

China's Economic and Financial Outlook

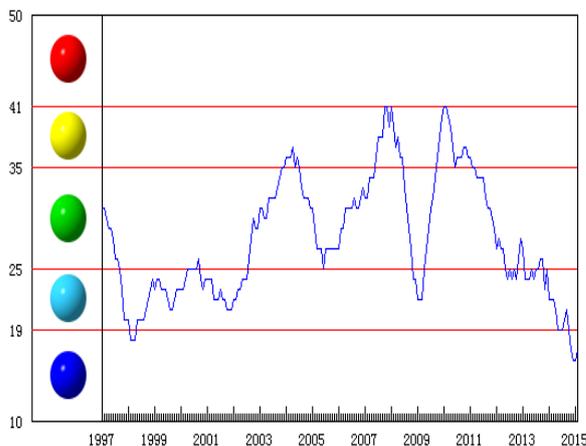
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Highlights

- In Q1 2015, while continuing the slowdown of last year due to property market adjustments, overcapacities and weak external demands, China's economy sees refined structure, enhanced quality and improved income distribution as well as remarkably promoted sustainability, balance and inclusiveness in development.
- Looking into the second quarter, we expect stable economic growth, given the improving external environment and the increasing effects of growth-stabilizing policies. However, economic growth will also face uncertainties caused by inertial reduction in investment, higher leverage ratio, and continued negative PPI. The Q2 GDP is predicted to grow at around 7.2%, while CPI may go up by about 1.3%.
- Under the currently high downturn pressure and low inflation, proactive fiscal policy and more flexible and targeted monetary policy are needed so as to create a favorable monetary environment for stable growth.
- Objectively speaking, stabilizing growth will increase the leverage; while in the case of high leverage ratio, "deleveraging" approaches will be required. Therefore, it is necessary to keep a balance. We suggest insisting on range-based macro-control instead of large-scale stimulus. In particular, against the backdrop of "absorbing the effects of previous economic stimulus policies", relatively higher leverage and serious overcapacities, China needs to balance between stabilizing growth and "deleveraging".

China's economic climate index



Source: Institute of International Finance, BOC

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Keep Balance Between Stabilizing Economic Growth and “Deleveraging”

-- China's Economic and Financial Outlook (Q2, 2015)

In the first quarter of 2015, while continuing the slowdown of last year due to property market adjustments, overcapacities and weak external demands, China's economy sees refined structure, enhanced quality and improved income distribution as well as remarkably promoted sustainability, balance and inclusiveness in development. The Q1 GDP is estimated to grow at around 7%, 0.4 percentage points lower than the same period last year and CPI is estimated to increase by about 1.2%. Looking into the second quarter, we expect stabilized economic growth, given the improving external environment and the increasing effects of growth-stabilizing policies. However, economic growth will also face uncertainties caused by inertial reduction in investment, higher leverage ratio, and continued negative PPI. The Q2 GDP is predicted to grow at around 7.2%, while CPI may go up by about 1.3%. Under the currently high downturn pressure and low inflation, we need proactive fiscal policy and more flexible and targeted monetary policy, so as to create a favorable monetary environment for stable growth. Given that, a moderate easing policy is expected. However, objectively speaking, stabilizing growth will increase the leverage; while in the case of high leverage ratio, “deleveraging” approaches will be required. Therefore, it is necessary to keep a balance. We suggest insisting on range-based macro-control instead of large-scale stimulus. In particular, against the backdrop of “absorbing the effects of previous economic stimulus policies”, relatively higher leverage and serious overcapacities, China needs to balance between stabilizing growth and “deleveraging”. As for sector development, on the one hand, it is important to support the service sector, especially such productive services as R&D and design, procedural optimization, marketing and logistics; on the other hand, the “Made in China” strategy shall be carried forward. The fundamental way for stable and sustainable economic development lies in seizing the new-generation revolution of science and technology and upgrading “Made in China” approaches based on the “Made in China 2025” strategy.

I. Economic Review and Outlook

I.1 Economic review for Q1

I.1.1 Economic growth drops slightly and five major changes indicate an improving economy

During the first quarter, affected by property market adjustments, overcapacities and weak external demands, China's economy continued its ebbing trend since last year. In the first two months, major economic growth indicators slowed down remarkably, including investment, industrial production and power generation. The growth of crude steel dropped by 3.5 percentage points, while that of steel products and auto production went down by 2.8 percentage points and 7.9 percentage points respectively, indicating a big economic downturn pressure. We expect the Q1 GDP to grow at around 7%, about 0.4 percentage points lower than that of last year and that of the same period last year.

Figure 1: China's GDP growth

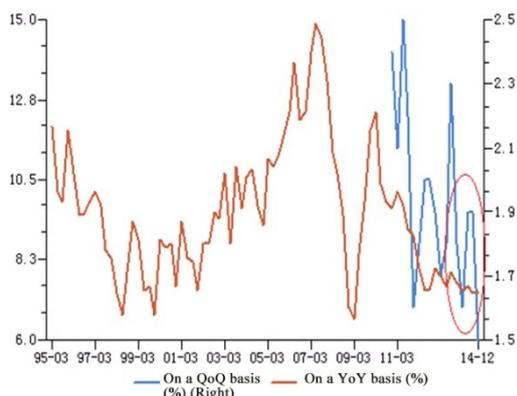
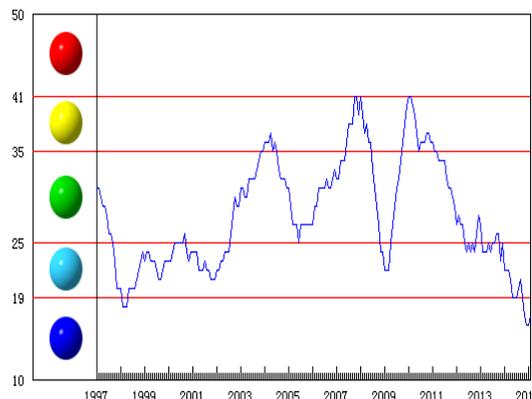


Figure 2: China's economic climate Index



Source: Wind; Institute of International Finance, BOC

In spite of the slowdown, we should recognize that China's economy is getting better with a series of positive changes occurring recently. China saw rapid growth of the tertiary industry and private investments, robust profit increase in equipment and high-tech manufacturing and speedy expansion of communications devices, information consumption and tourism, which have been the targets of economic development for years. To a certain extent, stable economic growth is accompanied by better structure, quality and income distribution, which is the optimal state of economic growth and indicates that the growth is becoming markedly more sustainable, balanced and inclusive.

First, the tertiary industry develops rapidly and becomes the main driver of employment generation and stabilization. In 2014, the tertiary industry grew by 8.1%, 4 and 0.8 percentage points higher than the primary and secondary industry, respectively; it occupied 48.2% of GDP, 5.6 percentage points higher than the secondary industry. During January and February 2015, the service sector is estimated to go up by 7.4%, 0.6 percentage points higher than the industrial production during the same period. The service-dominant tertiary industry has become a main factor to provide jobs and stabilize employment, given its rapid growth and increasing share in GDP. In 2014, one percentage of GDP growth created 1,786,000 new jobs, 59% higher than 2010 (which was 1,123,000); the elasticity of employment with respect to GDP (ratio of the growth rate of working population to the GDP growth rate) changed from the downward trend in the past to rise (Table 1).

Table 1: Changes to China's employment elasticity

	GDP growth rate (%)	Growth rate of working population (%)	Employment elasticity
1880-1990	9.2	4.3	0.465
1991-2000	10.5	1.1	0.103
2001-2010	10.5	0.54	0.052
2011-2013	8.3	0.38	0.046
2014	7.4	0.36	0.048

Source: Wind; Institute of International Finance, BOC

Second, with a refined demands structure, consumption makes a bigger contribution to economic growth. Consumption in 2014 grew by 12% and contributed 51.2% to economic growth, 1.2 percentage points higher than the previous year. In January and February this year, the real growth rate of consumption reached 11%, 0.2 percentage points higher than the same period of 2014. Greater contribution made by consumption to economic growth is expected in the first quarter.

Third, emerging industries, emerging businesses and private economy show a sound momentum and the economic growth is becoming increasingly self-sustaining. This January and February, the added value of high-tech industries went up by 11.2% year on year, 4.4 percentage points higher than that of the industry above designated size. The added value of equipment manufacturing increased by 8.2% year on year, 1.4 percentage points higher than the whole industry. Stimulated by streamlined administration, delegation of powers, eased market access control and accelerated reform on the investment and financing system, private capital is invigorated and investments in services and other fields increase rapidly. In 2014, the number of national newly registered enterprises went up 45.88% year on year, indicating a vitalizing market where start-ups funded by the masses are thriving. In January and February, private investment rose 14.7% year on year, 0.8 percentage points higher than the total investments. Internet-related new-type businesses continued speedy expansion. In the first two months this year, national online sales of commodities and services amounted to RMB475.1 billion, representing a year-on-year increase of 44.6%. Online sales of commodities went up 47.4% year on year to RMB399.1 billion, with a growth rate 36.7 percentage points higher than that of total retail sales of consumer goods, pushing the latter up nearly three percentage points.

Fourth, progress is made in energy saving and emission reduction with a markedly smaller elasticity coefficient of energy consumption¹. In recent years, the government has been stepping up supportive policies for energy saving, emission reduction and clean energy use. Meanwhile, economic slowdown leads to restrained growth of traditional industries with high energy consumption and high pollution such as iron & steel, cement and electrolytic aluminum, bringing remarkable progress in energy saving and emission reduction. In 2014, energy consumption per RMB10,000 GDP dropped by 4.8%, outperforming the government's preset target of 3.9%. The elasticity coefficient of energy consumption fell from 0.48 of the previous year to 0.30 (Table 2), indicating new progress made in energy saving and emission reduction.

Table 2: Elasticity coefficient of energy consumption from 2010 to 2014

Year	2010	2011	2012	2013	2014 (E)	2015Q1 (E)
Energy consumption growth (%)	6.0	7.1	3.9	3.7	2.2	1.0
GDP growth (%)	10.4	9.3	7.7	7.7	7.4	7.0
Elasticity coefficient of energy consumption	0.58	0.76	0.51	0.48	0.30	0.14

Note: Data of elasticity coefficients in 2014 and 2015 are estimated by the author.

Source: Wind; Institute of International Finance, BOC

¹Elasticity coefficient of energy consumption is an indicator reflective of the relationship between energy consumption growth and economic growth. The calculation formula is: elasticity coefficient of energy consumption = annual average growth rate of energy consumption/annual average economic growth rate.

Fifth, income distribution is improving and residents' income growth outgrows GDP growth. In terms of income distribution, in 2014, disposable income per capita increased by 10.1%, or 8% on an inflation-adjusted basis, both higher than GDP growth rate during the same period. As for urban-rural income gap, the ratio of urban income to rural income was 2.92² in 2014, 0.11 percentage points down from the previous year (3.03), the biggest drop in the recent five years. In respect of residents' income distribution, the country's Gini coefficient was 0.469 in 2014, the lowest since 2008, indicating a big shrinkage in income gap (Table 3).

Table 3: Changes in ratio of urban income to rural income from 2010 to 2014

Year	Gini coefficient	Urban residents' disposable income per capita (in RMB)	Rural residents' net income per capita (in RMB)	Ratio of urban income to rural income	Changes in ratio of urban income to rural income
2010	0.481	19109.4	5919.0	3.23	
2011	0.477	21809.8	6977.3	3.13	0.10
2012	0.474	24564.7	7916.6	3.10	0.02
2013	0.473	26955.1	8895.9	3.03	0.07
2014	0.469	28844.0	9892.0	2.92	0.11

Source: Wind; Institute of International Finance, BOC

1.1.2 CPI continues the downward trend and PPI shows negative growth for 36 consecutive months

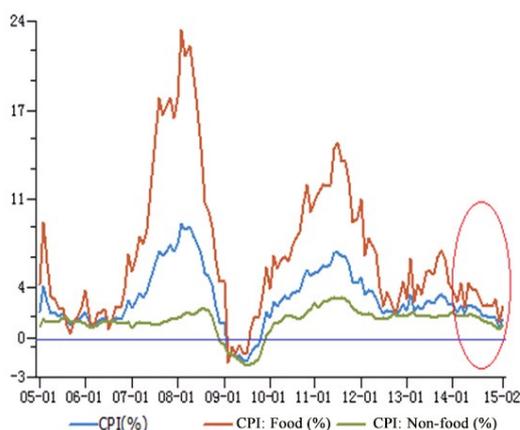
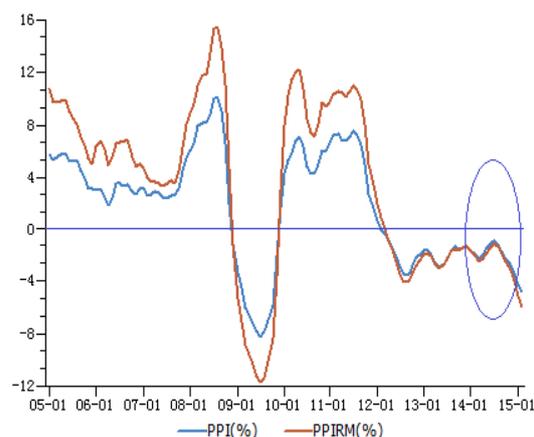
Under the shadow of the downward economy, slowing demands growth, the one-month-late 2015 Spring Festival and diminishing carryover effect, prices continued to drop in the first quarter with CPI (Consumer Price Index) climbing at a slower pace and PPI (Producer Price Index) dropping further. Major characteristics of prices in the first quarter include:

First, the growth rate of CPI goes down on a year-on-year basis but rises on a quarter-on-quarter basis. During January and February, CPI went up 1.1% cumulatively, one percentage point lower than the same period last year and 0.9 percentage points lower than the whole year of 2014 (Figure 3). Monthly speaking, CPI in January and February went up 0.8% and 1.4%, respectively, and the steeper rise of CPI in February was mainly connected with the rapid price rises of food and services during the Spring Festival. It is expected that March will see a year-on-year increase in CPI of 1% at least.

On a month-on-month basis, CPI has increased substantially from 0.3% in January to 1.2%. In March, as the weather is getting warmer and production and transportation conditions of vegetables and other products are improving, price rise in food will further slowdown. The Q1 CPI is

² Ratio of urban income to rural income refers to the ratio of urban residents' income to rural residents' income, which is an important indicator of urban and rural income gap. The larger the indicator is, the wider the gap between urban income and rural income is. To ensure comparable calculation criteria, we adopt urban residents' disposable income per capita and rural residents' net income per capita to produce ratio of urban income to rural income.

estimated to grow around 1.2%, 1.1 percentage points lower than the same period last year and 0.8 percentage points lower than the whole year of 2014. Though price rise remains at a low level in January and February and the deflation pressure seems to be growing, the deflation pressure is actually diminishing instead of augmenting on both month-on-month and year-on-year basis.

Figure 3: CPI fluctuates at low levels**Figure 4: PPI increases negatively for 36 consecutive months**

Source: Wind; Institute of International Finance, BOC

Second, price rise in food, housing, transportation and communications weakens substantially, which is the main cause for the sluggish CPI. Due to the warm winter and the Spring Festival, food price only increased 1.7% during the first two months, 1.5 percentage points lower year on year. Affected by property market adjustments and dropping property price, housing price only went up 0.7%, 2.1 percentage points lower on a year-on-year basis. Since the second half of 2014, international crude oil price has dropped substantially and domestic prices of oil products have seen several adjustments (ten price cuts from July to December 2014), which pulled down transportation & communications prices in the CPI basket by 2%, 1.89 percentage points higher year on year. Prices of recreation, education and culture articles increased 1.1%, 1.6 percentage points lower year on year, which was partially attributed to the reduction in high-end entertainment consumption and dropping tourist prices. Based on preliminary estimates, prices of these four categories of goods and services lowered the CPI growth of the first two months by about 1.3 percentage points.

Table 4 Changes in the eight categories of goods and services in the CPI basket (%)

Year	CPI	Foods	Tobacco and wine	Clothing	Household devices	Health care	Transportation and communications	Recreation, education and culture	Housing
2011	5.4	11.8	2.8	2.1	2.4	3.4	0.5	0.4	5.3
2012	2.6	4.8	2.9	3.1	1.9	2.0	-0.1	0.5	2.1
2013	2.6	4.7	0.4	2.3	1.5	1.3	-0.4	1.8	2.8
2014	2.0	3.1	-0.6	2.4	1.2	1.3	-0.1	1.9	2.0
2014.1-2	2.2	3.2	-0.7	2.1	1.4	1.1	-0.11	2.7	2.8
2015.1-2	1.1	1.7	-0.5	2.9	1.2	1.8	-2.0	1.1	0.7

Source: Wind; Institute of International Finance, BOC

Third, PPI sees an expanding negative growth for 36 consecutive months. Due to weak demands, overcapacities and dropping import prices, PPI in the first quarter this year continued the negative growth for 36 consecutive months, dropping 4.6% during the first two months. The decline was 2.8 percentage points higher than the same period last year and 2.7 percentage points higher than the whole year of 2014 (Table 5). On a month-on-month basis, PPI drops more rapidly in January and February. By sub-sectors, the falling PPI during the first two months is mainly caused by the dropping prices of capital goods (-6.2%), especially the substantial price drops of 20.1% and 9.2% in the mining industry and the raw materials industry, respectively. Prices of consumer goods generally maintain stable with prices dropping within 1% in every sub-sector. The negative increase of PPI continued to expand during January and February, due to economic downturn, weak market demands as well as the dropping PPIRM (Purchasing Price Index of Raw Material, Fuel and Power) caused by decreasing prices of international crude oil, coal and iron ore. Since March, the international crude oil price has dropped further, and the market demand remains weak. Prices of iron ore, iron & steel etc. fluctuate at low levels. Given that, it is predicted that the Q1 PPI will slip further by around 4.4%.

Table 5: Changes to PPI by sub-sectors (%)

Year	PPI	Capital goods	Capital goods			Consumer goods	Consumer goods			
			Mining industry	Raw materials industry	Processing industry		Food s	Clothing	General daily necessities	Consumer durables
2011	6.0	6.6	15.4	9.2	4.6	4.2	7.4	4.2	4.0	-0.6
2012	-1.7	-2.5	-2.4	-2.0	-2.7	0.8	1.4	2.1	0.9	-0.9
2013	-1.9	-2.6	-5.7	-3.1	-2.0	0.2	0.7	1.2	-0.1	-0.9
2014	-1.9	-4.3	-6.5	-3.2	-1.8	0.0	0.2	0.7	0.1	-0.8
2014 (1-2)	-1.8	-2.5	-13.2	-6.4	-2.0	-0.3	-0.3	0.8	-0.1	-1.1
2015 (1-2)	-4.6	-6.2	-20.1	-9.2	-3.5	-0.1	-0.1	0.8	-0.2	-0.6

Source: Wind; Institute of International Finance, BOC

I.1.3 Investment growth slows down, while consumption and net exports are making a bigger contribution

First, consumption growth remains stable with rapid consumption growth of communications devices. During the first two months of 2015, total retail sales of consumer goods grew 10.7% nominally and 11% actually, 0.2 percentage points higher than the same period last year (Figure 5). Based on these, we estimate retail prices of consumer goods to drop 0.3 percentage points on a year-on-year basis. Retail price index of goods deflated too, down 0.5% and 0.1% in January and February 2015, respectively. Such deflation also happened during 1998-2003 and in 2009, reflecting a sluggish economy and big downturn pressure. By sub-sectors, consumption of communications devices continued the rapid increase of last year with the growth rate of 38.5%, much higher than other goods. Consumptions of traditional Chinese and western medicines, daily necessities, construction and decoration materials, furniture, household appliance and audio-visual equipment grew rapidly at a rate of over 12% (Figure 6).

Figure 5: Nominal growth and actual growth of consumption

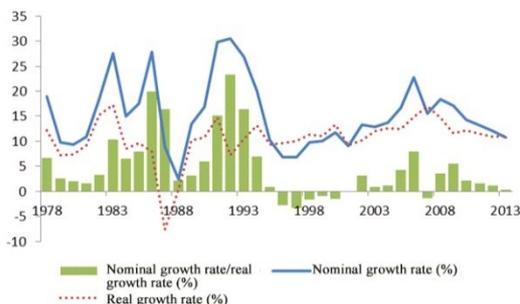
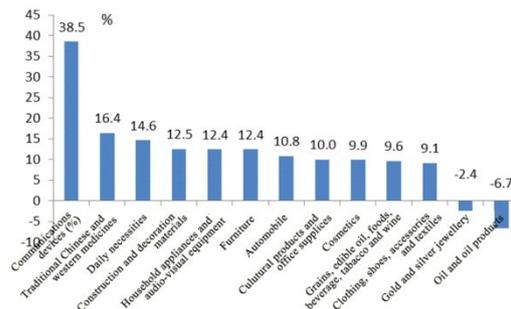


Figure 6: Changes to consumption growth by sub-sectors



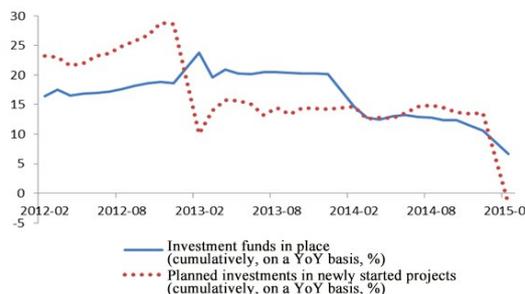
Source: Wind; Institute of International Finance, BOC

Second, investment growth slows down remarkably with lower growth in both real estate and manufacturing investments. During January and February of 2015, growth in fixed asset investment further slowed down at a year-on-year rate of 13.9%, four percentage points lower than the same period last year. As for investment structure, the substantial growth deceleration of investments in real estate and manufacturing directly led to a remarkable slowdown of investment growth. Specifically, the growth rate of real estate investment fell 8.9 percentage points and that of manufacturing investment dropped 4.5 percentage points on a year-on-year basis. Meanwhile, driven by supportive policy, infrastructure investments maintained a rapid growth of 20.8% year on year, two percentage points higher than the same period last year. Investment growth substantially slows down, which reflects two serious problems in current investment: First, attractive investment projects are wanting and investors are not enthusiastic. During the first two months this year, planned investment on newly started projects decreased 1.8%, and the growth rate of planned investment on construction projects fell by 12.3 percentage points from the same period last year, quite similar to the situation in 2007 and 2011. Second, due to insufficient funding for investment projects, investment growth is restricted. In January and February, investment funds in place only grew 6.7%, 7.9 percentage points lower than the same period last year. In particular, loans witnessed zero growth, similar to the case in 2012.

Figure 7: Continuous drops in Investment growth



Figure 8: Insufficient investment funds and newly started projects



Source: Wind; Institute of International Finance, BOC

Third, imports and exports go to two extremes, further expanding trade surplus. During the first two months of 2015, China's exports grew rapidly by 15% year on year, 3.5 percentage points higher than the average level of previous years since the financial crisis. The rapid growth of exports is mainly due to the low base number of last year. As a matter of fact, the season-adjusted

growth rate of exports in this January and February was not altogether impressive, lower than the monthly growth rate since May 2014. Meanwhile, imports experienced a substantial negative growth, -20.2% on a year-on-year basis, and the decrease is only second to that in 2009 in the recent 10 years. The monthly year-on-year import growth has been negative for four consecutive months, demonstrating weak domestic demands and big economic downturn pressure. Among the recent ten months, six months have seen positive export growth but negative import growth, which is quite similar to the period from August 1996 to May 1997. The widening growth gap between import and export resulted in an enlarging trade surplus, which has hit record highs repeatedly and amounted to USD120.7 billion during the first two months, even higher than USD104.3 billion during the first six months of 2014.

Figure 9: Import and export growths from 1996 to 1998

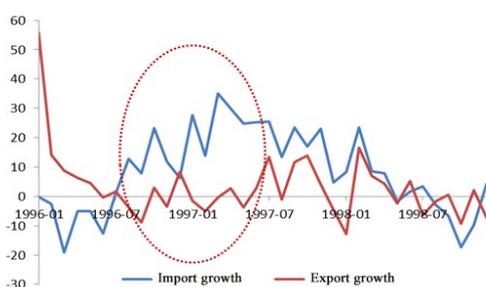
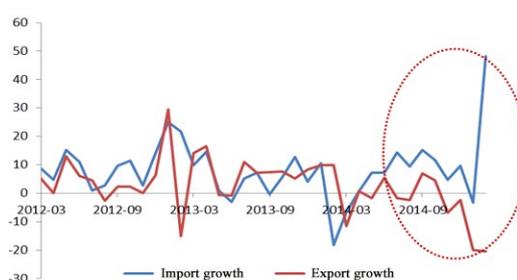


Figure 10: Import and export growths from 2012 to 2015

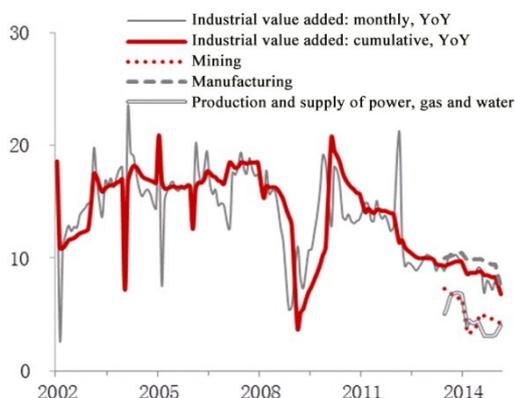


Source: Wind; Institute of International Finance, BOC

I.1.4 Industrial production drops substantially and overcapacities are still accumulating

In January and February this year, industrial value added went up 6.8% year on year, 1.8 percentage points lower than the same period last year, 1.5 percentage points lower than December 2014, the lowest since June 2009 (Figure 11). This coincides with the substantial slowdown of power generation and industrial power consumption, indicating the elevated economic downturn pressure.

Industrial slowdown is mainly due to the slowing middle- and down-stream manufacturing. In January and February, manufacturing value added went up 7.5%, 2.3 percentage points lower than the same period last year. Except seven sectors characterized by accelerating increase in added value (e.g. wine and beverage, textiles, manufacture of chemical fibers, transportation equipment, computers and communications, manufacture of measuring instruments and others), the other 24 sectors experienced decelerating increase over the same period last year. Among them, nine sectors saw their added value grow slower than that of the whole industry, namely, agricultural foods, clothing, paper making, printing, cultural and entertainment products, oil processing, processing of ferrous metals, general-purpose equipment, and special-purpose equipment. Outputs of automobiles, iron & steel and other main commodities increased at a lower rate. Added value of the upstream mining went up 4.2%, 0.7 percentage points higher than the same period last year, which was mainly due to the recovering added value of ferrous metals mining and dressing and the narrowing reduction in mining-supportive activities. Production and supply of power, gas and water remained a stable growth rate of 4%.

Figure 11: Growth rate of industrial added value

Figure 12: Price changes to products of overcapacity industries


Source: Wind; Institute of International Finance, BOC

Among the overcapacity industries, outputs of crude steel and flat glass dropped 1.5% and 6.8% year on year, respectively. Increase in outputs of electrolytic aluminum fell to 4.85%. Driven by massive investments in infrastructure and construction, outputs of cement had a recovering growth of 11.2%. Meanwhile, prices of these products are still dropping (Figure 12) with high inventories. In other words, when demands are sluggish, overcapacities are still accumulating.

PMIs of both January and February of 2015 are below 50, and prices of industrial products are dropping at an accelerating pace, which will curb investment and production of enterprises. However, we should see that in order to address the downward trend, the government has adopted a series of measures such as lowering reserve requirements and cutting interest rates, which, to a certain extent, help lessen enterprises' burden. Moreover, the decrease in PPIRM is larger than that in PPI, which means lower production costs of certain middle and downstream enterprises. In the February PMI, new order index and expectations for production recovered to above 50. Generally speaking, the Q1 industrial value added is expected to be around 7.2%.

1.1.5 The property market is subjected to continued adjustments with a number of indicators dropping

During the first quarter, the property market has experienced continued adjustments that kicked off in 2014. While property investments and funding are basically stable, other indicators are continuously dropping.

First, property investments remain stable. During January and February, cumulative property investments went up 10.4% year on year to RMB878.6 billion, and the growth rate remained stable from the end of 2014 (slightly dropping 0.1 percentage points). While maintaining stable, property investments are at the lowest level in the recent five years.

Second, housing sales fall more rapidly. Influenced by the slack season and other factors, housing sales continue to descend. During January and February 2015, China's sold floor areas decreased 16.3% year on year to 87,640,000 square meters, and the decrease was 8.7 percentage points higher than the whole year of 2014. Total income from sales went down 15.8% to RMB597.2 billion, and the reduction was 9.5 percentage points higher than that of 2014 (Figure 13).

Figure 13: Housing sales on the decline

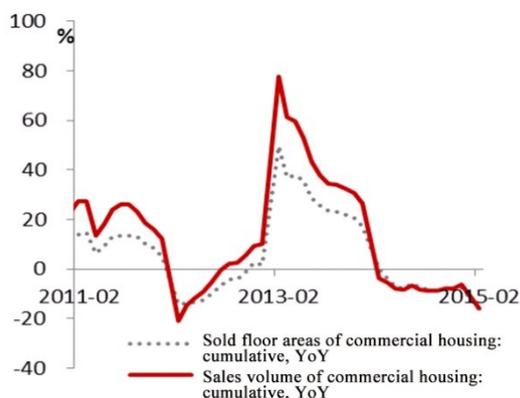
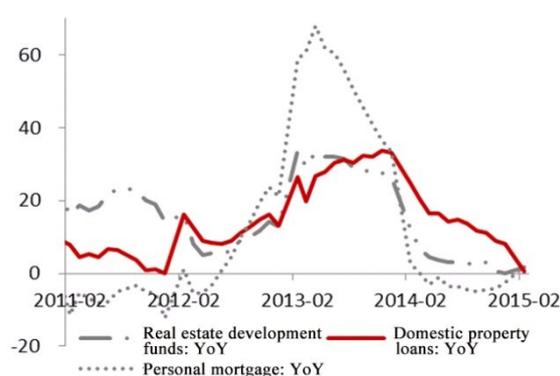


Figure 14: Slightly improving property funding source



Source: Wind; Institute of International Finance, BOC

Third, housing price has a shock-downward trend. After a one-month recovery, housing price returns to the downward track. In February 2015, housing price in 100 cities declined 0.24% month on month, but climbed 0.2% month on month in January. By far, housing price has been falling for 13 consecutive months (except for January 2015, see Table 6). Housing price in tier-one cities fluctuates dramatically, climbing a little in January but falling back in February; that in tier-two cities remains stable; that in tier-three cities sees sharper decline.

Table 6: Housing price with a shock-downward trend

Year		2014										2015	
Month		3	4	5	6	7	8	9	10	11	12	1	2
YoY (%)	Nationwide	10	9.1	7.8	6.5	4.7	3.2	1.12	-0.5	-1.6	-2.69	-3.1	-3.8
	Tier-one cities	20.3	18.5	16.6	14	11.3	9	5.4	2.9	2.1	0.58	0.2	-1.1
	Tier-two cities	8.5	7.5	6.4	4.6	2.8	1.1	-0.4	-1.8	-3.2	-4.28	-4.3	-4.8
	Tier-three cities	3.9	3.1	1.9	0.8	-0.4	-1.3	-2.8	-3.8	-4.9	-5.56	-6	-6.2
MoM (%)	Nationwide	0.38	0.1	-0.32	-1	-0.8	-0.6	-0.9	-0.4	-0.4	-0.44	0.2	-0.2
	Tier-one cities	0.71	0.32	-0.15	-1	-1	-0.3	-0.9	-0.1	0.3	-0.08	0.8	-0.1
	Tier-two cities	0.44	-0.03	-0.35	-1	-0.8	-0.9	-0.8	-0.5	-0.6	-0.38	0	-0.4
	Tier-three cities	-0.04	-0.07	-0.52	-1	-0.7	-0.6	-0.9	-0.8	-0.9	-0.68	-0.2	-0.4

Source: Wind; Institute of International Finance, BOC

Fourth, funding sources of real estate development are slightly improved. During January and February 2015, funding made available to property development went up 1.6% YOY to RMB2.1 trillion, 1.7 percentage points higher than the end of 2014. The improving funding is mainly ascribed to increasing personal mortgage loans at a YOY rate of 2.1%, 4.7 percentage points higher than the end of 2014. Besides, funding of real estate enterprises is improved slightly, which helps lower the risk of collapse of fund chains for some real estate enterprises.

Fifth, leading indicators such as new construction areas and purchased land areas remain weak. During January and February, new construction areas went down 17.7% to 137.44 million square meters, down 7 percentage points from the end of 2014. Purchased land areas decreased 31.7%, down 17.7 percentage points from the end of 2014. This indicates real estate enterprises' inadequate confidence in investment, which curbs future investment growth. Moreover, contraction of the land market will give rise to a reduction in land transfer income, thereby leading to rising debt repayment pressure for certain local governments. During January and February, the turnover of land transaction was RMB69.9 billion, down nearly 30% year on year.

Generally speaking, China's property market is still in the adjustment stage. However, we believe that this round of adjustments will only exert limited impacts on the whole financial system. This is because on the one hand, the Ministry of Finance (MOF) recently released the initiative of "issuing local government bonds to replace part of outstanding government debts", which lowers the liquidity risk of some local government debts caused by property market adjustments. On the other hand, with a new round of fiscal and tax reforms (such as the newly revised budget act) and the appraisal system for local government performance, disadvantages of "land finance" are being addressed, which weakens local governments' motives and moves of stimulating local economic development with real estate development.

I.2 Economic outlook for Q2

I.2.1 Stabilization in economic growth is expected and prices may stay at the low level

It is expected that the domestic and overseas economic development environments will maintain overall stable and exert neutral, event positive influence on China's economic growth in the second quarter.

First, the global economic recovery will be sustained. In the second quarter, the global economy will shift to the new normal featured by "low growth, low inflation and diverging pattern". The US economy will continue to recover. Europe and Japan, stimulated by the quantitative easing (QE), will see their economy back to the recovering track. In a word, the worldwide economic recovery will be continued. Our global report predicts that the world economy will improve in 2015 with a global GDP growth rate of 3%, higher than the 2.6% in 2014.

Second, the effects of policies will gradually emerge. Since the end of last year, with two interest rate cuts, lowered reserve requirements and targeted control through MLF (medium-term lending facility), we have seen relatively high market liquidity and lower interest rates. Flexible adjustments to monetary policy are conducive to spurring investment and consumption as well as reducing financing costs (both stock and increment). The government is expected to further utilize such monetary policies as open market operations, interest rates, required deposit reserve ratio and relending to keep stable growth of monetary credit. The government has clearly stated in its report that it will adopt proactive fiscal policy to sustain the momentum of economic growth. It will expand deficits by RMB270 billion from last year to RMB1.62 trillion and bring the deficit rate up to 2.3%, with priorities given to water conservancy, railway, shantytown overhaul, city infrastructure and people's livelihood in funds allocation. In addition, the government has recently announced the initiative to issue RMB1 trillion local government bonds to replace part of outstanding government debts and has made plans for implementation. The conversion of short-term high-interest-rate bonds into long-term low-interest-rate bonds is helpful for lowering local governments' interest burden and refining the debt structure.

Third, market reforms are advanced steadfastly, and the market is further invigorated by

streamlined administration and delegation of powers. Looking ahead, accelerated market reform, lowered market access threshold, delegation of powers and cancellation of over 200 administrative approval items will invigorate private investments and private enterprises and promote the self-sustained economic development. Meantime, the launch of “Made in China 2025” program will accelerate the transformation of China from a big manufacturer to a powerful manufacturer.

Fourth, the building of the free trade zone and “One Belt and One Road” will become crucial for China’s new round of opening up. “One Belt and One Road”, Beijing-Tianjin-Hebei integrated development, Yangtze River economic belt and other regional strategies will further enhance the level and quality of opening up.

Given all that, GDP growth rate is expected to stay around 7.2% in the second quarter, down 0.3 percentage points from the same period of last year.

In the second quarter, CPI is predicted to hover around the low level. **First, effects of PPI transmission:** As at the end of February, China’s PPI had dropped for 36 consecutive months, and it is expected to drop further due to continuous low prices of bulk commodities and limited expansion of demands on the international market. There is small possibility of turning the table around in the short term. Thus, we expect big pressure on CPI transmitted by the negative PPI growth, and the Q2 PPI is predicted to fall by 3.8%.

Second, importing deflation: We predict that in the second quarter, international prices of bulk commodities will stay low and China is still facing major pressure of importing deflation. According to predictions of IMF, international prices of crude oil, iron ore and copper will be USD56.7/barrel, USD74.1/ton and USD6,239/ton on average in 2015, down 41.1%, 23.5% and 9.1% from 2014, respectively.

Third, carryover effects: We estimate that the carryover factor, which would give rise to an increasing CPI in Q2, will be 0.76%, down 0.71 percentage points from the same period of last year (Table 7). In addition, emerging consumption and business models like online shopping and e-commerce, to some extent, will help lower prices of goods and services.

Table 7: Quarterly carryover factors from 2014 to 2015

Quarter	Q1	Q2	Q3	Q4	Average
2014	1.07	1.47	0.97	0.17	0.92
2015	0.29	0.76	0.49	0.16	0.42

Source: Institute of International Finance, BOC

It is preliminarily predicted that the Q2 CPI will rise about 1.3%, down 0.9 percentage points from the same period last year, down 0.7 from the whole year of 2014, but slightly up 0.1 from the first quarter. Deflation pressure may be relieved a little.

1.2.2 Domestic demand can hardly see notable increase and exports maintain rapid growth

First, consumption growth will remain stable, but hard to pick up notably. Income rise is the base of consumption growth, and rapid income rise is a contributing factor for stable consumption growth. In 2014, actual growth of residents’ disposal income per capita increased 8%, 0.6 percentage point higher than the GDP growth rate (Figure 15). From November 2014 to January 2015, CCI (Consumer Confidence Index) maintained above 105 for three consecutive months, a high level in recent two years (Figure 16), which indicated consumers’ confidence in future income and consumption. This will forcefully shore up stable growth of consumption. Meanwhile, the

government will nurture more consumption growth by means of policy, such as, promoting consumption in information, tourism & leisure, elderly care & housewifery, green undertaking, housing, education, culture and sports and providing broadband network, logistics, express delivery and other guarantees for online shopping and other emerging consumption modes.

Figure 15: Stable growth in urban and rural residents' income

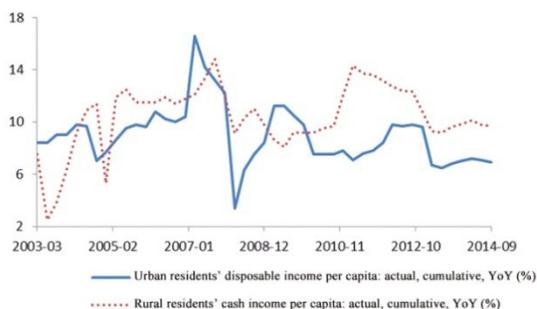
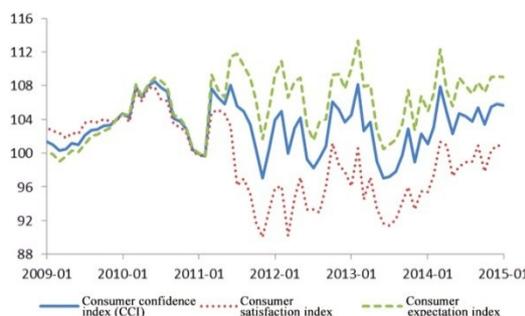


Figure 16: Consumer's upbeat sentiment



Source: Wind; Institute of International Finance, BOC

Second, infrastructure investment is expected to accelerate, which will boost stable growth of fixed asset investment. Due to previous speedy and robust investment and slowing growth of domestic and overseas demands, overcapacities in recent years have occurred in numerous industries with high excessiveness, long duration and difficulty in dissolving. Apart from iron & steel, cement, electrolytic aluminum, shipbuilding and flat glass with serious overcapacities, coal, auto-making, refinery, phosphate fertilizer and others also suffer from overcapacities to various degrees. As PPI has been negative for 36 consecutive months and CPI has been going lower, the manufacturing sector is facing high real interest rates (Figure 17), which restrain rapid growth of manufacturing investment. As of February 2015, new housing construction areas, sold areas and sales volume maintained negative growth for 13 consecutive months (Figure 18), which would further slow down property investment growth. Given high probability of slowing property and manufacturing investment, to stabilize investment growth in the second quarter is tied to rapid growth of investment in infrastructure and some service sectors. In particular, a series of moves by the central government are helpful for stabilizing investment growth, such as expediting funds allocation to water conservancy projects, speeding up investment and financing reforms, promoting PPP model, lowering access thresholds of private capital and encouraging innovative start-ups.

Figure 17: Actual risk-free interest rates stand at a high level

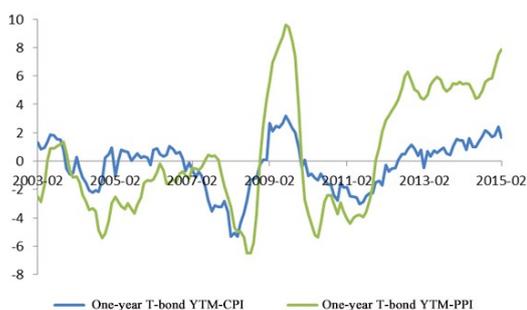
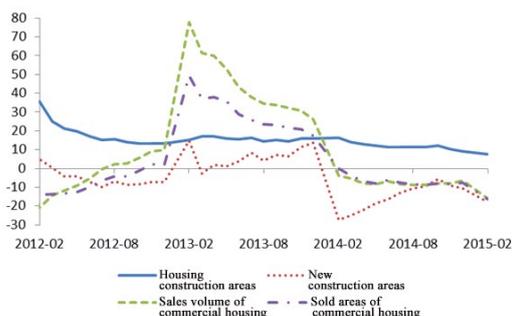


Figure 18: Sluggish new housing construction and housing sales



Source: Wind; Institute of International Finance, BOC

Third, exports are expected to maintain a rapid growth while imports growth will remain weak. In February 2015, new export order index of China's manufacturing PMI was 48.5, lower than the expansion-contraction line of 50 for five consecutive months, but up 0.1 percentage points from January (Figure 19). The Export Leading Index (ELI) released by China Customs was 39.6, lower than all the months of 2014 but slightly up from January. Given the steady recovery of ELI from a low level, improved global economic climate index (Figure 20), and the low base level of last year, China's exports are expected to maintain a rapid growth in the second quarter this year. As for imports, considering the dramatic fall in import prices of bulk commodities year on year, growth of imports is predicted to be weak in the second quarter of 2015, in spite of recovery in domestic demands, like investment.

Figure 19: China Manufacturing PMI-New Export Orders

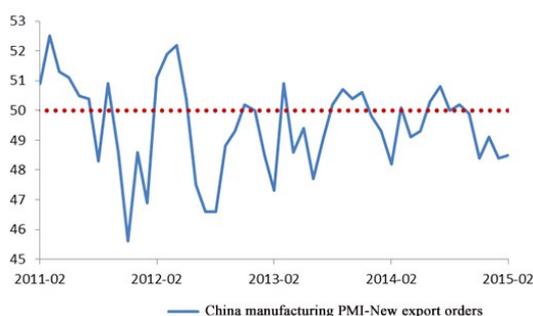
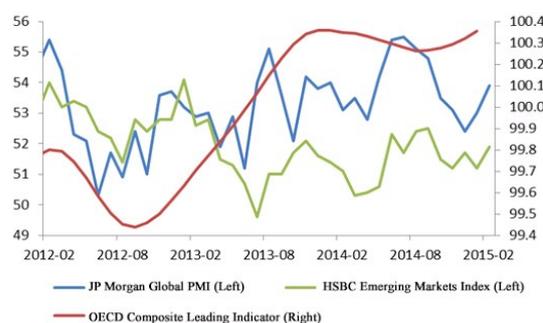


Figure 20: Global economic climate is picking up



Source: Wind; Institute of International Finance, BOC

1.2.3 Infrastructure construction investment will spur minor recovery of industrial production

On the one hand, bank reserve requirement ratio and interest rate cuts in the first quarter will start to show their effects, which, hopefully can lower financing costs and debt risks of real economy and boost enterprises' enthusiasm for investment and production. On the other hand, the starting of such major projects as railway, road, water conservancy etc. will stimulate demand for industrial products. Influenced by these factors, industrial production will probably see mild recovery. However, there are three restrictive factors. First, overcapacity is still a serious problem. PPI will continue to be negative and enterprises' profitability will be relatively low. Second, project implementation will be affected by tight funding and the investment growth may not drive the industry as remarkably as expected. Third, with stricter new environmental protection laws coming into force in 2015 and rising attentions to environmental protection given by the government and the public, industrial production of heavy industry-oriented areas will be affected to some extent. Given all that, industrial value added of the second quarter is expected to increase by about 7.8%; governmental investment will be the major force to drive industrial output; equipment manufacturing such as transportation equipment and computer & communications will maintain rapid growth.

1.2.4 Without sufficient driving force, the property market will fluctuate at the low level

In the second quarter, the property market will be boosted by the following favorable factors. First, interest rate cuts and bank reserve requirement ratio lowering will start to take effects, making it easier for residents to obtain property loans and bringing down the costs of purchasing house. Second, with easing policy, investment in government-subsidized housing will be further accelerated. Third, spring and summer are the peak season for housing sales. Meanwhile, there are

still some factors restricting the development. First, the launch of the immovable property registration will produce adverse impacts on residents' expectations for housing investment. Second, the prospering stock market will draw away part of property investment. Third, the increasingly diversified channels of wealth management and gradual lifting of regulation on individual overseas investment will lower residents' demand for housing investment.

Generally speaking, due to weak driving force, recovery of the property market will still hover around a low level in the second quarter. Specifically, property investment will drop slightly, about 8% to 10% in the second quarter. The drop of housing sales will slow down, and sold areas are expected to fall by around 14%.

II. Financial Review and Outlook

II.1 Financial review for Q1

II.1.1 Growth rate of monetary credit resumes a bit and on-balance-sheet financing gains a bigger weight

In February 2015, the balance of broad money supply (M2) was RMB125.74 trillion, representing a year-on-year increase of 12.5%, 1.7 percentage points higher than the growth of 10.8% in January (Figure 21). The accelerating growth of M2 was mainly due to the following factors. First, proactive macro policy started to show its effects and the release of monetary base increased. The central government lowered bank reserve requirement ratio at the beginning of February, offsetting negative influences on the release of monetary base exerted by decreasing funds outstanding for foreign exchange. Meanwhile, different from the past practice of making fiscal expenses at the end of the first quarter, fiscal deposits already decreased RMB470.5 billion in February, motivating the increase of monetary base. Second, since this year, credit growth has started to recover. The balance of RMB loans increased by 13.9% and 14.3% year on year in January and February, respectively, much higher than that at the end of last year. New RMB loans continue to expand, boosting derivative deposits and supporting stabilization and recovery of M2.

During the first two months of 2015, RMB loans grew rapidly. In January, new RMB loans amounted to RMB1.47 trillion, up RMB151.7 billion from the same period of last year. This is consistent with the practice of increasing lending at the year beginning, when there is sufficient credit line and ample project reserves of banks. In February, the growth momentum was unabated, and new RMB loans reached RMB1.02 trillion, RMB375.2 billion higher than the figure of RMB644.8 billion in February 2014. It is noteworthy that medium- and long-term business loans increased rapidly during January and February. Medium- and long-term loans increased RMB612.1 billion, up RMB107.9 billion year on year in January; while February saw an increment of RMB503.6 billion, up RMB213.1 billion year on year.

Financing aggregate grows stably with substantial structural change in the meantime. New cumulative increment in January and February 2015 was RMB3.4 trillion, a little less than the figure of RMB3.5 trillion during the same period of 2014 (Figure 22). It is noteworthy that the percentage of RMB loans in total financing expanded substantially, reaching 71.7% in January and 84.4% in February. Off-balance-sheet financing dropped rapidly. Entrusted loans, trust loans, undiscounted banker's acceptance bills and other off-balance-sheet financing shrank to 13.7% in January and 5.24% in February. Weak off-balance-sheet financing is partially attributed to the conversion of off-balance-sheet or non-standard financing to on-balance-sheet financing upon maturity; it also indicates that shadow banking is contracting under stricter supervision and weakening demand.

Figure 21: Rapid increase in monetary credit

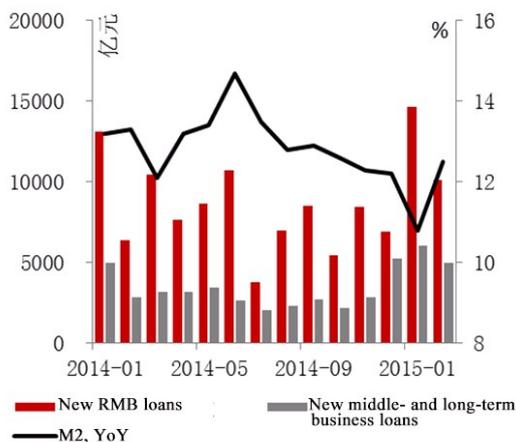
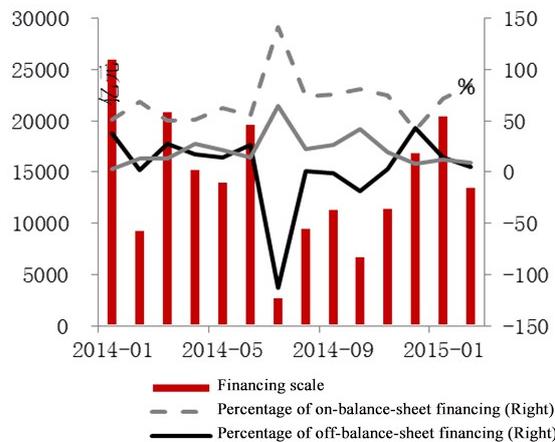


Figure 22: Changed structure of total financing



Source: Wind; Institute of International Finance, BOC

II.1.2 The money market is active with loosening-to-tightening liquidity

Since 2015, the transaction volume of the inter-bank market has been increasing dramatically. During January and February, the inter-bank market witnessed a total turnover of RMB51.57 trillion and a daily turnover of RMB1.36 trillion in the form of call borrowing, spot bonds and bond repo, up RMB21.31 trillion and RMB0.58 trillion, or 71% and 74% from the same period of last year, respectively. Interest rates on the money market went down before going up. In January, to offset the shrinking monetary base and seasonal fluctuations of liquidity before the Spring Festival, the central government conducted 7-day repo operations worth RMB50 billion on January 22, which, plus the RMB319.5 billion additional MLF launched by the central bank, amounted to RMB400 billion liquidity. Given the ample funds on the money market, overnight Shibor and one-week Shibor reduced to 2.67% and 3.89% respectively on January 27, down 86 and 57 BPs from the end of last year (Figure 23). However, due to robust market demands for funds at month end and during the Spring Festival, interest rates of the money market showed an upward trend, and overnight and one-week Shibor climbed to 3.44% and 4.77% respectively at the end of February, up 159 and 124 BPs from the same period of last year.

II.1.3 Interest rates of the bond market continue to drop and medium- and long-term risks are still quite worrisome

During the first quarter, interest rates of all sorts of bond products continuously went down under the influences of bank reserve requirement ratio lowering, interest rate cuts and other favorable policies. On March 16, 2015, the yield curves of one-year and five-year bonds lowered 14.84 and 20.39 BPs respectively from the end of last year (Figure 24). From the perspective of duration, short-term interest rates drop even faster. Take yield to maturity (YTM) of AA enterprise bonds as an example, rates of returns on one-year and five-year bonds went down 56.44 and 49.1 BPs respectively from the end of last year. Yields of one-year bonds fell faster, which indicates that the market is still highly concerned with medium- and long-term risks of bonds.

Figure 23: Movements of overnight and one-week Shibor

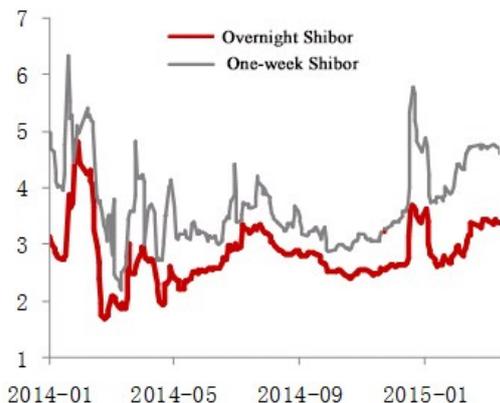
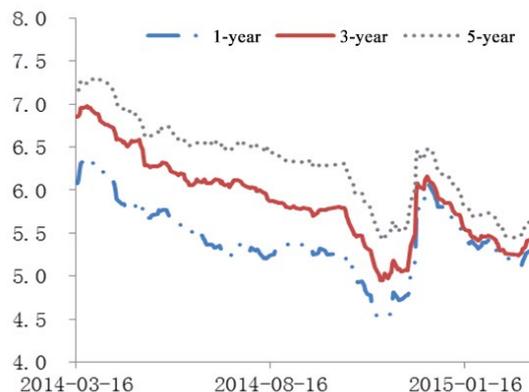


Figure 24: Changes to YTM of AA enterprise bonds

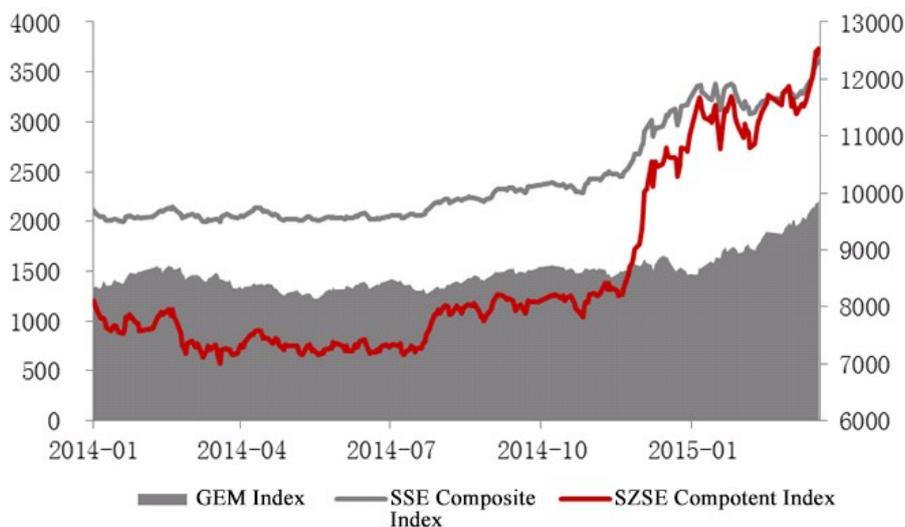


Source: Wind; Institute of International Finance, BOC

II.1.4 Shock-upward SSE and SZSE indices with substantial increase in market turnover

In the wake of rapid increase in November and December last year, the Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE) fluctuated at a low level before picking up again recently. On March 24, the SSE Composite Index once broke 3700 and closed at 3691, setting a new high in the past seven years, up 14.1% from the end of last year. The SZSE Component Index went up 16.2% from the end of last year to close at 12801 (Figure 25). Meanwhile, the Growth Enterprises Market (GEM) has been performing well since this year, which closed at 2358 on March 24, up 60.2% from the end of last year. The turnover went up remarkably. As in the mid and latter March 2015, the cumulative turnover of SSE and SZSE had increased 332% year on year to RMB22.4 trillion. The turnover of GEM amounted to RMB1.57 trillion, representing a year-on-year increase of 115%. It is analyzed that the recent booming stock market is mainly driven by continuous inflow of OTC (over-the-counter) funds, and the elevated expectations for the “growth stabilization” after the NPC and CPPCC and benefits from deepened reforms

Figure 25: Movements of SSE Composite Index, SZSE Component Index and GEM Index



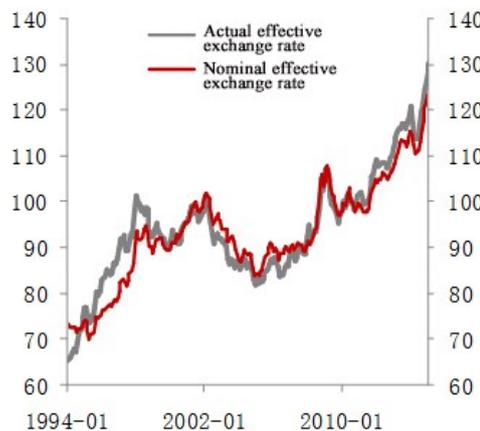
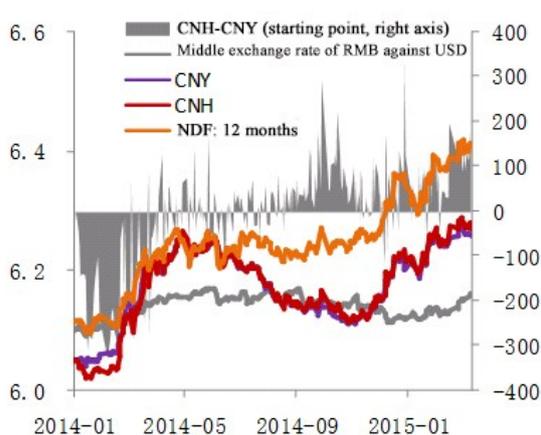
Source: Wind; Institute of International Finance, BOC

II.1.5 RMB-USD exchange rate continue to drop and RMB exchange rates are becoming more volatile

Since 2015, both CNH-USD and CNY-USD exchange rates have been going down, presenting the following characteristics: First, RMB-USD exchange rates showed a continuous depreciating trend before slightly bouncing back in the mid- and latter March. On March 16, the middle exchange rate of RMB against USD was quoted 6.1615, down 0.6% from the year beginning, and went up continuously in the following days to 6.1410 on March 25, up 0.3% from March 16 (Figure 26). Second, spot exchange rates plunged down to the bottom repeatedly, and the CNH-CNY spread widened before narrowing down. Since this year, CNY of the domestic market has been standing within the depreciating range of middle exchange rates. Especially since the beginning of February, it hit or came close to the largest fluctuation of 2% on many trading days. The CNH-CNY spread expanded first to nearly 200 BPs on February 17 before narrowing down during the mid- and latter March to such an extent that CNY was once 50 BPs higher than CNH. Third, effective RMB exchange rates continue to appreciate. As of the end of February 2015, the nominal and actual effective RMB exchange rates went up 1.7% and 3.2%, respectively, from the end of last year (Figure 27).

Figure 26: Movements CNY-USD and CNH-USD exchange rates

Figure 27: Movements of effective RMB exchange rates



Source: Wind; Institute of International Finance, BOC

At present, factors influencing movements of RMB exchange rates are becoming increasingly complex. Since this year, RMB have depreciated slightly against USD and RMB-USD exchange rate has become more volatile, which is mainly attributed to: First, the US economy has a robust recovery and expectations for Fed's interest rate rise heighten continuously. Meantime, developed countries like Japan and European countries show weak performance, while emerging countries present highly diverging trends. In particular, a large amount of capital flows back to the US and USD appreciates robustly, under the influences of the launch of QE by the European Central Bank, political turbulence in Greece, among others. The US Dollar Index (USDX) has cumulatively appreciated about 25% since July 2014, which adds to the pressure of RMB depreciation. Second, China faces the economic downturn pressure. Third, the pressure of capital outflow further fuels RMB depreciation. Due to China's slowing economic growth, general pressure amid emerging markets and increasing volatility of RMB exchange rates, China is suffering from continuous pressure of net cross-border capital outflow, which raises expectations for RMB depreciation.

II.2 Financial outlook for Q2

II.2.1 Money supply and credit growth will remain stable

The government's 2015 work report mentions that M2 is expected to grow around 12% this year, even higher in practice if it is required by economic development. Generally speaking, this year's monetary policy will remain prudent. In consideration that current interest rates are still quite high and financing demands are not released, we expect that M2 still has a downward pressure in the next few months and will maintain a growth rate of 12% in Q1. If the central government makes such adjustments as lowering bank reserve requirement ratios in the second quarter, the growth rate of M2 may rise to around 12.5%.

For the purposes of maintaining stable economic growth and providing funds for the real economy, RMB credit increase this year will not be smaller than that of last year, between 13% and 14% hopefully, and new RMB loans will be RMB10 trillion to RMB11 trillion. Generally speaking, credit extension is quite massive in the first quarter. In the first two months, there was a notable trend of off-balance-sheet financing converted into on-balance-sheet financing, and the credit extension will be around RMB3.5 trillion in the first quarter. Given stricter supervision and weakening financing demands of enterprises, off-balance-sheet financing will not have a big increase and the financing aggregate will remain stable.

II.2.2 Money market liquidity will remain moderate and interest rates may stay stable or drop a little

In the short run, with the slow flow-back of Spring Festival capital and massive seasonal release of fiscal deposits, the liquidity will improve somehow but capital price will remain at a high level in the near future. Looking into the second quarter, we predict that interest rates on the money market will maintain stable. First, USD will continue to appreciate and China will face depreciation pressure of RMB exchange rates and capital outflow pressure in the short run. Therefore, it is highly possible that the central government will replenish monetary base through lowering bank reserve requirement ratios. Second, the MOF released RMB1 trillion local government bonds to replace part of outstanding local government debts, and the replacement of local debts requires adequate liquidity. Third, the central government will continue to supplement liquidity in due course through open market operations, relending, rediscounting, SLF, MLF and other policy instruments to maintain moderate liquidity.

II.2.3 Rates of returns on the bond market will continue to drop and long-term risk premium are expected to diminish

In the second quarter, favorable factors for the reviving bond market include: First, in the light of weak macro-economic fundamentals and the downward trend of funds outstanding for foreign exchange, the easing of monetary policy is highly possible to continue. Second, with the RMB 1 trillion local government bonds in lieu of outstanding government debts released by the MOF, risks of city construction investment bonds will be relieved to some extent. There are also factors restricting the bond market. The bond replacement scheme leads to an increase in refinancing schemes on the bond market, and such increase in new supply would not help to bring down yields of bonds in the short run. Given all that, the bond market will continue to boom with dropping yields, which is beneficial for lowering long-term risk premium.

II.2.4 The stock market shows a powerful upward momentum and may fluctuate in a wide range

The recently resumed A-share market and increasing enthusiasm of investors may attract more OTC capital into the stock market. From March 9 to 13, there were 721,500 newly opened

accounts in SSE and SZSE, up 8.9% from the previous week, much higher than the average of 240,000 and setting another new high since this year. Meantime, the central bank regards capital flow into the stock market as direct supports for the real economy; stock issuance registration reform is about to kick off; Shenzhen-Hong Kong Stock Connect is about to be launched; and pension fund is expected to invest in the stock market. All these factors are fueling the stock market to continuously go upward. Give the unabated economic downward pressure and continuous capital outflow, the future stock market may fluctuate in a wide range, about which we are prudently optimistic.

II.2.5 RMB exchange rates will remain stable for a long time and two-way fluctuations will become normal

In the short run, RMB-USD exchange rates will bear certain depreciation pressure but even if depreciation does happen, it will be a small one. In the long run, RMB will stay stable and two-way fluctuations will become normal. First, China's economic fundamentals are improving in the long term. It is expected that China's GDP will grow about 7.2% in 2015, still a high level in the world. Meanwhile, China will keep surplus in its current account, which helps to stabilize RMB exchange rates. Second, the ample foreign exchange reserves will provide a powerful backing. At the end of 2014, China's foreign exchange reserves hit USD3.84 trillion, and such massive reserves will help us counteract shocks on the economy brought by large-scale outflow of international capital and maintain basic stability of RMB exchange rates. In addition, China still keeps sort of regulation on capital accounts, which enables it to effectively handle sudden large-scale outflow of short-term capital. Third, RMB internationalization will continue to advance. In recent years, recognition of RMB on the international market has been substantially enhanced, and market demands for RMB have been rising continuously. The advancing progress of RMB internationalization calls for stable value of RMB.

II.3 Cross-border RMB Index (CRI) and Off-shore RMB Index (ORI) of Bank of China

On March 16, Bank of China (BOC) released CRI for January 2015, which is shown to be 235, 21 points down from the previous month (Figure 28). Indices of the month demonstrate the following characteristics:

First, the cross-border use of RMB dropped as compared with the previous month. In January, affected by China's falling imports and exports, fluctuating RMB exchange rates and changing interest rates, cross-border use of RMB also plummeted dramatically and CRI shifted back to the downward track. However, in light of seasonal factors at the year beginning and uncertainties in the current economy, future movements of cross-border RMB indices still depend on their performance in the next few months. Second, the RMB current account appeared a monthly net inflow for the first time. The robust appreciation of USD since this year and the weakening RMB against USD is beneficial for our exports to some extent. While imports will continue to stay low due to such factors as lowering prices of bulk commodities on the international market. The widening trade surplus will bring in net RMB inflow. Third, RMB will maintain the world's fifth largest payment currency, only next to USD, euro, GBP and JPY. In addition, RMB has become the second most frequently used currency in documentary L/C and collections in the world.

Figure 28. Cross-border RMB Index of BOC

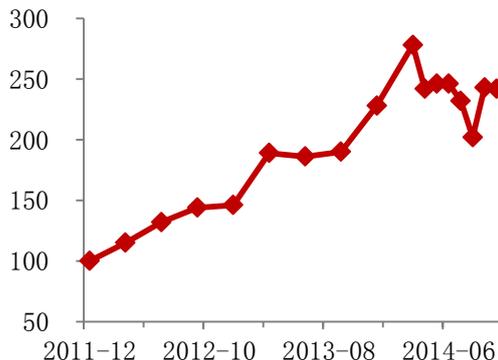
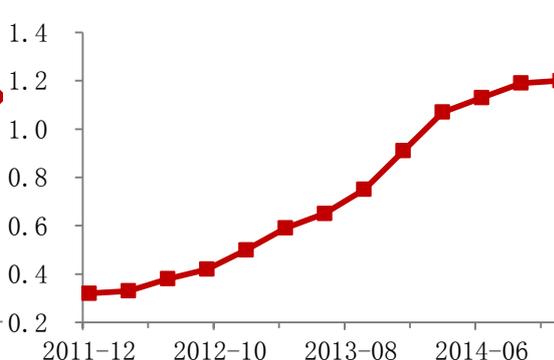


Figure 29: Off-shore RMB Index of BOC



Source: Global Trade Services Department of BOC

On March 19, BOC released ORI for the fourth quarter of 2014. The result showed that ORI for the fourth quarter of 2014 was 1.20%, up 0.07 from June (Figure 29).

The ORI indicates that, first, overseas RMB capital pool continues to expand. As of the end of 2014, overseas RMB deposits were about RMB2.78 trillion, representing a big increase from the year beginning. Second, growth of overseas RMB loans and financing is relatively flat, and the balance of RMB loans held by overseas banks will drop somehow in the third and fourth quarter. Third, the total of international bonds and equity investments denominated in RMB continues to rise and offshore RMB bond has become another important means of financing on the capital market. Fourth, foreign exchange transactions related to RMB are more active. RMB exchange transactions reached USD5.5 trillion during the whole year, increasing over 80% from 2013, while global foreign exchange transactions only grew 10% during the same period. Fifth, progress has been made in including RMB into foreign exchange reserves. In 2014, the British government, Canada's British Columbia government, Australia's New South Wales government and National Social Security Fund of France issued RMB-denominated sovereignty bonds successively. Besides, a number of countries' central banks participated in subscription for fixed-yield RMB products issued overseas.

It is estimated that among the major international currencies during the same period, the offshore USD index was 48.80%, up 0.75 from June; that of euro was 25.92%, down 0.35; that of BGP was 5.80%, down 0.45; and that of JPY was 5.60%, down 0.55. We can tell from these figures that relative positions of major international currencies are changing on a dynamic basis with the drop in importance for euro, BGP and JPY. In spite of the large absolute gap between RMB and other major international currencies in terms of share of use on the offshore market, the relative gap is narrowing down.

Table 8: Forecasts on China's main economic and financial indicators in Q2, 2015 (%)

Indicator	2011 (R)	2012 (R)	2013 (R)	2014 (R)	2015	
					Q1 (E)	Q2 (F)
GDP	9.3	7.7	7.7	7.4	7.0	7.2
Added value of industrial enterprises above designated size	13.9	10	9.7	8.3	7.2	7.8
Fixed asset investment	23.8	20.6	19.6	15.7	13.9	14.0
Total retail sales of consumer goods	17.1	14.3	13.1	12.0	10.7	10.8
Export	20.3	7.9	7.9	6.1	12.0	10.0
Import	24.9	4.3	7.3	0.4	-10.0	-10.0
Consumer Price Index (CPI)	5.4	2.6	2.6	2.0	1.2	1.3
Producer Price Index (PPI)	6.0	-1.7	-1.9	-1.9	-4.4	-3.8
Broad money supply (M2, end of period)	13.6	13.8	13.6	12.2	12.0	12.5

Source: Institute of International Finance, BOC

III. Orientation of Macro Policies

III.1 Proactive fiscal policy will be adopted to sustain the momentum of economic growth and increase economic returns, which will release more effective demands.

In the second quarter, proactive fiscal policy will be stepped up. Meanwhile, the Chinese government will continue to cut tax and reduce fees, deepen the investment and financing reform and tax system reform, and expedite the nurturing of “dual engines”.

First, efforts will be made to increase fiscal expenditure and actively channel social capital. In the second quarter, the government will continue to step up investment in water conservancy, railway, road, information, power, oil, gas, shantytown overhaul, underground pipeline system and other major projects. Major water conservancy projects in the central and western regions will be accelerated and it is expected that the central government will have put in place over 90% of budgetary investment funds by the end of June. Meanwhile, the central government will provide transitional funds for local governments in the form of bridge loan etc. and channel social capital to participate by means of fiscal discounting.

Second, tax cut and fees reduction will be carried on to increase supports for the real economy. The government will crack down on illegal charges so as to substantially increase supports for small and micro enterprises, start-ups and corporate innovation. At the same time, the

government will make use of tax policy to guide acceleration of adjustments in the supply structure, and extend more supports to new products, new businesses and new business models. Emphasis will be placed on completing specific plans on levying value added tax (VAT) on immovables in lieu of business tax, and expanding the coverage of VAT to life service industry, financial industry, construction industry and real estate industry, in a bid to complete the conversion of business tax to VAT within 2015. The scope of ad valorem of resource tax will be enlarged, in a bid to make new progress on tax system reform.

Third, local governments' borrowing and financing system will be innovated and improved to strictly control fiscal and financial risks. Under the new economic normal, the government will focus on balancing the relationship between local government debt management and economic growth stabilization. On the one hand, it will establish a normalized local government borrowing system that combines general debts and specific-purpose debts. The pricing mechanism and market-based constraint mechanism shall be introduced and improved for local government bonds issued and redeemed on their own. The building of accrual basis accounting and comprehensive government financial reporting system will be speeded up. It is planned to issue RMB500 billion general bonds and RMB100 billion specific-purpose bonds this year. On the other hand, outstanding debts and subsequent financing for projects in construction will be properly handled. Outstanding debts, after being sorted and screened, will be categorized and included into budget management, and be replaced gradually so as to lower interest burdens and improve the duration structure. Meanwhile, a grace period will be arranged to prevent collapse of fund chains and fiscal and financial risk.

III.2 Aggregate and targeted controls will be carried out and monetary policy will be made more flexible and prudent

In a traditional sense, the final goal of monetary policy is to ensure the economy running at the potential growth rate. And the major indicators that are used to access consistency between actual economic growth rate and the potential one are employment and prices. If involuntary unemployment increases or prices continuously go down, it indicates that resources are not sufficiently utilized or demands are weak, and discretionary approaches should be adopted in monetary policy to pull the economy closer to the potential growth rate. Based on this, we believe that though the prudent monetary policy shows an easing trend this year, this is only flexible operations in response to the new economic normal, and the tone and orientation of China's monetary policy should be "adjusting" instead of "stimulating". China's future monetary policy will have the following characteristics:

First, the orientation of monetary policy will not change. It is generally held that the target of M2 growth is two to three percentage points higher than the sum of economic growth target and inflation target. The GDP growth target set for this year is about 7%, and the expected inflation rate is 3%, which is consistent with the expected M2 growth rate of 12%. It indicates that China's monetary policy is still prudent in general with no major changes to expect.

Second, to satisfy demands for liquidity, the government will lower bank reserve requirement ratios for hedging. Since USD has shifted to the upward track, the pattern of two-way fluctuations of RMB exchange rates is gradually taking shape and enterprises and individuals are showing an increasing intention of holding foreign exchanges, we expect this year, increase in funds outstanding for foreign exchanges will be quite limited and the gap of monetary base will be quite big. As deposit reserves are playing a role in hedging against increase or reduction in funds outstanding for foreign exchanges and moderating the scale of monetary base, lower reserve requirement ratios, under the context of decreasing funds outstanding for foreign exchanges, is a way for the central government to hedge against liquidity gap. The bank reserve requirement ratios

are expected to lower for two or three times in the future.

Third, in face of continuous lowering prices, the government may wield aggregate-based policy to cope with it flexibly. PPI has been growing negatively for 36 consecutive months, which reflects overcapacities are not improving, manufacturing production is still contracting and growth of real economy is under some pressure. It is necessary for the central bank to adopt aggregate control, deal with the situation flexibly and give play to the positive role of monetary policy on stabilizing economic growth. Lowering of reserve requirement ratios can replenish liquidity of the financial system and encourage banks to increase credit extension. Interest rate cuts may bring down nominal interest rates to guide market interest rates down and reduce enterprises' capital costs, helping them expand reproduction. If the economy continues the downturn in the short run, further interest rate cuts will be highly possible.

Fourth, structured monetary policy will continuously be adopted to mutually supplement aggregate-based policy. Structured monetary policy, which started to appear in the recent years, will be continuously employed in 2015. The reasons are: on the one hand, China's financial market is not running completely in a market-led way and a complete yield curve is still wanting, which makes it impossible for short-term interest rates to effectively produce medium- and long-term effects. Compared with short-term interest rates, medium-term policy-related interest rates are of great significance for lowering financing costs. Thus, it is important to continuously innovate in the policy toolkit and utilize structured policy to guide medium- and long-term interest rates lower. On the other hand, with basically liberalized interest rates, high financing costs are mainly due to high risk premium, and the guiding role of benchmark interest rates is limited. This requires targeted measures to directly support those industries beneficial for economic growth and structural adjustment.

III.3 Reforms in investment and financing systems will be accelerated

First, the government will focus on advancing comprehensive reforms on the investment system, continue to streamline the administration and delegate power to lower levels and cancel and reduce pre-approval conditions and administrative approval items. Major tasks in building the investment project approval system will have been completed by the end of June 2015, connecting the online approval and supervision platforms for investment projects of central ministries and departments. Second, private investment will be encouraged and guided mainly through lowering thresholds, and the ability to supply public products will be enhanced. Uniform market access will be adopted to attract private capital into such major projects as food supply, water conservancy, transportation, energy, ecological and environmental protection, health care and elderly care. Third, with emphasis on accelerating infrastructure construction and based on the portfolio of region-specific strategies for the western area, northeast area, central area and eastern area as well as "One Road and One Belt", Beijing-Tianjin-Hebei integration and Yangtze River economic belt, the government will put in place the "seven project packages" to expand investment in transportation, energy, information, water conservancy and other infrastructure construction.

III.4 New competitive edges in exportation will be nurtured

First, export enterprises will be encouraged to participate in the country's "One Belt and One Road" strategy to expand exports of railway, power, communications, engineering machinery, automobile, airplane and electronic products. Second, regulations on export tax rebate mechanism will be implemented, and unreasonable charges of exports will be cleared away and regulated to reduce enterprises' burdens in import and export. Third, efforts will be made to build an efficient and convenient clearance environment, increase integrated clearance efficiency in Beijing-Tianjin-Hebei and Yangtze River economic belt and implement the *Trade Facilitation Agreement*. Fourth, transformation and upgrading of processing trade will be boosted, scope of the

cross-border e-commerce pilot program will be expanded, innovation in foreign trade business models will be encouraged and development of service trade will be accelerated. Fifth, scale of export credit insurance will be enlarged to insure financing for exported large complete sets of equipment as much as possible. Sixth, the government will adopt more active pro-import policies, promote Europe and the US to increase exports of high and new technologies and widen channels to use foreign exchange reserves.

III.5 Real estate control policy will be loosened

We expect that there is a growing possibility for moderately loosening real estate control policies. First, the government will increase supports for demands of improving housing conditions by lowering the required minimum percentage of down payment for the second house. Meantime, access conditions for the first house and standards for identifying the second house will probably be changed. Second, various measures will be taken to actively reduce the housing stock. For instance, some existing commercial housing will be converted into public rental housing and resettlement housing by means of physical guarantees and money subsidy. For tier-three and tier-four cities with large housing inventory, the government will further lower the access of applying for housing provident funds, lifting some restrictions on buy-house-for-*Hukou* and granting tax subsidies to promote consumption of existing housing. Third, greater efforts will be made to overhaul shantytowns.

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