As the interest rate spread between China and the US narrows, two-way movements of international capital will become normal.

Figure 33: Movements of RMB Exchange Rate against US Dollar

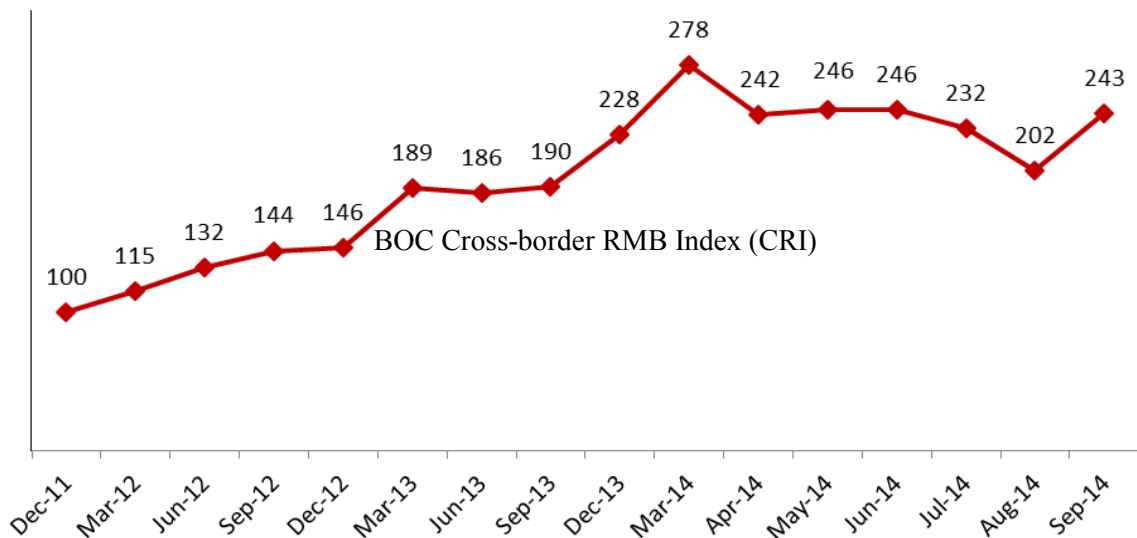


Source: Wind; Institute of International Finance, BOC

II.3 BOC Cross-border RMB Index

The BOC Cross-border RMB Index (CRI) published recently for September 2015 was 243. CRI movements showed the following characteristics in 2014: Firstly, showing an overall trend of stable growth, CRI hit a peak in the 1Q before starting a slow downturn, which gained speed notably in July and August, and returned to an upward trend in September. Secondly, RMB use became more active under direct investment, standing as the main contributor to CRI rises in the year. Thirdly, net cross-border RMB flows remain outgoing, yet in a downtrend, representing increasingly balanced use of RMB in cross-border payments. Fourthly, overseas RMB use became broader and more active. With use of RMB expanding fast in Asia, Europe, the US and Australia, RMB remains the world’s seventh largest payment currency.

Figure 34: BOC Cross-border RMB Index (CRI)



Source: Wind; Global Trade Services Department of BOC

According to the *White Paper on RMB Internationalization Business (2014)* published by the BOC on November 4, 2014, compared with 2013, domestic and overseas enterprises were more upbeat about the international status of the RMB, laying a stronger foundation for cross-border RMB use. RMB use in payments among overseas third parties improved notably, suggesting a further boost in the international pricing function.

With regard to financial products, overseas RMB financial services became available more broadly, with a wider range of products offered after one year of development. Settlement products, as the most commonly used cross-border RMB products, contributed most to the convenience of cross-border RMB use. Fortune 500 companies participated more in the RMB internationalization, taking a more mature attitude towards RMB exchange rate fluctuations.

The BOC has received positive comments on its cross-border RMB products and services from the majority of surveyed enterprises. In particular, the integrated domestic and overseas services of the BOC are mostly recognized among corporate customers.

Table 2: Forecasts on China's Main Economic and Financial Indicators in 2014-15 (%)

Indicator	2010 (R)	2011 (R)	2012 (R)	2013 (R)	2014 (E)	2015 (F)
GDP	10.4	9.3	7.7	7.7	7.4	7.2
Added value of industrial enterprises with annual revenue of RMB20 million or more from their main business operations	15.7	13.9	10	9.7	8.5	8.3
Fixed asset investment	24.5	23.8	20.6	19.6	16.0	15.0
Total retail sales of consumer goods	18.4	17.1	14.3	13.1	12.1	11.5
Export	31.3	20.3	7.9	7.9	6.0	8.0
Import	38.3	24.9	4.3	7.2	3.0	5.0
Consumer Price Index (CPI)	3.3	5.4	2.6	2.6	2.0	2.4
Producer Price Index (PPI)	5.5	6.0	-1.7	-1.9	-1.8	-0.5
Broad money supply (M2, end of period)	19.7	13.6	13.8	13.6	13.0	12.5

Source: Institute of International Finance, BOC

III. Direction of Macro Policies

III.1 Fiscal policy to be more proactive to energize the market with innovation and reform

In 2015, the fiscal policy will be more proactive, likely to push up government deficits. Meanwhile, focus will be placed on optimizing public spending structure, innovating financing methods, improving structural tax cuts and further deepening the fiscal and taxation system reform.

Firstly, optimize the structure of fiscal expenditure and innovation with investment and financing mechanisms in key fields. Against the backdrop of an economic downturn, government revenue growth slowed while inflexible spending on people's livelihood is not cut, indicating sharper contradictions between fiscal revenue and expenditure. Therefore, the government will further cut general spending in 2015 and allocate more funds for agriculture-related activities, social security, small and micro businesses, technological innovation, strategic emerging industries and water conservancy. Also, the government will introduce innovative investment and financing mechanisms, promote the public-private partnership (PPP), allow social capital, in particular private capital, to invest in hydro-power, nuclear power, railways, ports, inland navigation facilities and hub airports, trunk airports, urban water supply and heating, treatment of waste-water and municipal solid wastes and public transportation, provide a larger arena for effective social investment and further stimulate the activity and development potential of market participants.

Secondly, improve the structural tax cut policy and further tax reforms in key fields. The government will further implement preferential tax policies, including those for small and micro businesses, and continue to consider and issue relevant supporting policies according to economic situation developments. In 2015, tax reforms are expected to go further in the fields of value added tax (VAT), consumption tax, resource tax, environmental protection tax, real estate tax and personal income tax. The business tax-to-VAT" reform, which was extended to railway transport, postal services and telecommunications in 2014, will be further expanded to life services, construction, real estate and financial services to achieve full coverage in 2015. In addition, the consumption tax reform will likely proceed to the deployment stage in 2015, the resource tax reform may be extended to major mineral products in addition to coals, the legislation of real estate tax and environmental protection tax will be accelerated and an "integrated" new mechanism will be gradually created for personal income tax.

Thirdly, deepen the fiscal and taxation system reform to prevent and mitigate public finance risk. China will expand the pilot program on local government bond issuance to replace LGFVs, promote the PPP model and speed up the effort to establish a disciplined borrowing and financing mechanism for local governments to prevent and mitigate public finance risk. Also, with the aim of implementing the *Overall Plan for Deepening Fiscal and Taxation System Reform* and accelerate the establishment of a modern public financial system, the Chinese government will move ahead with urgency regarding tax reform, reallocation of expenditure responsibilities between central and local governments and local tax system development.

III.2 Monetary policy to remain prudent with greater flexibility and pertinence

In 2015, from the perspective of keeping policy continuous and stable, PBOC will continue its prudent monetary policy to provide a moderately neutral monetary and financial environment for economic restructuring, transformation and upgrading. Meanwhile, the monetary policy may become more flexible and pertinent according to changes in then macroeconomic and financial environments.

Firstly, Money supply will remain stable while its structure will be optimized. The monetary policy will remain prudent and stable in aggregate money supply, taking into consideration the

economic downturn and low price levels in 2015. We expect the government to set the M2 growth rate at 12% for 2015. Also, the current monetary policy also shoulders the responsibility for economic restructuring. PBOC is expected to continue to use and innovate in structural policy instruments and continue to adopt target-specific control policies.

Secondly, the likelihood of further rate cuts is on the rise. PBOC lowered the benchmark rates of deposits and loans in late November 2014. The benchmark rate of one-year lending was reduced by 0.4 percentage points to 5.6%; the benchmark rate of one-year deposit was lowered by 0.25 percentage point to 2.75%. These rate cuts were intended mainly to mitigate the elevated costs of enterprises and ensure the healthiness of economic growth. Overall, the rate cuts were neutral in nature and did not indicate any directional change in monetary policy.

The likelihood of further rate cuts in 2015 depends principally on the effectiveness of current policy in lowering financing costs in the real economic sector. We expect that relevant authorities will continue to lead interest rates downwards in the inter-bank market to bring down loan prices. Benchmark rates of deposits and loans will be further lowered if enterprises' financing costs remain elevated and, in particular, economic downturn worsens and employment deteriorates. We predict a high likelihood of further benchmark rate cuts in 2015.

Thirdly, the probability of lowering reserve requirements to replenish monetary base is high. In 2015, the incremental funds outstanding for foreign exchange will not be massive as PBOC stops routine intervention in the RMB exchange rate and the US is likely to raise interest rates. According to its reservoir theory, the PBOC raised reserve requirements earlier to offset the liquidity pressure from international capital influxes. Now as the funds outstanding for foreign exchange falls, the PBOC is more likely to lower reserve requirements to replenish the monetary base. In addition, since the PBOC has lowered interest rates to improve availability and lower the price of funds to enterprises, from the perspective of stabilizing growth and restructuring the economy, the PBOC will use quantitative tools while continuing the use of price tools. We expect reserve requirements to be lowered once or twice in 2015.

III.3 Accelerate reforms in investment and financing systems

With regard to investment policy in 2015: Firstly, China will further cancel and reduce approval requirements, grant more discretionary decision power to enterprises, in particular state-owned enterprises and those directly controlled by central government, to emphasize the investor status of enterprises in the course of deepening institutional reforms. Secondly, private capital will be allowed to play a larger role in infrastructure and public utilities investment and operation, PPP and other franchise modes will be piloted in selected provinces or projects and explorations will be made in setting up policy financial institutions for urban infrastructure and residential properties to step up financing supports for infrastructure investment. Thirdly, China will take the opportunity of the "One Belt and One Road" program to step up infrastructure development in transport, logistics, warehousing, telecommunications and electricity in inland and border areas and also increase the transshipment and customs clearance capacity of coastal ports.

III.4 New consumption policy to fuel rapid growth of new consumption models

Firstly, China will continue to encourage new consumption models, further carry out the "Broadband China" and "Smart Cities" programs, encourage information consumption including mobile Internet and Internet of Things and further establish or improve urban and rural logistics systems. Secondly, China will give further play to affordable housing projects, relax conditions on lending against and withdrawal of housing provident funds and stabilize consumption regarding housing and related furniture, home appliance, building materials and decoration materials. Thirdly, China will strictly implement the employees' paid leave system, create a favorable environment for

leisure and travel consumption, encourage private investment in schools, hospitals and elderly care organizations and enhance consumption in the educational, cultural, sports, health and elderly care fields.

III.5 Foreign trade policy to stress transformation and upgrading of trade structure

Firstly, China will stabilize exports of transport, electromechanical and other conventionally strong products and cut over capacities in steel, electrolytic aluminum and flat class. Secondly, China will adjust the processing trade policy to restrict and prohibit energy-intensive, heavy-polluting foreign investment projects and promote transformation and upgrading of coastal areas, orderly industrial transfer from coastal to inland areas and continuous expansion of border trade. Thirdly, China will encourage and support exporting of high value added, high-yield products with proprietary intellectual property rights and brands. Fourthly, China will expand importing of digital, intellectual and other cutting-edge technologies and equipment, critical parts and components and resource-stabilizing commodities to increase the reserve of strategic commodities. Fifthly, China will continue to carry out the pilot program on trade facilitation in Shanghai FTZ and extend proven policies and measures to broader areas.

III.6 Real estate control policy to stress implementation and accelerate housing finance reform

Firstly, the differentiated credit policy will be continued for the real estate industry. Secondly, stronger funding supports will be provided for China Development Bank's affordable housing projects. Thirdly, mortgage-backed securitization (MBS) will be accelerated to improve the housing finance system.

IV. Topical Analysis

Topic 1: Explore new engines of economic growth – what will drive China's economy in the future?

We expect China's GDP growth to remain above 7% in 2015, the last year of China's 12th Five-year Plan. That means China's GDP will grow by around 7.8% annually on average during the 12th Five-year Plan period (2011-2015). China boasts the strongest growth rate of the world's major economies during this period. At present, however, China's potential growth rate is starting to fall. So, what are China's new engines of growth in the foreseeable future? How to maintain the annual GDP growth rate at around 7%? They are major issues to be studied and addressed with respect to China's economy.

1. Strategic emerging industries: new locomotive of economic growth

Building on major technological breakthroughs and development needs, strategic emerging industries (SEIs) play a material leading role in driving the overall, long-term economic and social development, characterized by knowledge and technology intensiveness, less consumption of physical resources, great potential for growth and strong overall benefits.

For rapid and healthy development of SEIs, China developed and issued detailed plans and guidelines. The State Council announced to accelerate the effort to foster and develop the seven SEIs in July 2012. The National Development and Reform Commission (NDRC) published the *Guiding Catalogue on Key Products and Services in Strategic Emerging Industries* in March 2013, with 3,100 products and services identified are under 125 sub-categories, 24 categories in the seven SEIs.

With investments expanded and supporting policies issued in recent years, China has begun laying

a solid foundation for SEIs, which started to shape new core competitive edge industries. Innovation in SEIs accelerated in the first three quarters of 2014, with smooth progress seen in “core electronic devices, high-end generic chips and basic software”, new-generation broadband wireless mobile communication networks, high-end numerical control machines, large aircraft and other major scientific and technological programs of China. Industrial value added in high-tech manufacturing grew by 12%, faster than the average of all industries. Take new energy vehicles for example, 38,500 vehicles were manufactured in the first three quarters of 2014, up 2.9 times year-on-year. China’s SEIs are likely to grow by around 20% a year on average in coming years, thereby gradually becoming a major driver of economic growth. In 2020, the value added in SEIs will account for about 15% of GDP, with some industries and key technologies ranking among the world’s leading ones.

Table 3: Seven Strategic Emerging Industries Identified by China

Plan objective	Industry	Sub-sector	Products and services
Pillar industries in 2020	Energy conservation and environmental protection	High efficiency and energy saving	740 items
		Advanced environmental protection	
		Recycling and re-use of resources	
	New-generation information technology	Next-generation information network	950 items
		Core and basic electronics	
		High-end software and emerging information services	
	Biotechnology	Bio-pharmaceuticals	500 items
		Bio-medical engineering	
		Bio-agriculture	
		Bio-manufacturing	
	High-end equipment manufacturing	Aerospace	270 items
		Satellite and related applications	
		Rail transport equipment	
Marine engineering equipment			
Intelligent manufacturing equipment			
Leading industries in 2020	New energy	Nuclear power technology	300 items
		Wind energy	
		Solar energy	
		Biomass energy	
	New materials	New functional materials	280 items
		Advanced structural materials	
		High-performance composite materials	
New energy vehicles		60 items	

Source: State Council; National Development and Reform Commission; Institute of International Finance, BOC

2. Modern service sectors: New areas of economic development

The tertiary industry with a focus on modern service sectors has been contributing more and more to China’s economic growth in recent years, even more than the secondary industry. The tertiary industry contributed 49.1% of GDP growth in the first three quarters of 2014, 3.4 percentage points more than the secondary industry, suggesting that the tertiary industry is gaining a bigger weight in national economy. The tertiary industry not only plays an increasingly important role in creating jobs (for details, please see the report for 3Q), but is also playing a fundamental role in stabilizing

growth. It naturally occurs when Chinese economy grows into a stage of medium to high income, and also comes as an outcome of China's restructuring and transformation efforts since the financial crisis took place. The tertiary industry is expected to contribute further more to GDP growth in the next five years, to reach about 55% in 2020 and become the primary engine of economic growth.

Figure 35: Industrial Contributions to GDP Growth

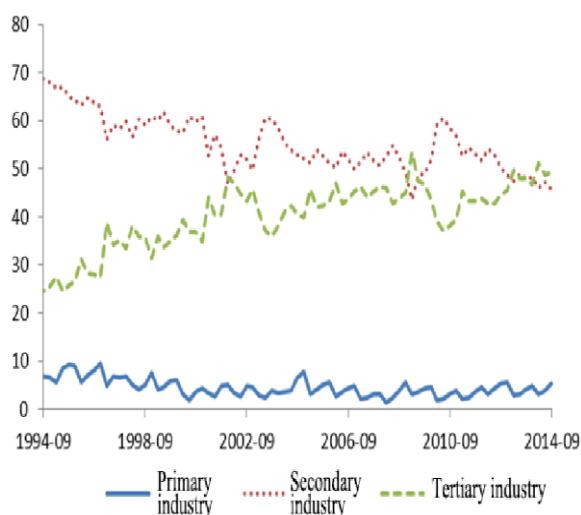
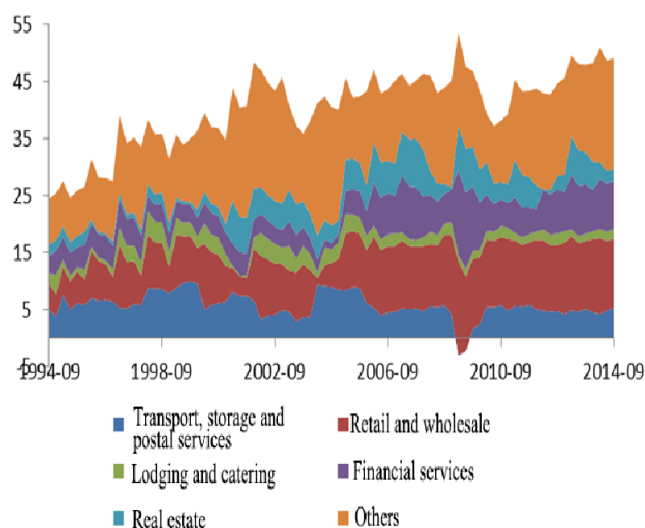


Figure 36: Service Sectors' Contributions to GDP Growth



Source: Wind; Institute of International Finance, BOC

A further exploration of fixed asset investment in the tertiary industry in the past three years shows that the investment growth in most sub-sectors outpaced the industry average, showing a strong momentum of development. For example, financial services, leasing and commercial services and wholesale and retail trade grew at an average monthly rate of over 30% in the past three years, and the rate were more than 25% for information transmission, software and information technology services, culture, sports and entertainment as well as scientific research, technological services and geological prospecting. With respect to industry policy, since it took office in early 2013, the new government has attached great importance to the development of modern service sectors. The State Council issued a number of policy documents that give guiding opinions on the development of producer services, scientific and technological services, logistics and cultural and creative sectors. With the combined effects of the market's decision maker role, the community's participant role and the government's regulator role, these service sectors are expected to grow by 20% or faster in the next five years.

Table 4: Some Service Sectors with Rapid Investment Growth

Sector/the last 3-year average monthly growth rate	Investment	Sub-sector/ the last 3-year average monthly growth rate	Investment
Wholesale and retail trade	31.4	Wholesale	30.0
		Retail trade	31.6
Transport, storage and postal services	12.7a	Pipeline transport	48.1
		Loading, unloading and transport services	50.3
		Warehousing	25.5
Accommodation and catering	22.9	Accommodation	25.0
Information transmission, software and	28.8	Internet and related services	38.0

information technology services		Software and information technology services	53.6
Financial services	46.0	Monetary and financial services	22.8
		Capital markets services	118.2
		Insurance	55.7
		Other financial services	191.1
		Real estate	21.9
Leasing and commercial services	34.2	Leasing	49.1
		Commercial services	34
Scientific research, technological services and geological prospecting	26.8	Research and experimental development	22.4
		Professional technological services	35.4
		Science and technology promotion and application	33.6
Water, environment and public facilities administration	22.1a	Water conservancy management	23.7a
		Public facilities management	22.1a
Resident, repair and other services	19.7	Resident services	24.1
Health care and social work	22.6a	Social work	41.2
Culture, sports and entertainment	27a	News and publishing	23.5
		Radio, television, film, and television recording and production	28.4
		Culture and arts	33.2
		Entertainment	33.6
Public administration, social security and social organizations	5.4a	People's Political Consultative Conference and democratic parties	274
		Social security	26.3
		Mass and social organizations, and other membership organizations	58.8
Overall	19.9		

Note: Data suffixed with the letter “a” are for the period from November 2011 to October 2014, while other data are for the period from October 2011 to September 2014.

Source: Wind; Institute of International Finance, BOC

Table 5: Government Highly Values Development of Modern Service Sectors

Sector	Title of document	Reference number	Date of issue
Scientific and technological services	Opinions of the State Council on Accelerating Development of the Scientific and Technological Services Sector	Guofa [2014] No. 49	2014-10-28
Sports	Opinions of the State Council on Accelerating the Sports Sector Development and Promoting Sports Consumption	Guofa [2014] No. 46	2014-10-20
Logistics	Notice of the State Council on Issuing the Medium- and Long-term Development Plan for the Logistics Sector (2014-2020)	Guofa [2014] No. 42	2014-10-4
Marine shipping	Opinions of the State Council on Promoting Healthy Development of the Marine Shipping Sector	Guofa [2014] No. 32	2014-9-3
Tourism	Opinions of the State Council on Promoting Reform and Development of the Tourism Sector	Guofa [2014] No. 31	2014-8-21
Modern insurance services	Opinions of the State Council on Accelerating Development of the Modern Insurance Services Sector	Guofa [2014] No. 29	2014-8-13

Producer services	Guidelines of the State Council on Accelerating Development of the Producer Sector and Promoting Industrial Restructuring and Upgrading	Guofa [2014] No. 26	2014-8-6
Capital markets	Opinions of the State Council on Further Promoting Healthy Development of Capital Markets	Guofa [2014] No. 17	2014-5-9
Cultural, creative and design services and related sectors	Opinions of the State Council on Promoting Integrated Development of Cultural, Creative and Design Services and Related Sectors	Guofa [2014] No. 10	2014-3-14
Health services	Opinions of the State Council on Promoting Healthy Development of the Health Services Sector	Guofa [2013] No. 40	2013-10-18
Elderly care services	Opinions of the State Council on Accelerating Development of the Elderly Care Services Sector	Guofa [2013] No. 35	2013-9-13
Rail transport	Opinions of the State Council on Reforming the Railway Investment and Financing System and Accelerating Railway Construction	Guofa [2013] No. 33	2013-8-16
Broadband network	Notice of the State Council on Issuing the “Broadband China” Strategy and Implementation Plan	Guofa [2013] No. 31	2013-8-16
Information consumption	Opinions of the State Council on Promoting Information Consumption and Expanding Domestic Demand	Guofa [2013] No. 32	2013-8-14
Energy conservation and environmental protection	Opinions of the State Council on Accelerating Development of the Energy Conservation and Environmental Protection Industry	Guofa [2013] No. 30	2013-8-12

Source: State Council; Institute of International Finance, BOC

3. Selected industrial sectors: important drivers of growth

In spite of the industrial sectors’ reduced contribution to economic growth as substantial progress in economic restructuring has driven up service sectors’ contribution to economic growth, the secondary industry remains a major engine of economic growth. In the first three quarters of 2014, the contribution ratio of secondary industry was 37.4%, and increased 2.7 percentage points of GDP growth rate. The secondary industry’s contribution to economic growth is expected to further fall in coming years, but it will remain a major driver of economic growth.

Table 6: 13 Industrial Sectors with Strong Growth

Sector/ the last 3-year average monthly growth rate	Total profit	Industrial value added	Fixed asset investment
Timber processing and bamboo, cane, palm fiber and straw products	24.8	12.1	27.1a
Food manufacturing	24.7	10.9	24.8
Gas production and supply	18.7	14.6	28.1a
Nonmetal minerals mining and dressing	18.3	11.0	22.4
Cultural, educational and sports goods	18.2	12.9	26.0
Medical and pharmaceutical products	17.2	13.9	31.4
Manufacture of automobiles	17.0	11.0	20.0
Manufacture of furniture	16.9	10.8	27.1a

Manufacture of alcohol, beverages, and refined tea	16.8	11.0	32.2a
Processing of food from agricultural products	14.6	11.1	28.6
Manufacture of measuring instruments	11.7	11.6	21.7a
Printing and reproduction of recorded media	11.7	10.7	21.2a
Reuse of waste resources	11.2	16.1	38.3a
Overall	8.6	9.9	19.9

Note: (1) The data regarding total profit and industrial value added are year-on-year monthly growth rates; the data regarding fixed asset investment are year-on-year cumulative growth rates; (2) total profit data and fixed asset investment data suffixed with letter “a” are for the period from October 2011 to September 2014, while industrial value added and other fixed asset investment data are for the period from November 2011 to October 2014.

Source: Wind; Institute of International Finance, BOC

An exploration of monthly data regarding the profit, value added and fixed asset investment by sub-sectors shows that 13 sectors outperformed the industry average in terms of the above three indicators, which can be considered direct evidence of strong growth. These sectors are expected to remain major drivers of growth in the coming five years. Specifically speaking, firstly, food manufacturing, processing of food from agricultural products and manufacture of alcohol, beverages, and refined tea will remain on the fast track. Secondly, as residents’ consumption is upgrading from food and clothing to housing, travel, culture, education and entertainment, timber processing and bamboo, cane, palm fiber and straw products, manufacture of furniture, gas production and supply, manufacture of automobiles, manufacture of measuring instruments, cultural, educational and sports goods as well as printing and reproduction of recorded media will continue to grow rapidly. Thirdly, taking into consideration the aging population, improving standard of living and rising demand for medical services, health care and environmental protection, the manufacture of medical and pharmaceutical products and reuse of waste resources will continue to grow fast. Lastly, nonmetal mine is broadly applied in various sectors of national economy, and its mining and dressing sector is expected to continue rapidly.

Taking into consideration of the current situation, prospects and policy factors of all industries and sectors, we predict that, in the next five years, China’s economy will be led and driven mainly by the seven SEIs, some of which will become pillars of the economy in 2020, while modern service sectors will become the primary engine of growth and contribute more than half of GDP growth. In addition, some industrial sectors will remain strong contributors to rapid economic growth.

Topic 2: China’s economic leverage ratio measurement and potential risks

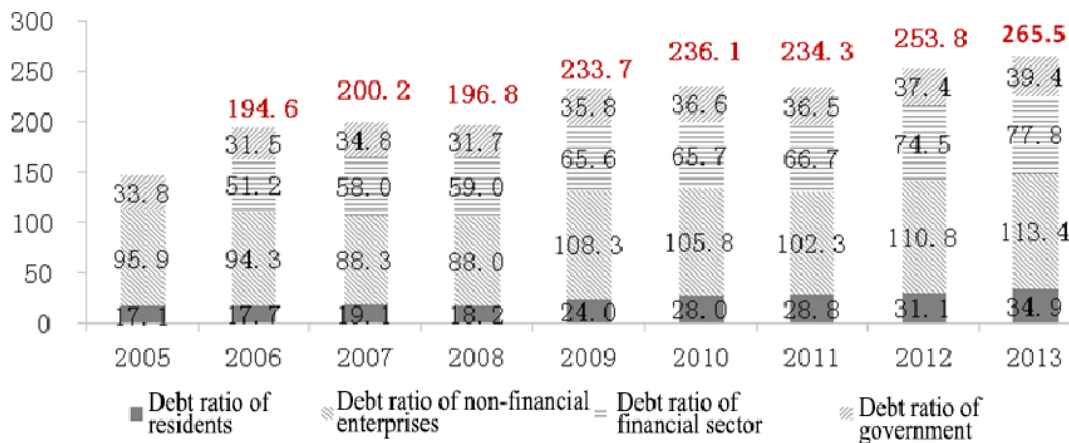
The movements of leverage ratio (debt ratio) are usually related closely to economic cycles and monetary and credit environments. Leverage is helpful but also has its negative effect. If an economy uses debts properly, a moderate rise in leverage ratio helps increase its financing capacity, improve efficiency of fund allocation and promote steady, rapid economic growth. However, over-leveraging may lead to overheated economy, bubble inflation and debt risk rises. Currently as China is shifting into a new normal of slower growth and better structure, the debt risk has become a cause for close concern. How the leverage ratio of China’s economic sectors changes, what risks are there and how to respond in the future? These will be discussed below.

1. Measurement and evolvement of China’s leverage ratios

Since the eruption of the Financial Crisis in 2008, China's overall leverage ratio has increased amid massive stimulus packages. In 2013, China’s overall leverage ratio (covering governmental,

resident and business sectors) reached 265.5%, up 70.8 percentage points from 2006. Leverage ratio rose in all economic sectors, of which the financial sector and non-financial enterprises saw a high and fast-growing leverage ratio. The financial sector's leverage ratio was 77.8% up 26.6 percentage points from 2006, mainly due to the substantial increase in liabilities to other depository corporations, other liabilities and bond issues, whose percent weights in GDP rose by 12.4, 13.7 and 6.3 percentage points from 2006 respectively. The non-financial enterprise sector's leverage ratio was 113.4%, up 19.1 percentage points from 2006, mainly due to the sharp rise in corporate bonds. The resident and governmental sectors had a relatively low leverage ratio. The resident sector's leverage ratio was 34.9%, up 17.2 percentage points from 2006; the governmental sector's leverage ratio was 39.4%, up 7.9 percentage points from 2006.

Figure 37: Changes in China's Leverage Ratios by Economic Sector in the Past Decade



Note: Leverage ratio of residents = residents' loans/GDP; leverage ratio of non-financial enterprises = (loans to non-financial enterprises and other sectors + debts of enterprises)/GDP; leverage ratio of financial sector = (total liabilities – liabilities to non-financial institutions and households – deposits in liabilities to other financial corporation that are counted in M1 calculation)/GDP; leverage ratio of government is from IMF, only including liabilities of central government.

Source: Institute of International Finance, BOC

2. Potential risks derived from leverage ratio changes

Currently the leverage ratios in China's economy mainly show the following problems:

(1) Local government debt risk rises in spite of relatively low overall leverage ratio

Compared with other countries, China's overall debt ratio is relatively low. In particular, the leverage level of central government and residents is much lower than most countries. China's overall leverage ratio was 236.1% in 2010, lower than Japan (515.8%) and the US (298%) in the same period. In particular, the relatively low leverage ratios in central government and residents create conditions for reallocation and optimization of leverages among economic sectors to prevent "hard landing" of the economy.

It is noteworthy that the government debts mentioned above do not include local government debts, leading to an underestimation of Chinese governments' leverage level. According to a report of the National Audit Office (NAO) of China, local government debts (including contingent debts) totaled RMB17.9 trillion at June 2013, representing 31.5% of GDP. Against the backdrop of greater downside pressure, property market adjustments and de-capacity, local governments face a bigger pressure on fiscal revenue and expenditure. Due to regional disparities in economic development and debt management capability, some local governments have had trouble in

repaying debts. Meanwhile, as regulators have strengthened monitoring over financing platforms and shadow banking in recent years, local governments rely increasingly more on trust loans and other new financing channels, which has been driving up the implicit debt risk.

Table 7: Debt Structure and Overall Leverage Ratio by Country (% of GDP)

	Financial sector	Public sector	Business enterprise sector	Resident sector	Overall leverage Ratio
Japan	120	229.8	99	67	515.8
UK	219	84.3	109	98	510.3
Spain	76	70.4	134	82	362.4
France	97	84.4	111	48	340.4
Italy	76	120.7	82	45	323.7
South Korea	93	31.7	107	81	312.7
US	40	99	72	87	298.0
Germany	87	83	49	60	279.0
Australia	91	73	59	105	328.0
Canada	63	85.9	53	91	292.9
China	65.7	36.6	105.8	28	236.1

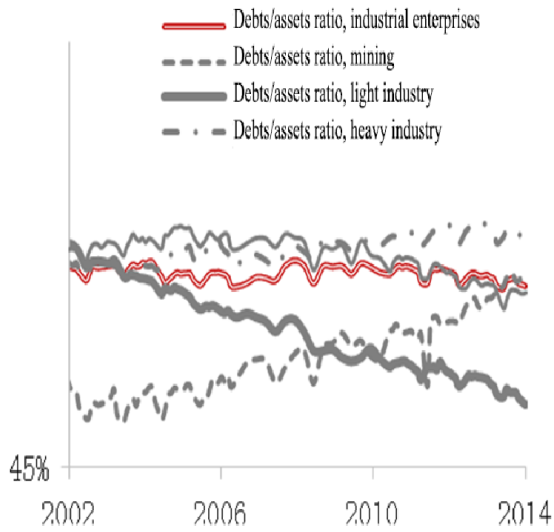
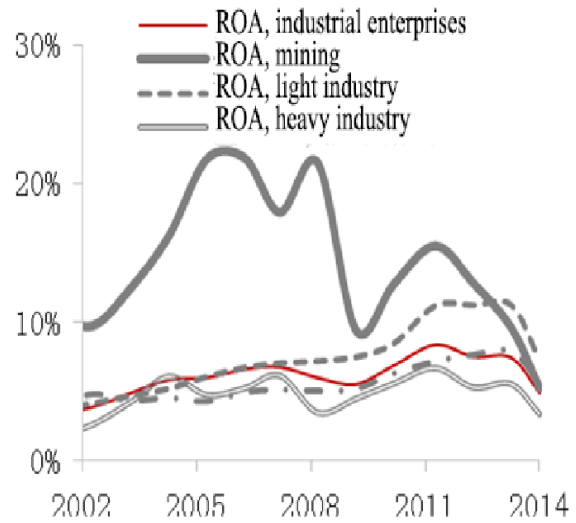
Source: Governmental debt data are from IMF; non-China data are from the *Debt and Deleveraging: Uneven Progress on the Path to Growth* released by McKinsey in 2012.

(2) Financial system vulnerability worsen by non-financial corporations' higher leverage ratio than global average

By economic sector, the leverage ratio of China's non-financial corporations was not only higher than other sectors of the Chinese economy, but also higher than developed economies like the US, Japan and Germany. For example, the leverage ratio of Chinese corporations was about 105.8% in 2010 (113.4% in 2013), compared with 49%, 72% and 99% of German, US and Japanese respectively. The rising costs and over-leveraging of enterprises will not only add to the financial burden of businesses, but also worsen the risk of overcapacity and the vulnerability of the economic and financial systems. In particular, as over capacities will remain amid the future economic downturn, some enterprises with excessive debt burden and weak profitability will face the risk of collapse of fund chains.

(3) Coal industry and most heavy industries have a higher leverage ratio

Among industrial enterprises, mining and heavy industries saw a rise in leverage ratio and a decline in return on assets, posing a high debt risk. Of mining industries, the coal mining and dressing industry has a debts/assets ratio higher than industry average and other mining industries and a return on assets much lower than average and other mining industries. Heavy industries, except non-metal mineral products and metalwork, showed weak performance, with the debts/assets ratio on the rise and higher than industry average and the return on assets staying a relatively low levels. Light industry and emerging manufacturing saw the debts/assets ratio on the decline and lower than industry average, with relatively high return on assets, posing a relatively low risk.

Fig. 38: Debts/Assets Ratio by Industry**Fig. 39: Return on Assets by Industry**

Source: Wind; Institute of International Finance, BOC

3. Countermeasures

Currently China's debt risk and de-leveraging pressure are concentrated in local governments and non-financial corporations. Future macro controls should respect the inherent laws of economic de-leveraging and control overall leverage ratio at reasonable levels by a proper combination of encouragements and discouragements. China needs control buildup in over capacities and inflation of asset bubbles arising from the ongoing de-leveraging of enterprises and financial institutions on the one hand and also prevent the rise in financial risk due to drastic de-leveraging on the other hand. In particular, focus should be placed on addressing the fundamental contradictions in economic operation to prevent intensification of conflicts due to simple curbs on credit expansion.

The leverage distribution among central government, local governments and enterprises should be adjusted optimally to increase the leverage ratios of central government and residents appropriately. At present, to stabilize growth, advance reforms and promote inclusive growth, the central government funding is expected to play a stronger role, leaving more time for local governments and enterprises to de-leverage. China may increase the leverage level of shantytown redevelopment, agriculture-related activities and small and micro businesses by providing more public funding and financial supports, while de-leveraging local government financing platform, real estate and industries with over capacities, thereby controlling the overall leverage ratio at reasonable levels. China should further tap into the consumption potential of residents to strengthen the self-sustaining growth of the economy. Taking advantage of the new budget law promulgated in September 2014, China should strengthen the management of local government debts so that local governments' borrowing activity will be disciplined and transparent.

A range of measures should be taken to de-leverage enterprises. China should accelerate the development of equities and other direct financing methods to optimize the financing structure and lower the debt ratio of enterprises. China also should speed up industrial restructuring, channel funds into strategic emerging industries, eliminate outdated capacities steadfastly, improve mechanisms for bankruptcy and reorganization of businesses and increase the efficiency of investment.

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