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BANK OF CHINA

Institute of International Finance

## Global Economic and Financial Outlook

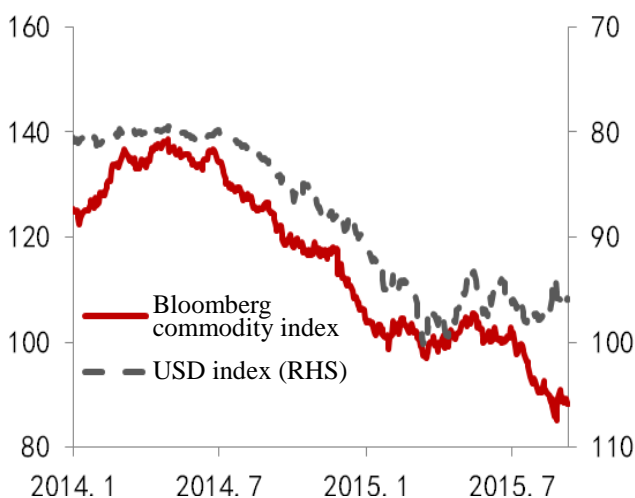
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### Highlights

- In the first three quarters of 2015, developed economies witnessed steady recovery, economic growth in emerging economies continued to slow down, and such countries as Russia and Brazil sunk into a deep recession. The situation is severe.
- Sharp currency depreciation in emerging countries, drastic volatility of stock markets and continuous depression of commodity prices have exacerbated the volatility of global financial market and aggravated systematic financial risk.
- In the last quarter of 2015, it is forecast that global economy will sustain weak recovery, risks that financial market faces will not decrease, and Fed' s rate hike is imminent, which will further lead to spillover effect worldwide.
- This report focuses on the new uncertainties in Fed' s rate hike, economic situation in Europe and the impact of financial turmoil in emerging markets, downward pressure on commodity prices and changes in RMB exchange

### Movement of Commodity Prices and USD Index



Source: BOC Institute of International Finance

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## Global Economy Stumbles forward amid Financial Turmoil

### --Global Economic and Financial Outlook (Q4 2015)

In the first three quarters of 2015, global economy recovered weakly, a new round of financial turmoil broke out in emerging markets alongside corrections in developed countries, and foreign exchange market became notably volatile. It is forecast that in the last quarter global economic and financial situation will still give no reason for optimism, and the spillover effect to be triggered by Fed's rate hike will continue to rage. Hence, we further revised downward global economic growth expectations. This report focuses on new uncertainties in Fed's rate hike, sustainability of European economic recovery, financial fragility of emerging markets, depression of commodity market and impact of RMB exchange rate volatility.

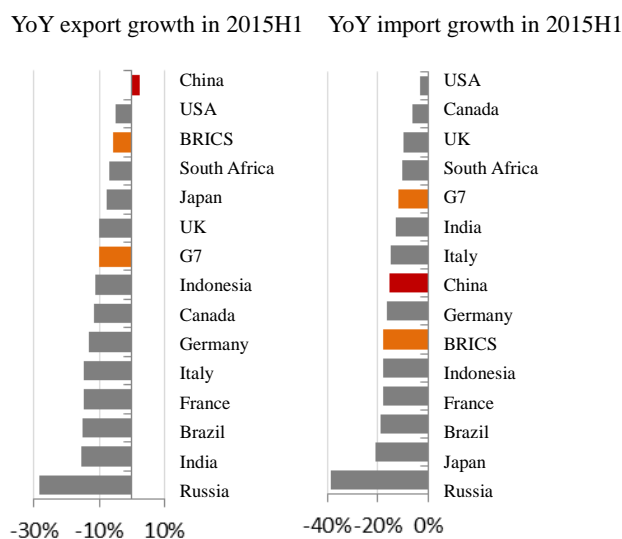
### Part I Quarterly Economic Review and Outlook

#### I. Growth in emerging markets slowed down and global economic recovery remained weak

In the first three quarters of 2015, global economy continuously experienced a sluggish growth. The US and Europe witnessed a modest recovery, but some large emerging economies (Russia and Brazil) have sunk into a deep recession. Since 2015Q3, exacerbated financial turmoil in emerging markets and weaker-than-expected economic growth have partly neutralized the growth of developed economies. According to our estimation, the quarter-on-quarter seasonally-adjusted global economic growth in Q3 is 2.9%, slightly higher than 2.4% in the previous quarter. The year-on-year economic growth slows down to 2.5% (Figure 1).

With financial turmoil abating, global economic growth is expected to inch up to 3.1% in 2015Q4. Since economic growth in emerging countries, typically Russia and Brazil, is slower than expected, we have revised downward global economic growth forecast to 2.6% for 2015, basically the same as the previous year. The growth rate is lower than 3% for the fifth consecutive year, suggesting that global economy has not yet gotten out of crisis.

Due to sharp volatility of exchange rates, depression of commodity prices, weak demand and adjustment of global industrial chain and economic restructuring, global trade experienced the biggest decline in the first half of 2015 since the financial crisis in 2008. Trade in goods in G7 and BRICS declined by 10.9% year on year (Figure 2); China, the largest trader in goods, posted a 7.7% year-on-year decrease in total imports and exports in the first eight months. In April 2015, WTO forecasted a 3.3% growth of world trade in goods this year, but it is not likely at the moment.

**Figure 1: Movement of Global Economy****Figure 2: Trade Growth of G7 and BRICKS**

Sources: BOC Institute of International Finance, OECD

From the last quarter of 2015 to 2016, the global economy is expected to continue slow recovery against higher downturn risk. In developed countries, diverging economic recovery will result in differentiation of monetary policy. The Fed and Bank of England are forecast to raise interest rates for the first time in the recent decade. However, European Central Bank and Bank of Japan are still likely to expand quantitative easing (QE) policy. The resulting international capital flow and foreign exchange market turbulence will continue affecting global economic and financial stability. UK's possible exit of the EU will deal a blow to European integration. If commodity prices stay depressed, Canada and Australia will continuously suffer negative impact.

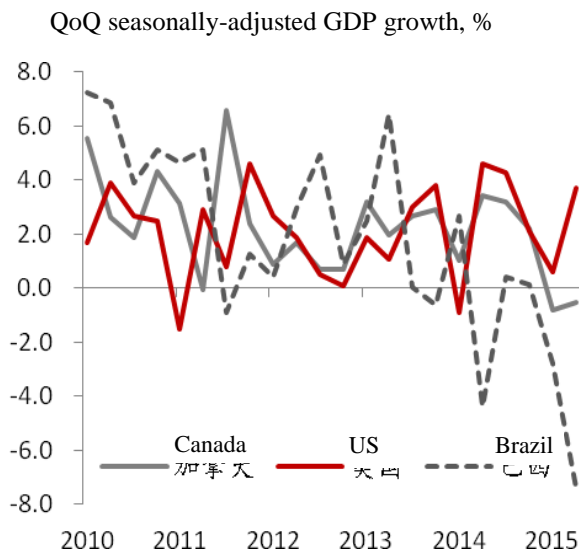
In emerging markets, political and economic uncertainties will continuously put pressure on financial market. For example, the fight against IS terrorism and refugee crisis will continue in the Middle East, and the security problem and domestic political risks in Turkey will deteriorate; deepening economic recession, investigation into oil company corruption and the falling support rate of president in Brazil will possibly trigger political risk and exert an adverse impact on the government's economic stimulation policy; India's land acquisition bill and commodity service tax law reform fails to be supported by the public, leading to question over the country's ability to sustain a higher economic growth through domestic reform.

## II. Some new features and trends of global economy

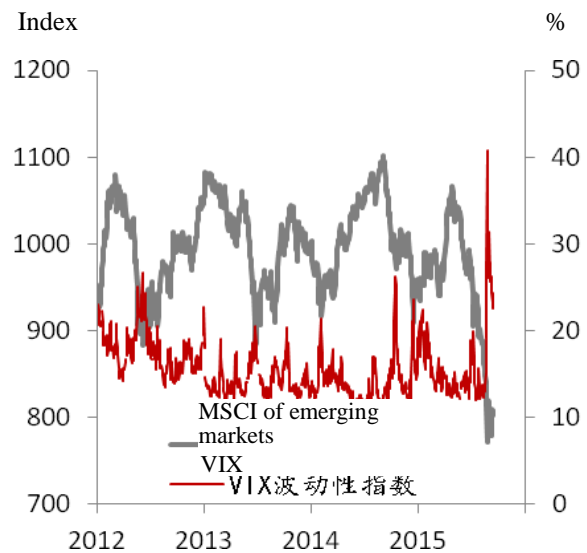
**First, the US is the cause for international economic and financial turmoil with a falling role in driving global economy.** By 2014, the US still contributed 22.5% of global GDP. According to our latest forecast, the US will record a 2.5% economic growth in 2015, the highest among developed countries. However, Canada and Latin America which have the closest economic and trade ties with the US encounter economic downturn or depression (Figure 3) in 2015. The sluggish economy and financial turmoil in other regions contrast sharply with the steady recovery in the US. It is partly attributed to the reindustrialization policy and oil and gas resource development in the US that leads to a decline in global commodity demand. For example, the US has turned into a net energy exporter, intensifying the depression of global commodity prices. Second, the uncertainties in Fed's rate hike and QE tapering have triggered several rounds of

international financial turmoil and become the source of global economic instability, posing a serious impact on emerging markets (Figure 4). Third, foreign policies of the US, including sanctions against Russia and Iran, military interventions in the Middle East and Northern African countries and return to Asia-Pacific, have given rise to geopolitical tension and disturbed the stability and recovery of these regions. Moreover, the speculative force in the financial market of the US has a huge influence on global markets.

**Figure 3: Economic Divergence between the US and American Countries**



**Figure 4: MSCI Movement and Volatility in Emerging Markets**



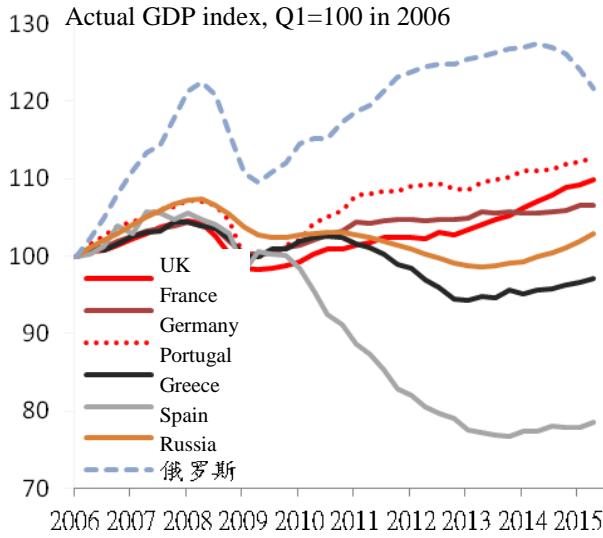
Sources: Wind, BOC Institute of International Finance

**Second, European economies are diverging despite modest recovery.** Despite stable recovery in Europe since 2015, good-performing countries are only limited to such core countries as UK, Germany and France as well as some emerging markets in East Europe. Peripheral Euro area countries in debt crisis are still at the economic bottom, and Russia suffers a double dip as a result of economic sanction by the US and European countries and the falling international oil price, dragging on economic recovery in East Europe.

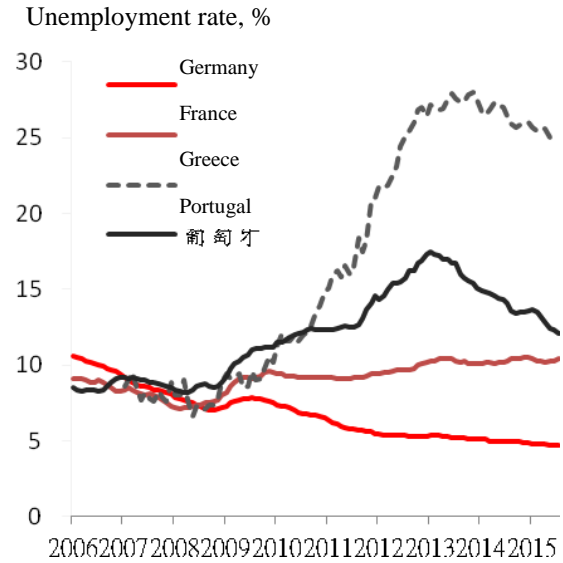
According to our latest forecast, economic growth in the UK and Euro area will reach 2.6% and 1.5% respectively in 2015, and Euro area's economic recovery will be mainly fueled by oil price drop, QE policy and euro weakness. Judging from real GDP, economy of peripheral countries like Greece and Portugal in 2015Q2 is only equivalent to 74.6% and 93.0% of the peak levels prior to the financial crisis in 2008 (Figure 5), indicating that the two countries are still at the economic bottom with a high unemployment rate (Figure 6). Russia is expected to post a GDP decrease of 3.5% in 2015, directly dragging on the emerging East European markets to a negative growth.

In the context of single currency and international oil price volatility, the divergence of economic recovery in Europe is essentially the transfer of production and employment between core countries and peripheral countries in Euro area and the transfer of economic growth between oil importers and exporters. Overall, Europe's economic recovery remains fragile, and it will take a long time to get out of crisis.

**Figure 5: Economic Recovery Progress of Some European Countries**



**Figure 6: Unemployment Rates of Some European Countries**



Sources: Wind, BOC Institute of International Finance

**Table 1: Global Economic Trend and Growth Forecast of Major Economies (%)**

Region	Year/Quarter Country	2013	2014	2015 <sup>f</sup>	2014				2015			
					Q1	Q2	Q3	Q4	Q1	Q2	Q3 <sup>e</sup>	Q4 <sup>f</sup>
America	US	2.2	2.4	2.5	-0.9	4.6	4.3	2.1	0.6	3.7	2.5	2.5
	Canada	2.0	2.4	1.0	1.0	3.4	3.2	2.2	-0.8	-0.5	1.5	2.0
	Mexico	1.4	2.1	2.2	2.0	3.2	2.4	2.8	1.7	2.0	2.5	2.5
	Brazil	2.5	0.0	-3.0	2.7	-4.4	0.4	0.2	-3.0	-7.2	-2.0	-1.0
	Chile	4.2	1.9	2.5	3.5	-0.3	1.3	3.2	4.5	0.0	3.0	2.0
	Argentina	2.9	0.5	1.5	-1.9	3.3	-0.3	1.3	0.8	4.0	1.0	0.5
Asia-Pacific	Japan	1.6	-0.1	0.8	4.5	-7.6	-1.1	1.3	4.5	-1.2	1.3	1.0
	Australia	2.1	2.7	2.5	3.6	2.5	1.5	2.2	3.6	0.7	2.8	3.0
	China	7.7	7.3	7.0	6.6	7.8	7.8	6.1	5.7	7.0	6.5	7.0
	India	6.4	7.3	7.5	6.6	7.4	8.9	5.3	8.2	6.5	7.5	7.8
	South Korea	3.0	3.3	3.0	4.4	2.0	3.2	1.1	3.3	1.3	3.5	3.5
	Indonesia	5.6	5.0	4.5	4.9	4.9	4.8	4.8	4.5	4.7	4.0	4.5
Europe and Africa	Euro Zone	-0.5	0.9	1.5	0.8	0.3	1.0	1.6	2.1	1.4	2.0	2.0
	UK	1.7	2.8	2.6	3.6	3.7	2.9	3.4	1.5	2.7	3.0	3.0
	Switzerland	1.9	2.0	1.0	2.1	0.5	2.4	2.9	-0.9	1.0	1.5	1.0
	Russia	1.3	0.6	-3.5	0.6	1.5	-1.3	-2.7	-6.1	-7.8	-0.5	1.0
	Turkey	4.2	2.9	3.5	5.9	-0.9	1.5	4.0	6.0	5.5	5.0	5.0
	South Africa	2.2	1.5	1.5	-1.6	0.5	2.1	4.1	1.3	-1.3	2.0	2.0
Global GDP		2.5	2.7	2.6	2.2	2.6	3.3	2.6	2.2	2.4	2.9	3.1

Note: Quarterly GDP growth rate stands for quarter-on-quarter seasonally-adjusted GDP growth, e for estimates and f for forecast.

Source: BOC Institute of International Finance

**Third, decelerated economic growth in Asia-Pacific region should not be regarded as cause for market turbulence.** Asia-Pacific region has the most economic dynamism in the world, of which Chinese economy contributes more than 25% of global economic growth though its economic growth is slowing down. In the second half of 2015, some analysts attribute the financial market turbulence to China's economic slowdown and reform in RMB central parity rate formation mechanism, which are actually exaggerated and misleading. Economic slowdown of emerging economies, typically China, is partly caused by currency depreciation of many countries and international capital outflow triggered by potential Fed's rate hike. Compared with other regions, Asia-Pacific region's real economy has the most stable performance. We forecast that Asia-Pacific emerging economies will maintain an economic growth of over 6%, less than 0.5 percentage points lower than the growth in the previous year; Asia-Pacific developed economies perform relatively well. Economic growth of major economies like Japan and India quickens up in comparison with the previous year. South Korea and ASEAN countries have many bright spots, including intensification of regional integration, sharpening of competitive edge and steady domestic demand. Asia-Pacific region is still the main driving force for global economic growth (Table 1).

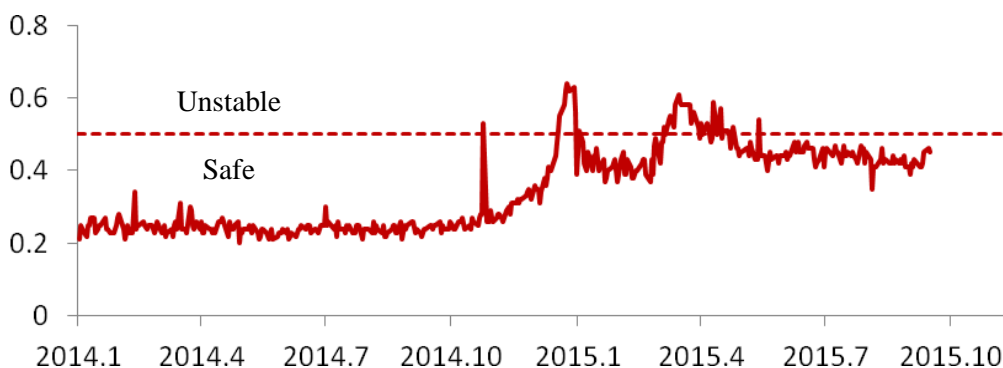
## Part II Quartely Financial Review and Outlook

### I. Global financial market fluctuations intensifies

#### I.1 US money market becomes a temporary safe heaven

In 2015Q3, many investors temporarily transferred funds from stocks and bonds to money market against the global financial market turmoil, driving up assets of the US money market to USD2.7 trillion at the end of August, the highest level in five months. The A2/P2 interest spread of commercial drafts reflecting the stability of money market of non-financial institutions dipped in Q3, and finds it hard to decrease to the level in 2014 (Figure 7).

Figure 7: 30DA2/P2 Interest Spread of Non-financial Commercial Drafts in the US (%)



Source: Fed

#### I.2 Stock markets become volatile

Major stock markets in the globe were dramatically volatile in 2015Q3, especially in August when stock prices slumped and volatility increased sharply. Driving factors include uncertainties in Fed's interest rate policy; deceleration of global economy; price decline and correction after price distortion caused by price distortion following stock market rally. For example, PE of US S&P 500

index keeps increasing in recent years and reached 27 in June, higher than the historical average of 21. Many factors combined trigger stock market correction, and stock volatility index VIX has entered dangerous area for the first time since the European debt crisis in 2011.

As the economic fundamental of the US is sound, stock market decline is possibly market correction and it is unlikely to further dip 20% and enter bearish market. As viewed from historical experience, an over 20% dip in the US stock market is generally accompanied with economic recession and yield curve inversion. In the future, stock market volatility is likely to remain high for a certain period of time. It should be noted that margin financing in the US stock market skyrockets over the past several years due to market stability and fund adequacy, and its proportion in GDP increased to a dangerous level of 2.7% in Q3. When the market volatility increases, leveraged investors will usually shrink debts and sell off stocks, possibly impairing the support role of fundamental and further dragging on the stock market.

Stock markets of emerging markets nosedived in Q3 and dropped by nearly 40% from the peak in April to the end of August, technically suggesting that stock markets have been bearish. The 12-month PE of MSCI emerging market stocks is 10.8, lower than the average value of 11 and 15.4 in the global market. Volatility of stock markets in emerging markets soared substantially in Q3, far higher than the historical level and approaching to the level during the market turbulence in 2011. The correlation between stock markets of emerging markets (S&P emerging market BMI) surged to 0.38 in Q3, far higher than the historical average of 0.2. The yield dispersion of stock markets in emerging markets declined to 8.2% in Q3, lower than the historical average of 9%. Increasing correlation and shrinking dispersion mean decline in investor diversification and increase in systematic risk.

### **I.3 Bond market risks increase**

Global economic slowdown and energy price drop in Q3 drive up market risk and default risk of global corporate bonds. Risks mainly come from emerging markets, energy sources and high-yield products. The driving factors for the increase and decrease of US government bond yield appear alternately. The economic and inflation uptrend and China's sell-off of US government bonds drive up yield increase; however, market capital's reflux into US government bonds holds back yield increase. This trend will possibly continue in the last quarter, and extreme change in US government bonds is less likely but volatility may go up. Since long-term bond maturity and risk premium remain low, unexpected changes, including inflation and abrupt hike of short-term interest rates may give rise to interest rate.

In emerging markets, corporate bonds outperform stocks, and issuance and fund inflow decelerate but still keep increasing. Bond market risks will possibly go up due to slowdown of economic growth in emerging markets, fall in energy price, decrease in corporate profits and rising interest spread and dropping liquidity of high-yield corporate bonds and government bonds. Given that USD-denominated bonds account for up to 40% of total, interest rate hike and USD appreciation in the US will drive up the repayment and refinancing pressure of USD bond debtors, particularly in Turkey and Brazil.

### **I.4 Currencies of emerging markets generally depreciate in foreign exchange market**

In the context of falling energy price and decelerating global economy, currencies of major exporting countries depreciate. In 2015, Malaysian Ringgit depreciated nearly 15% against USD to the lowest level over the past 17 years; the exchange rate of Indonesian Rupiah against USD once dipped to the bottom after July 1998; Thailand Baht accumulatively depreciated nearly 9%, and Indian Rupee and Philippines Peso accumulatively dropped nearly 5%. The GDP-weighted average exchange rate of 15 currencies of emerging markets against USD fell 9.4% in 2015Q3, which is

only second to the drop in the Asian financial crisis in 1990s. Currencies are likely to further depreciate on account of rising uncertainties in Fed's interest rate policy and financial market pressure of emerging markets.

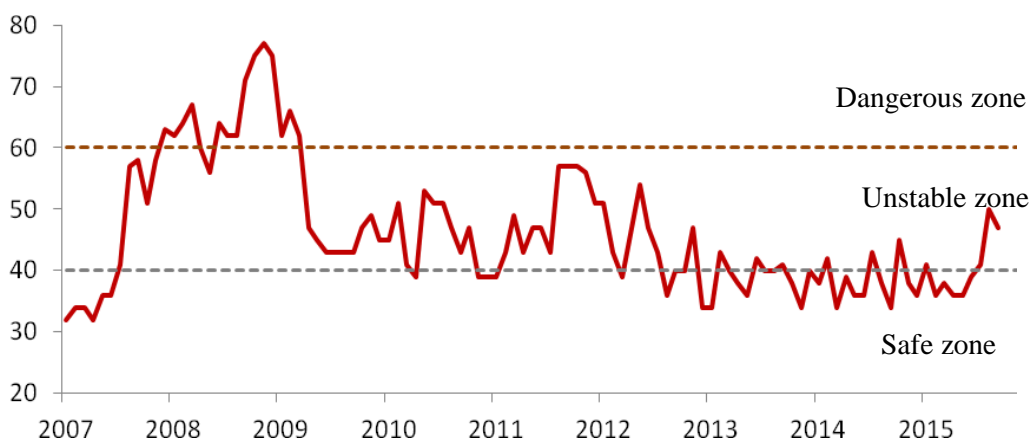
### I.5 Commodity market stays depressed

Global oil prices remain volatile in Q3. Such factors as global economic slowdown and stock market slump push oil price to a six-year low; however, the better-than-expected economic data of the US and crude oil inventory rise once drive oil price up. With the oil price drop, non-OPEC countries, including the US, will gradually reduce their crude oil output. In the short term, OPEC will not cut oil output, and global crude inventories will remain sufficient. In parallel with the slowdown of global economic growth, oil price will face downside pressure. US EIA predicts that the monthly average price of West Texas crude WTI in November 2015 is USD34-USD64 per barrel at the confidence level of 95%; OPEC members forecast that Brent crude oil will range from USD40 to USD50 per barrel by the end of 2015.

## II. The US financial risk monitoring indicator enters the unstable zone, and financial risks in the emerging markets increase

In 2015Q3, the monthly average of the risk of financial crisis index (ROFCI) in the US that we prepare rose from 37 in the previous quarter to 46, enters the unstable zone for the first time since 2013Q3, and has the biggest rise in August (Figure 8). Major risk factors include exacerbated volatility of stock markets, quick rise of risks in banks' stocks and bonds, and increase in corporate credit risk and volatility of foreign exchange market. However, money market remained relatively stable. It is forecast that Fed's interest rate policy change in 2015Q4 may impact on financial market stability, and ROFCI is likely to remain unstable.

**Figure 8: Trend of ROFCI**



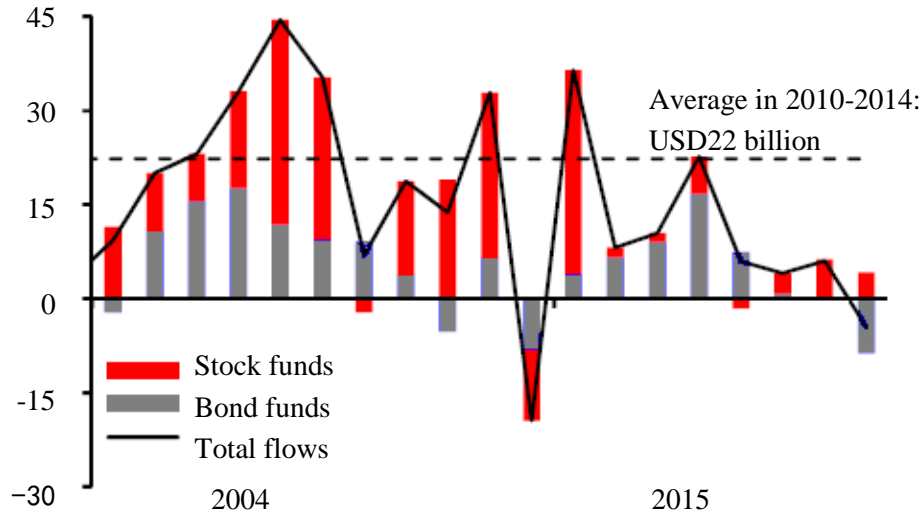
Sources: New York Branch of BOC, BOC Institute of International Finance

Viewing from cross-border fund flow, emerging markets witnessed a net outflow of nonresident financial assets in 2015Q3. In August, net outflow of stock funds reached USD8.7 billion, and net inflow of bond funds dropped to USD4.2 billion. Since 2015, net capital inflow in emerging markets is far lower than the average monthly net inflow over the past five years (Figure 9). Net outflow mainly takes place in Asia and Europe due to exceptions for Fed's rate hike, energy price dip and pressure of economic slowdown in emerging markets, which have triggered reallocation of financial assets. In Q3, the proportion of stocks and bonds in emerging markets in the global

markets dropped to 11%, approaching the level during the Asian financial crisis in 2008. The capital outflow pressure of emerging markets will remain big in the future.

**Figure 9: Net Inflow of Nonresident Securities Investments in Emerging Markets**

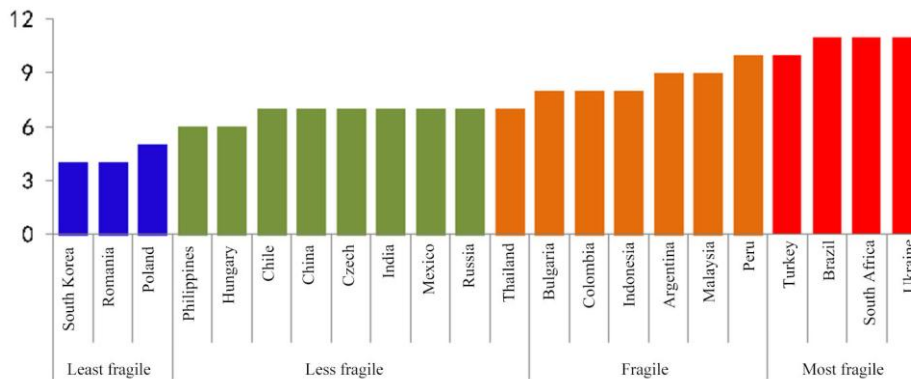
Unit: USD1 billion



Source: IIF

According to the data of the International Institute of Finance (IIF) in September 2015, financial fragility index of a country is composed of external financial fragility (mainly based on the country’s dependence on foreign investment), domestic financial fragility (mainly based on the status of the country’s financial sector and real economy) and economic policy fragility (mainly based on the policy’s reliability and political stability). The financial fragility of the country is scored based on the comprehensive analysis of the three items above. The least fragile is 3-4 points, relatively less fragile is 5-7 points, fragile is 8-10 points and most fragile is 11-12 points. In this sense, the countries with the most external financial fragility in 2015Q3 include South Africa, Argentina, Ukraine, Bulgaria, Malaysia and Turkey; countries with the most domestic financial fragility include Peru, Indonesia, Brazil and Turkey; countries with the most policy fragility include Russia, South Africa, Brazil, Argentina and Ukraine. Overall, the countries with the most financial fragility are Brazil, South Africa and Ukraine, which are followed by Bulgaria, Indonesia, Argentina, Colombia, Malaysia, Peru and Turkey.

**Figure 10: Financial Fragility Indicator of 22 Emerging Countries (September 2015)**



Sources: IIF, BOC Institute of International Finance

Judging from changes, the financial fragility of emerging markets in 2015Q3 is characterized by less least fragile countries and most fragile countries, as well as increase of less fragile countries to 10 from originally eight. The total score of overall fragility of 22 countries rises to 169 from 163. It should be specially noted that the number of the countries with the least external fragility increases to six from three as a result of global financial turmoil. In the near future, we must pay particular attention to the risk that financial crisis may take place in the most financial fragile countries (including Ukraine, South Africa, Brazil, Turkey, Peru, Malaysia and Argentina).

## Part III Hot Topic Analysis

### I. New uncertainties in Fed's interest rate policy normalization

#### I.1 Market turbulence postpones Fed's monetary policy normalization

While talking about US interest rate normalization in the Q2 report, we mention that according to the attitude of the Federal Open Market Committee (FOMC), the start time and rhythm of monetary policy normalization will depend on the employment condition and the assessment result of inflation rate moving towards the target of 2% in the US. According to the employment data of the US in August 2015, non-agriculture unemployment rate was 5.1%, the lowest after April 2008; the number of employed people increased 170,000 in the month, lower than market expectations, but the figure was revised upward in both June and July, increasing the three-month average to 221,000.

Judging from the current situation, unemployment rate has triggered the level that the Fed initiates monetary policy normalization, but the inflation rate is still less than its target of 2%. Fischer, Vice Chairman of the Fed, stated at the conference in Jackson Hole that the inflation rate and its depressed expectation should be attributed to the price decline of energy sources, particularly oil, and therefore it is temporary and will gradually return to normal. Based on the two factors above, we forecast in the Q2 report that the Fed is likely to raise interest rates in September.

Entering mid-August, major stock indices of the US slumped, exacerbating global financial market turmoil. As at August 25, DJW dipped 12% from a recent peak on August 17, and Nasdaq and S&P 500 lost 13% and 12.5% respectively. On August 26, China's central bank implemented the easing monetary policy by cutting RMB benchmark deposit and lending interest rates of financial institutions to stimulate economy, driving global stock markets up for two consecutive days; DJW, Nasdaq and S&P indices rebounded 3.95%, 4.24% and 3.9% respectively, which, however, were still lower than the recent peak levels. Volatility of the US stock market swelled at the end of August. VIX index once topped 40, and VVIX even exceeded the highest level since the financial crisis in 2008; euro showed a negative correlation with US S&P 500 index and became a safe-haven currency. This scenario is similar to that before the financial crisis. After the end of August, the market started to suppose that financial market volatility was likely to be one of the factors drawing attention from the Fed in the near future, and the probability of interest rate hike that the federal funds futures market expects decreased to less than 30% from 50% when the stock market slumped.

How to assess the US stock market slump at the end of August? In the crash of global stock markets, the US stock market only lost USD2.75 trillion and still gained 157% (USD13.7 trillion) as compared to the bottom in 2009, though it experienced a drastic correction. Based on the rule of thumb of wealth effect, for every dollar that the stock market loses, consumers' consumption value

will decrease by two cents and the domestic consumption in the US will decline by about USD55 billion in the coming two years. Certainly, the negative effect may exceed pure wealth effect, particularly when the global economy sinks into an overall recession that will deal a heavy blow to US exports and pose negative influence on its future economic growth. In other words, the Fed is likely to accept only reasonable volatility of global financial market. This year, Yellen, Chairman of the Fed, once complained that the financial market is too calm to reflect the Fed's rate hike expectation in market volatility.

At the FOMC conference on September 16 and 17, the Fed resolves to remain interest rates unchanged in view of the conditions of global and surrounding financial markets, including global stock market slump, USD appreciation and widening of risk interest spread. Certainly, the slump and volatility of US stock market have gone beyond the tolerance of the Fed and led to a decline in consumer confidence and liquidity squeeze in global financial market. Meanwhile, we note that the movement of interest margin of corporate credits poses a potential impact on banks and even the entire financial system; emerging countries like Brazil are facing serious economic recession and financial turmoil.

### **I.2 Reassessment and forecast of US interest rate movement**

Despite the foregoing uncertainties in financial market, we still believe the Fed is likely to raise interest rates once by the end of this year because it needs to nail down the long-term expectations for monetary policy normalization and instill more stability and confidence into the market. Based on the employment and inflation status and expectation in the US and the conservative estimation of long-term labor productivity and population growth in the country in the future, our forecast of the US Federal funds in the next two years (2016 and 2017) tends to be more prudent. The interest rate hike in the two years is likely to be slower than previous expectations and the interest rate policy normalization will be further prolonged.

### **I.3 Influence of Fed's policy change on global economy**

In the previous quarterly report, we have comprehensively analyzed the influence of the Fed's rate hike on the global market, and conclude that such influence on emerging economies and developed countries is controllable. If the Fed's rate hike rhythm further slows down as the analyzes above, we hold that the emerging markets' USD debt pressure will be moderately relieved, and the motive for arbitrage between European currencies and USD as well as yen and USD will decline, and USD DXY index will remain flat for a certain period.

To diminish the uncertainties of interest rate policy, the Fed should intensify effective communication with the market. At present, there are certain differences between market expectations and Fed signals, resulting in market uncertainties that will gradually decrease with the Fed's clarification of monetary policy normalization.

## **II. Sustainability of economic recovery and prospect of monetary policy in EU**

In the face of financial turmoil and economic slowdown in emerging markets, EU overcomes the trouble caused by Greece debt crisis and sustains steady recovery. The continuous recovery of EU, the largest economy in the world, will make important contributions to global economic stability in the future.

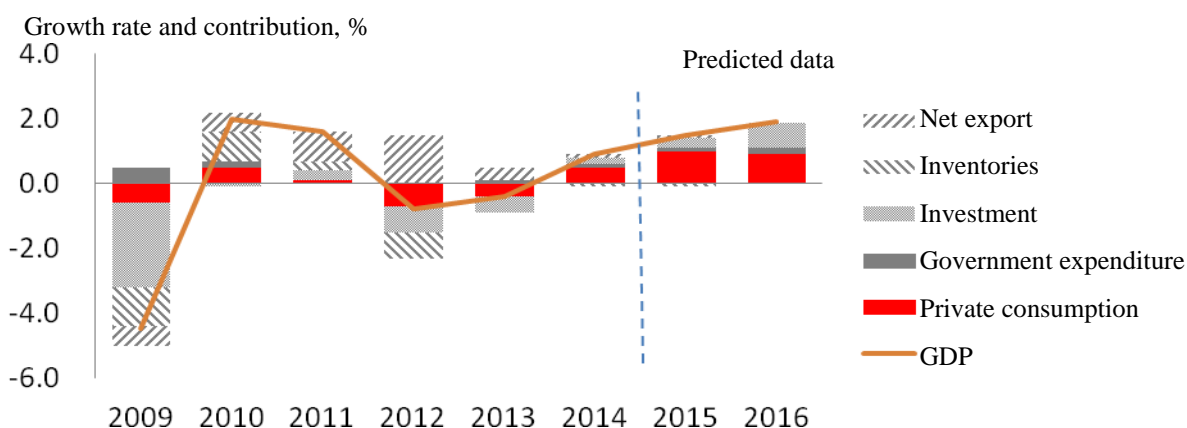
### **II.1 Domestic demand is a major driving force for economic recovery in EU**

In 2015Q2, EU posted a quarter-on-quarter GDP growth of 0.4%, showing a stable and modest recovery trend, and all members have realized a positive growth. Among the major contributors, such core countries as UK and Germany played an important role. Spain's GDP grew at 1%,

maintaining a strong momentum; Italy put an end to nearly three-year stagnation and achieved modest recovery for two consecutive quarters in the first half of this year; Greece resuscitated quickly with a 0.9% GDP growth in Q2, without being influenced by its debt crisis. However, France and the Netherlands were nearly stagnant in Q2 following a strong growth in the previous quarter, indicating Europe was still clouded by uncertain factors and economic recovery dynamism should be further strengthened.

Compared with historical data of economic recovery in EU, consumption growth driven by domestic demand undoubtedly has become the major driving force for economic growth at present. UK's family consumption expenditure rose 3.3% year on year and 0.7% quarter on quarter in 2015Q2, realizing positive growth for the 16th consecutive quarter; government expenditure grew by 0.9%, 1.9% faster than a year earlier. In Euro area, energy price collapse has triggered shopping spree, driving up the contribution of private consumption to more than 50% of GDP last year and even two thirds of GDP this year; investment also increased for two consecutive years and is expected to rebound faster in 2016. Net export has a small contribution due to weak external demand (Figure 11).

**Figure 11: Euro Area Economic Growth Prospect and Contribution Factors**



Source: European Commission

## II.2 External environment basically benefits economic recovery in Europe

Judging from external environment, some factors that are deemed negative previously will benefit European economy in a certain period, despite the weakness of global demand. Europe's economic recovery is supported by various positive external factors, including low international oil prices, stable economic growth in the US, continuous depreciation of euro and initiation of QE on a full scale; moreover, Greece's debt problem has been solved, the geopolitical tension triggered by Ukraine crisis has been eased, and capital flows from emerging markets back to Europe. All these factors will contribute to Europe's economic recovery. However, the monetary policy normalization in the US will give rise to financial market volatility and pose a certain negative influence on European economy. In the short term, positive factors play an active role, while negative factors are relatively impaired. Overall, advantages outweigh disadvantages, and the low oil price, weak exchange rates and zero interest rate will help spur the modest recovery of European economy.

## II.3 The driving force of QE policy of European Central Bank starts to emerge

It has been nearly six months since European Central Bank formally launched QE in March this year. The data disclosed by Eurostat show that various indicators are getting better:

seasonally-adjusted unemployment rate in Euro area dropped to 10.9% in July, the lowest since February 2012; economic sentiment index in Euro area increased to 104.2 in August, hitting a four-year high; the proportion of national fiscal deficits further declined. Though several months are too short to certify that QE plays a critical role, the performance of Euro area in the first half of 2015 depended on the oil price to a certain degree (Table 2). With the gradual rebound of oil price, whether GDP can grow as expected remains to be seen, and the role of QE will be tested in the second half of 2015 and the whole year of 2016. It is certain that Euro area members must continue to carry out structural reforms, quicken the pace of investment, pursue responsible fiscal policy and take various steps to boost Euro area economy.

**Table 2: Factors for Euro Area GDP Growth in 2015**

Estimated GDP growth in 2015 (%)	1.5
- Potential output growth	0.8
- Oil price fall	0.5
- Monetary policy	0.8
- Geopolitical conflict	-0.2
- Residual risk	-0.4

Source: European Commission

#### **II.4 Europe is expected to sustain economic recovery and its monetary policy tends to diverge**

European economy is experiencing a favorable time. Overall risks tend to be balanced and various short-term factors will further stimulate European economy, despite the uncertain economic prospect. The factors like QE policy, European investment plan and oil price rebound will mitigate deflation risk, drive investment up and slow consumption expenditure in the second half of 2015. Dragged by low oil price, inflation rate will approach to zero. With the oil price rebound, increase in domestic demand, reduction of inventories and Euro depreciation in 2016, import commodity prices will go up, and CPI in Euro area is expected to quickly rise to above 1%, and UK's CPI will be close to the target of 2% set by the Bank of England by the end of 2016. If inflation rate still cannot improve in the first half of 2016 due to deterioration of peripheral factors, it does not rule out the possibility that European Central Bank will continue extending QE policy and take further steps. However, UK will remain its interest rates at 0.5% and raise interest rates next year.

### **III. Emerging economies diverge and financial crisis will not recur**

Recently, emerging economies witnessed rapid currency depreciation and decline in foreign exchange reserves. At the same time, investors sold off assets in emerging economies, leading to a drop of about 15% in emerging market MSCI since March this year and capital flow from emerging economies to the US and European markets. Financial turmoil triggered by capital outflow occurred in emerging economies, spreading from countries with bad economic conditions in the beginning to those with sound macro economy.

#### **III.1 Causes for financial turmoil in emerging economies**

**Economic downside pressure in emerging economies kept increasing.** Real economic growth of emerging economies continuously decelerates. Following a quick growth in the 2010s, economic recovery in emerging economies came to a climax in the aftermath of financial crisis. Thereafter, economic growth of emerging economies kept slowing down. The continuous slowdown of

economic growth is attributed to weak external demand, return of domestic demand to normal level and domestic structural factors. Among them, structural factors mainly include the potential slowdown of economic growth, and its influence will last for a longer period and cannot be reversed.

**USD rate hike expectations resulted in capital outflow.** Since the financial crisis, emerging economies have first recovered, siphoning a large amount of capital from developed countries. Enormous inflows of capital, to a certain degree, have shored up economic growth in these regions, and emerging countries started to concern about the impact of developed countries' exit from economic stimulus packages. When the Fed proposed QE exit in May 2013, volatility in global financial market, especially emerging countries, intensified. Since 2015, expectations for Fed's rate hike have grown, intensifying capital outflow.

**International commodity prices kept falling.** Commodity prices have kept falling since the middle of 2014, deteriorating the fiscal revenue, international payment and enterprise profitability of commodity exporting countries. In 2015, except for several countries undergoing political unrest, almost all the top 20 emerging countries whose currencies depreciated the most are oil and commodity exporters, including Russia, Brazil, Malaysia and South Africa.

### III.2 Further divergence of financial situation in emerging markets

**Financial situation in commodity exporting countries will further deteriorate.** Prices of most international commodities will remain low (to be analyzed below), posing such problems as currency depreciation, increasing domestic inflation and monetary policy dilemma to commodity exporters.

**Financial fragility of emerging countries highly dependent on foreign investment will increase.** Global capital flow will completely change based on the current capital flow trend. Credit growth in emerging countries highly dependent on foreign investment will decelerate once these countries lose stable capital inflows. At the same time, such countries will also face pressure of increasing debt costs. After the Fed raises interest rates, it is forecast that a large amount of non-performing loans will occur in the countries highly dependent on foreign investment, and their financial fragility will go up sharply.

**Financial situation in emerging countries importing commodities will become stable.** Falling commodity prices, functioning as tax cut, will boost the economic growth of net commodity importers. The price fall of commodities will also help reduce inflation rate and leave room for stimulus monetary policy. Emerging countries in Asia are net importers of oil and raw materials and new production base of export processing trade. These countries have joined the global manufacturing chain and become an important force stabilizing world economy.

**Financial situation in economically well structured emerging countries will improve.** Following several financial crises, some emerging countries have carried out a series of structural reform to improve monetary policy, exchange rate regime, foreign exchange reserve, economic structure and fiscal policy. Some emerging economies adopt inflation target system in terms of monetary policy and floating exchange rate system in terms of exchange rates, place emphasis on foreign exchange reserve management, and exercise strict financial discipline to gradually turn foreign debts into domestic debts. These countries also attach importance to domestic demand and channel capital to high-end industrial chains.

### III.3 Financial turmoil in emerging countries will not trigger a new round of global crisis

**Global liquidity remains adequate.** Given the decline of the potential economic growth rate in the US, the Fed's rate hike will be slow and progressive, leaving enough time for emerging

countries to adjust and react. Meanwhile, pursuit of easing monetary policy in Japan, Euro area, Canada and Australia will provide liquidity and low financing costs for emerging countries, and global liquidity will remain adequate.

**Emerging countries' risk tolerance will increase remarkably.** Compared with previous financial crises in emerging economies, except for several financially fragile countries like Brazil, South Africa and Turkey, most emerging countries are more capable of dealing with shocks, in consideration of their less deficits in current accounts, lower foreign debt scale, higher foreign exchange reserves and bigger room for domestic expansionary policy (Table 3).

**Table 3: Financial Fragility Indicators of Some Emerging Countries in September 2015**

	Hungary	India	South Korea	Mexico	Poland	Russia	Thailand	Indonesia	Brazil	Malaysia	South Korea	Turkey
<b>External financing fragility indicators</b>	0.33	0.33	0.27	0.39	0.40	0.20	0.33	0.50	0.44	0.53	0.56	0.61
Current account balance/GDP (%)	-8.5	-0.7	-6.9	-2.7	-3.4	-5.7	-4.5	-2.3	-3.9	-3.05	-4.3	-4.2
(Current account deficits-FDI net flow)/GDP (%)		0.8		-2.3				-0.9	-2.3		-4.6	-3.1
Foreign reserve coverage ratio	1.7	2.7	2.2	1.1	0.9	2.7	2.4	0.97	1.6	0.8	0.9	0.55
Short-term foreign debts/total foreign debts (%)	14	18	28	23	11	9	40	25	11	46	22	32
Foreign debts/GDP (%)	110	23	31	41	73	42	36	35	42	71	40	60
Real effective exchange rate (% deviation between current value and historical average)	-10	5	-4	-11	-4	-7	2	-7	-20	-8	-17	-10
<b>Domestic financing fragility indicators</b>	0.43	0.48	0.43	0.52	0.48	0.48	0.57	0.71	0.71	0.57	0.52	0.72
Enterprise debts/GDP (%), $\Delta$ 2010-2013)	-17.0	6.4	-0.6	1.7	3.3	3.3	6.7	8.4	15.0	10.2	-1.2	14.3
Family debts/GDP (%), $\Delta$ 2010-2013)	-9.5	0.1	5.3	1.2	3.3	0.8	18.0	4.8	9.2	1.4	-2.9	7.0
Private credit growth (YoY, %, average in 2010-2013)	-7	6	2	6	5	11	9	15	14	8	2	22
Consolidated foreign creditors' rights/domestic credits (% end-2013)	109	20	15	90	96	26	29	43	20	42	42	45
Percentage of local currency government debts held by foreign countries (% 2014)	34	4	11	36	40	24	18	36	19	44	36	22
Percentage of local equities held by foreign countries (% June 2014)	44	20	24	24	16	19	18	17	24	13	23	20
Nominal housing price growth (% yoy, average in 2010-2014)	-1	18	2	4	-1	3	3	7	13	9	6	
<b>Policy fragility indicators</b>	0.50	0.56	0.17	0.50	0.28	0.72	0.47	0.28	0.78	0.47	0.72	0.50
Inflation rate at end-2015 (compared with central bank target/range)	2.4 (3.0)	4.7 (6.0)	1.8 (2.5-3.5)	2.7 (3 $\pm$ 1)	0.5 (2.5 $\pm$ 1)	14.4 (5.0)		4.0 (4.0 $\pm$ 1)	9.1 (4.5 $\pm$ 2)		6.3 (3-6)	7.7 (5.0)
Real interest rate	-1.1	2.6	-0.3	0.3	1.0	-3.4	0.6	3.5	5.1	-0.1	-0.3	0.6
Fiscal balance/GDP (%)	-2.7	-7.2	0.3	-4.1	-2.9	-3.7	-1.9	-2.3	-5.3	-3.5	-4.2	-1.4
Total government debts/GDP (%)	75	64	37	51	49	19	48	26	66	57	48	33
World Bank's global governance index	0.65	-0.35	0.75	-0.16	0.84	-0.71	-0.30	-0.35	-0.03	0.39	0.23	-0.08
World Economic Forum's global competitiveness index	4.28	4.21	4.96	4.27	4.48	4.37	4.66	4.57	4.34	5.16	4.35	4.46
2015-2016 parliamentary or presidential election			2015.7		2015.7	2016.12	2016.9					

Source: IIF; red stands for high-risk, green for safe and the remaining for transition state

**Emerging countries continuously improve mutual help mechanism.** Emerging countries have established a large number of regional or collective rescue arrangements, including the multilateral Chiang Mai Initiative. BRICS have set up a foreign exchange reserve pool and a financial security network to jointly respond to the capital operation risk and financial turmoil. Hence, it is less likely that crisis will spread from specific emerging countries to globe.

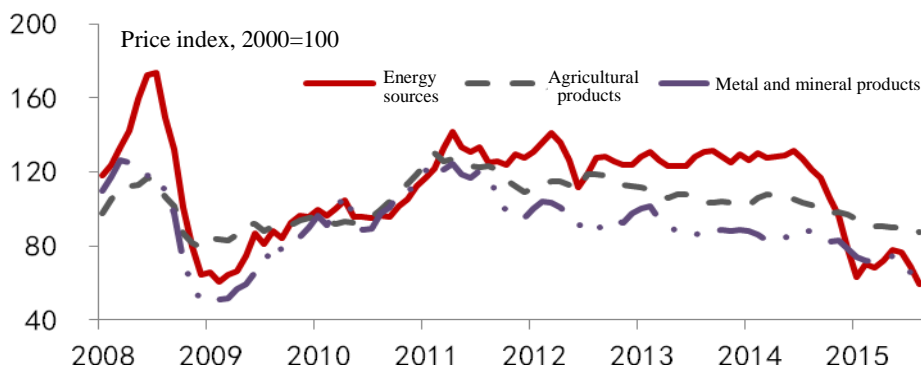
#### IV. Commodity market will stay depressed

##### IV.1 Movement of commodity prices since the financial crisis

The financial crisis in 2008 has hit the world economy and led to a plummet of commodity prices.

After the crisis, major economies, including the US, Euro area and Japan, have injected substantial liquidity into the market and expanded fiscal expenditure in response to the crisis, quickly lifting global demand (real demand increase at this stage is mainly due to the recovery of emerging economies) and driving the recovery of commodity market from the end of 2008 to early 2011. By early 2011, commodity prices have basically returned to the level prior to the outbreak the crisis (Figure 12).

**Figure 12: Movement of Commodity Price Index since the Financial Crisis**



Source: World Bank

With the marginal effect of demand increase driven by the recovery of emerging economies abating after 2011Q2, European sovereign debt crisis kept deepening, and market expectations for Fed's continuous injection of liquidity had been greatly scaled down (specifically, the US implements a "reversal" policy and substitutes short-term treasury bonds by those with a long term in a bid to reduce the yield rate of treasury bonds). The factors above will restrain commodity market in terms of demand. In terms of supply, most commodities have entered the stage of substantial release of supply synchronously. Take rubber for example, spurred by high prices, rubber was planted in main rubber growing areas (e.g. Thailand, Indonesia and Vietnam) on a large scale from 2005 to 2008. As rubber will be tapped in six to seven years, its supply will increase from 2011. Due to the sluggish demand and sharp increase of supply, prices of commodities, particularly metallic substance and farm produce, started to dip; however, emerging prices remained fluctuating on high level as a result of geopolitical factors and strong physical demand.

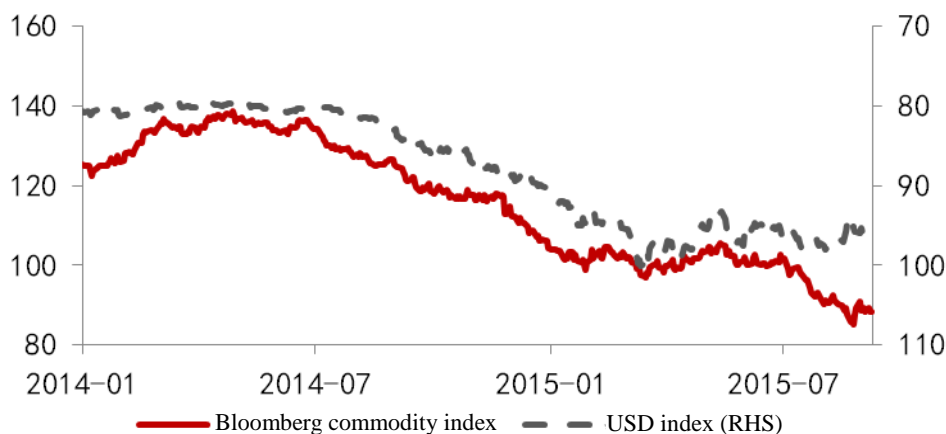
In the second half of 2014, prices of commodities, particularly energy products, started a new round of downswing, resulting from the increasing output of major commodities, such as crude oil, iron ore, soybean and other agricultural products, weak recovery of world economy and insufficient external demand. By the end of August 2015, the prices of almost all commodities had shown a downward trend, and prices of certain commodities like nickel, tin, coffee, white sugar and fuel oil, even dropped by more than 20%.

#### IV.2 Factors affecting commodity price change

**First, oversupply restrains commodity price.** Essentially, commodity price decline is attributed to oversupply. According to the latest data of the American Petroleum Institute on August 28, 2015, crude inventories were 450 million barrels, an increase of 17.59% over early 2015 and 26.64% over early 2014. Nonetheless, OPEC insists it has no intention of production cut. In July 2015, the US and Iran reached an agreement. Once the economic sanctions against Iran, a large crude oil supplier and exporter, are lifted, it will bring a new blow to the crude price. Analysts believe that Iran will add 1 million barrel of crude supply per day to the market after the sanctions are lifted, thereby further exacerbating the imbalance between supply and demand.

**Second, US dollar has been in the course of appreciation.** Since commodities are denominated in USD, its appreciation is bound to drive down the prices of commodities that are priced in the currency. Judging from a long cycle in the past, the movements of USD index cycle and commodity price cycle basically show a negative correlation. After the second half of 2014, USD index skyrocketed to 95.17 from 79.82 (as at September 11, 2015), appreciating by more than 19.23%. Accordingly, it is no surprise that USD-denominated commodity prices declined.

**Figure 13: Movements of USD Index and Commodity Index**



Sources: Bloomberg, Wind, USD index axis has been reversely processed

**Third, growing derivatives market exacerbates price volatility.** With the wide application of financial innovation tools such as futures and options, financial attribute of prices of commodities like crude and copper has stood out, and Brent crude futures prices and London LME copper futures prices have become the benchmark prices of global commodity market. The prices of commodity futures, as a financial asset, are not dependent on market supply-demand relations, but on the return on such asset in the future. With the rally of USD and stronger expectations for the Fed's rate hike, international investors predict that commodity prices will remain low, and financial capital will siphon out of commodity futures market to the real economy and securities market in the US, thereby leading to a drastic decline in commodity prices.

**Fourth, China's driving force is weakening.** Demand from China, a major buyer of commodities in the world (the second largest buyer of crude oil and the largest buyer of iron ore and copper), added the great fuel to the price hike in the "super-cycle" of commodities since 2000. After 2014, China's commodity demand declined and its role in shoring up commodity price abated as a result of economic slowdown, gradual change of economic growth mode, shift from an extensive production pattern featuring high input, high pollution and high emission to an intensive production pattern, and change of the focus of economic development from investment to three major demands.

### IV.3 Further trend of commodity prices

**As the supply-demand pattern of commodity market is unlikely to change in the near future, the market will remain weak in the last quarter of 2015.** Given that commodity prices have been relatively low and are bolstered by costs, a further decline is less likely. Hence, commodity prices will possibly swing at a low level in 2015Q4.

**Meanwhile, there may be some uncertainties in the prediction.** As for the crude oil market, in terms of supply, the biggest uncertainty is the geopolitical risk in such regions as Middle East and North Africa, which may lead to a marked rise of international oil prices in a short term; as for

metal ore market, strike and production accidents may result in substantial supply disruption and drive prices up; as for agricultural products market, we must pay particular attention to the impact of weather factors like El Nino on production. In respect of demand, as emerging economies underwent several substantial stock market shocks that triggered drastic commodity price fluctuation, we should constantly focus on the development of financial market in emerging economies, while keeping an eye on the development trend of their real economy.

**Table 4: Forecast of Commodity Price Index**

	Actual price index					Forecast		Change rate (%)		
	2010	2011	2012	2013	2014	2015	2016	2013-14	2014-15	2015-16
<b>Energy sources</b>	100	129	128	127	118	73	77	-7.2	-38.7	6.0
<b>Non-energy sources</b>	100	120	110	102	97	85	86	-4.6	-12.2	1.5
<b>Metal</b>	100	113	96	91	85	71	73	-6.6	-16.7	3.1
<b>Agricultural products</b>	100	122	114	106	103	92	93	-3.4	-10.8	1.1
Foodstuff	100	123	124	116	107	94	95	-7.1	-12.3	1.2
Grain	100	138	141	128	104	94	95	-19.0	-9.4	1.4
Edible oil and meals	100	121	126	116	109	89	91	-5.9	-18.1	1.9
Other foods	100	111	107	104	108	101	101	4.3	-7.1	0.3
Beverage	100	116	93	83	102	93	92	22.2	-8.2	-1.2
Raw materials	100	122	101	95	92	85	86	-3.6	-7.9	1.9
Fertilizer	100	143	138	114	100	96	95	-11.6	-4.9	-0.5
<b>Precious metal</b>	100	136	138	115	101	92	91	-12.1	-9.3	-1.1
<b>Crude oil (USD/barrel)</b>	79	104	105	104	96	57	61	-7.5	-40.3	6.4
<b>Gold (USD/ounce)</b>	1225	1569	1670	1411	1266	1175	1156	-10.3	-7.2	-1.6

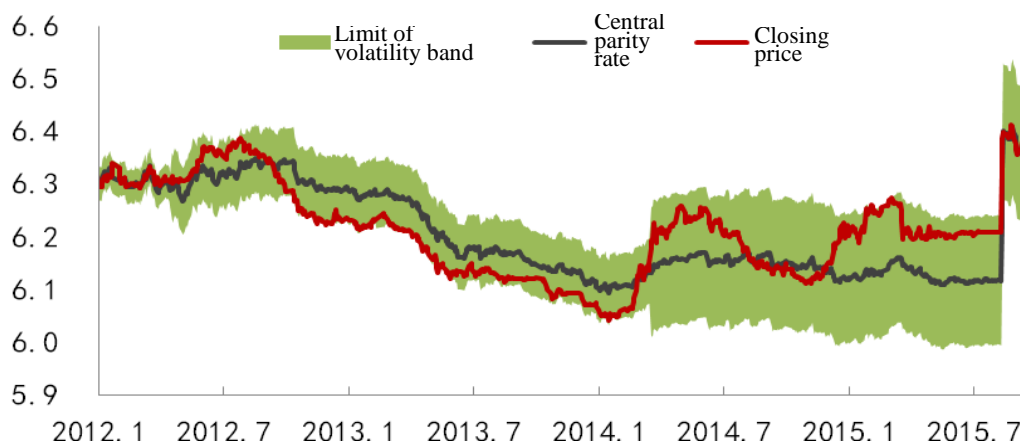
Sources: World Bank, BOC Institute of International Finance

## V. Reform of RMB exchange rate formation mechanism and its positive influence

The People's Bank of China adjusted RMB central parity rate formation mechanism on August 11, 2015. The adjustment helped enhance the liberalization and benchmark role of central parity rate and further liberalize RMB exchange rates. The adjustment of spread between central parity rate and market exchange rate caused drastic volatility, leading to overshooting of offshore RMB exchange rates. While the volatility of offshore and onshore RMB exchange rates intensifies, we should strengthen expectation management, mitigate overshooting risk and give play to positive factors.

### V.1 RMB exchange rate reform enhances exchange rate liberalization

**RMB central parity rate has deviated from market expectations for a long term.** In the past, RMB central parity rate, as the market benchmark rate, was interpreted by market players as the orientation of RMB change rate policy adjustment, guiding market expectations and assisting in maintaining relative stability of exchange rates. In special circumstances, however, the deviation between RMB central parity rate and market expectations was widened for a longer period. In the course of continuous appreciation of RMB, the spread between the central parity rate and CNY was basically kept at about -500; when RMB started to depreciate in the second half of 2014, the spread quickly increased to about +1200 (Figure 14), indicating that its market benchmark position and authority have been seriously challenged.

**Figure 14: Movement of Central Parity Rate and Spot Rate of RMB against USD**


Sources: Wind, BOC Institute of International Finance

### **Central parity rate mechanism reform reinforces the liberalization of RMB exchange rates.**

According to the new mechanism for quotation of RMB central parity rate, foreign exchange market makers should provide a central parity rate quotation to China Foreign Exchange Trade System on a daily basis before opening of interbank foreign market, by reference to the closing exchange rates in the market of last day, taking into account foreign exchange supply and demand and changes in the exchange rates of major international currencies. The adjusted quotation mechanism will greatly enhance the liberalization of RMB central parity rate and make it more referable as a market benchmark. RMB central parity rate, to a certain degree, reflects market expectations, intensifies the synchronization and consistency with exchange rate volatility trend, and helps enhance the liberalization of RMB exchange rates.

### **V.2 RMB exchange rates will fluctuate under the new equilibrium in a short term and remain strong in a medium and long term**

**In a short term, RMB exchange rates will maintain two-way volatility under the new equilibrium.** This round of currency depreciation in emerging markets corresponds with the spillover effect of monetary policy change of the US in the sphere of international capital flow. The recent continuous hike of USD exchange rates intensified commodity market turbulence, leading to a heavy outflow of international capital from emerging markets and putting the pressure of currency depreciation on emerging markets. Therefore, RMB depreciation under the new exchange rate regime is normal. Before the new exchange rate reform, China's domestic macro-economic growth continued slowing, while the real effective exchange rates of RMB climbing, making it necessary to reduce the rates to reflect the changes in economic fundamental. According to our behavior equilibrium exchange rate model (BEER), the real effective exchange rates of RMB have started to be overestimated since the second half of 2014, and deviated about 4% from its equilibrium level in the second half of 2015; after adjustment of exchange rate regime, the deviation was continuously corrected with depreciation of RMB and widening fluctuation of exchange rates. It is forecast that the real effective exchange rates of RMB and the exchange rates between RMB and USD will remain volatile under the new equilibrium in a two-way manner.

### **We should strengthen expectation management and prevent exchange rate overshooting.**

Theoretically, correcting the spread between the central parity rate and market exchange rates once for all can avoid the large-scale risk-free arbitrage trade in the market caused by progressive adjustment. Viewing from the market performance, one-off substantial spread correction means the recognition of RMB depreciation pressure. It can intensify the market expectations for RMB

depreciation, trigger self-cycle of expectations, and amplify downside pressure of RMB exchange rates. Especially in the offshore RMB market, overshooting takes place as there are no restrictions on exchange rate volatility. With the intensification of exchange rate overshooting in the offshore RMB market, the spread between offshore market and onshore market kept widening while arbitrage window broadened noticeably. In order to guard against various risks in onshore RMB exchange rates spread from offshore market to onshore market, the central bank should strengthen management of foreign exchange market expectations and realize smooth transition to the new mechanism, while advancing exchange rate liberalization.

**RMB exchange rates will remain strong in a medium and long term.** In a comparatively long period, inclusion of RMB in SDR and internationalization of RMB will sustain the stability of RMB exchange rates. Though China's economic growth slows down, its absolute level is still faster than major economies. Besides, China maintains current account surplus and huge foreign exchange reserves. Its inflation is not high, and its fiscal deficits and government debts are expected to be maintained within a safe range. These factors undoubtedly will provide substantial support for RMB exchange rates.

### **V.3 We must realize the positive role of RMB exchange rate reform objectively**

In a more liberal environment, two-way volatility of RMB exchange rates under equilibrium will become a new normal. We must take a more objective view concerning the positive impact of RMB exchange rate formation mechanism reform.

**Enhanced liberalization of RMB exchange rates helps drive China's financial reform.** Market-oriented reform of RMB interest rates and exchange rates is an important objective of China's financial reform. After adjustment of the mechanism for quotation of RMB central parity rate, RMB central parity rate may, to a certain degree, reflect market expectations, intensify the synchronization and consistency with exchange rate volatility trend, help enhance the liberalization of RMB exchange rates and give play to the decisive role of fund price in effectively allocating financial resources.

**A more flexible adjustment mechanism helps promote the equilibrium of China's international payment.** RMB exchange rates have started to face depreciation pressure since the second half of 2014. In the international market, the Fed will tighten monetary policy; USD appreciated sharply, while Euro and Yen weakened, and currencies of emerging markets and commodity manufacturing countries kept depreciating. Given that the effective exchange rates of RMB remain relatively stable, there is need to devalue RMB. Rigid and fixed exchange rates do not conform to China's conditions and are unsustainable. It will cause price distortion in each sector at home and abroad and give rise to problems and contradictions. The new exchange rate reform released once for all the accumulated 3% depreciation pressure of RMB exchange rates, and basically corrected the deviation with overall risks under control. It is significant for the country to boost foreign trade and international payment equilibrium.

**The reform pushes forward the process of RMB internationalization and stability of international monetary system.** Offshore RMB market has developed rapidly since 2013, the RMB trade scale of which has exceeded onshore market, and offshore RMB prices continuously challenge the RMB exchange rate pricing power of onshore market. The new exchange rate reform will effectively strengthen onshore RMB exchange rate pricing power, align the tendency of onshore and offshore prices and lay a foundation for linking domestic and overseas markets. RMB exchange rate liberalization will further activate foreign exchange trade in offshore RMB market, promote the innovation in RMB financial products, improve RMB product mix, and provide more diversified investment, financing and risk management instruments for market players. Moreover, exchange rate liberalization will help dismantle technical barrier of including RMB in SDR. IMF

pointed out that selection of appropriate RMB exchange rates is one of the technical problems for including RMB in SDR. Specifically, there is still deviation between CNY and CNH, and CNH is not an ideal tool to hedge RMB exchange rate risk. Measures should be taken to reduce the deviation between CNY and CNH. IMF also mentioned the issues such as benchmark interest rates of RMB in SDR and variety of RMB hedging tools. It is certain that intensifying RMB exchange rate liberalization will help solve the technical problems above. Including RMB in SDR will help diversify the composition of currencies in SDR and further stabilize its value. IMF and China have the same intention and interests in promoting international trade growth and financial capital flow by SDR and ensuring stability of international monetary system.

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