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Institute of International Finance

China's Economic and Financial Outlook

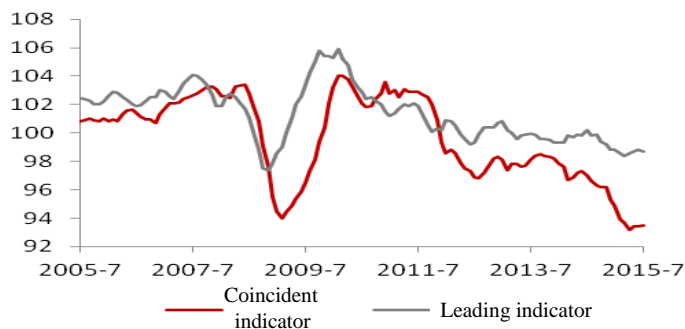
2015Q4 (Issue 24)

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Highlights

- In Q3, against international financial market rollercoaster and impotent global economic recovery, China faced increased economic downward pressure due to multiple factors such as domestic capacity cuts, deleveraging and emerging financial risks. Growth of main indicators like investment, export and industry slowed down. Under the sharp reshuffle of the stock market, the financial industry also decelerated markedly, and the Q3 GDP is expected to grow by around 6.8% and CPI around 1.9%.
- Looking into Q4, we expect the growth-stabilizing policies to continue showing effects, and constraints from “people” and “money” on investment to gradually ease. With a low base, economic growth in Q4 is expected to stabilize, with potential GDP growth rate edging up from Q3 to around 7%. The yearly GDP may grow by about 7%, 0.3 percentage points down from last year.
- In the medium and long-run, China is in a critical period featuring switchover of growth engines, restructuring, phase shift and risk mitigation, when new growth engines are being nurtured but still in small scale and traditional engines are adjusting and fading. China's economy is expected to run at the bottom of the business cycle for a while.
- In the crucial period of switchover of growth engines, it is important to keep loose policy so as to gain time for growth of new engines and economic restructuring, especially for growth stabilization and risk prevention. Neither the general direction of deepening reform nor the short-term underpinning policy should be changed.

China's Macro-economic Climate Early Warning System



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China Must Secure Minimum Growth and Prevent Risks when Bottoming out

--China's Economic and Financial Outlook (2015Q4)

In Q3, against international financial market rollercoaster and impotent global economic recovery, China faced increased economic downward pressure due to multiple factors such as domestic capacity cuts, deleveraging and emerging financial risks. Growth of main indicators like investment, export and industry slowed down. Under the sharp reshuffle of the stock market, the financial industry also decelerated markedly, and the Q3 GDP is expected to grow by around 6.8% and CPI around 1.9%. Looking into Q4, we expect the growth-stabilizing policies to continue showing effects, constraints from “people” (local initiatives) and “money” (capital) on investment to gradually ease and the real estate market to resuscitate further. With a low base, economic growth in Q4 is expected to stabilize, with potential GDP growth rate edging up from Q3 to around 7%. The yearly GDP may grow by about 7%, 0.3 percentage point down from last year. Over the medium and long-term, China is in a critical period featuring switchover of growth engines, restructuring, phase shift and risk mitigation, when new growth engines are being nurtured but still in small scale and traditional engines are adjusting and fading. China's economy is expected to run at the bottom of the business cycle for a while. In this critical period, it is important for China to maintain loose policy so as to gain time for growth of new engines and economic transformation. In particular, China must make efforts to fulfill the two tasks, i.e. stabilization of growth and prevention of risks. Neither the general direction of deepening reforms nor the short-term underpinning policy should be changed.

I. Economic Review and Outlook

I.1 Q3 economic review

I.1.1 Economy and finance cooled down simultaneously and economic downward pressure increased

In 2015, China's economy continued to decline with a 7% GDP growth rate in the first half year, down 0.3 percentage point from the same period last year (Figure 1). The rapidly growing financial industry fueled by the booming capital market contributed to the 7% growth in a large part. In the first half year, value added of the financial industry grew by 17.5%, 9.6 percentage points higher than a year earlier. The financial industry drove GDP up 1.4 percentage points, 0.7 percentage points higher than the same period last year. Against the backdrop of a cooled economy, the heated financial industry (mainly the stock market) helped achieve a 7% economic growth in the first half year.

Figure 1: China's GDP Growth

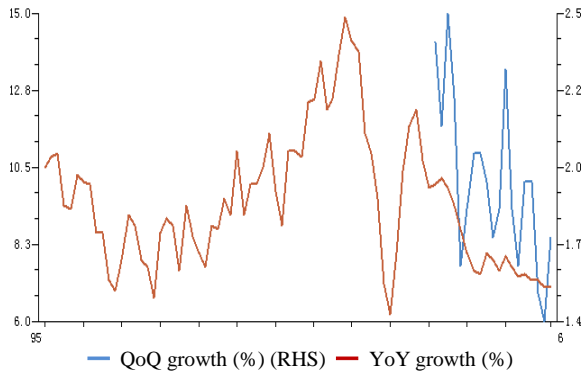
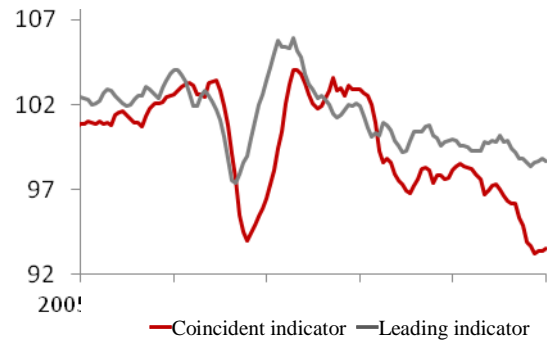


Figure 2: China Macro-economic Climate Early Warning System



Sources: National Bureau of Statistics, BOC Institute of International Finance

However, since Q3, both economy and finance have cooled down: On the one hand, growth of real economy indicators such as investment, export and industrial production slowed down compared with Q2 (only consumption edged up); on the other hand, the financial industry's driving effect on the economy abated substantially due to several sharp corrections of the stock market since mid-June. Thus, GDP growth rate is unlikely to reach 7%. We expect the Q3 GDP to grow by around 6.8%, slightly down from Q2. By sectors, services and consumption made an increasing contribution to economic growth and its stability; while the contribution of export, investment and industry to economic growth continued to reduce.

In August, consumption and industrial production accelerated slightly, while growth of investment continued to decelerate. Newly started projects and capital source were improving, which indicated the economy was bottoming out and economic downward pressure were somewhat alleviated. However, such alleviation was attributable to a series of policies taken by the government, and the power sustaining independent growth remained inadequate. In the critical period of switchover of growth engines, the government should keep loose policy to win time for growth of new engines and economic transformation.

I.1.2 Consumer prices rebounded slightly, while CPI and PPI continuously diverged

The economic decline brought down prices this year. In the first eight months, CPI cumulatively went up 1.4%, 0.8 percentage point lower than the equivalent period last year but 0.1 percentage point higher than the first half year. In particular, CPI in August rose by 2%, the highest in the past 12 months (Figure 3). Also in this period, PPI dropped by 4.9%, 3.3 percentage points up from the same period last year and 0.3 percentage points up from the first half year. In August, PPI recorded the biggest drop of 5.9% since October 2009 (Figure 4). Prices in Q3 were highly divergent, that is, price scissors between the rising CPI and the falling PPI were widening.

Figure 3: “Pork Cycle” Drives CPI to Edge up

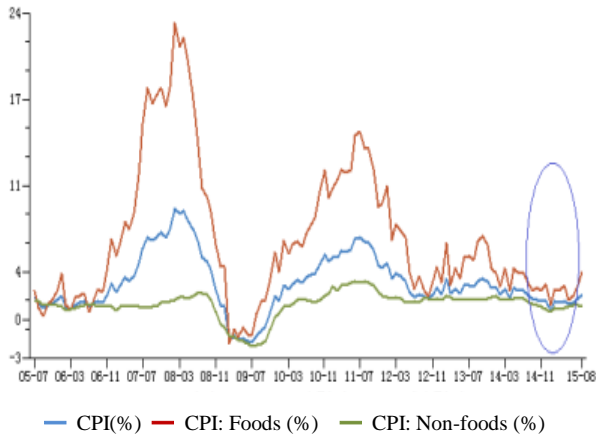
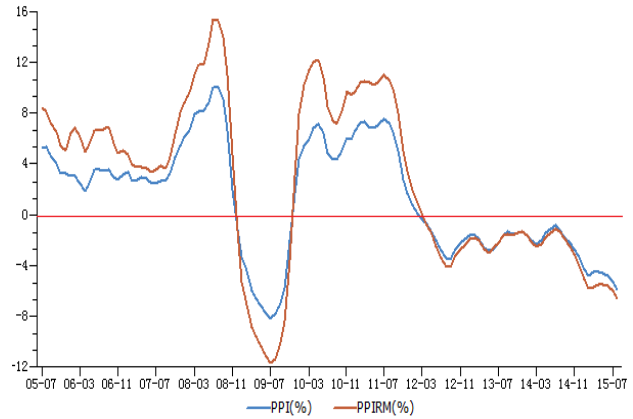


Figure 4: PPI negative for 42 consecutive months



Sources: Wind, BOC Institute of International Finance

First, food prices like pork increased remarkably and non-food prices remained steady. Entering Q3, pork price hiked by an increasingly bigger margin due to pork production at the cyclic bottom, reduced pork output and hoarding by some pig farmers. Pork price went up 16.7% and 19.6% on a year-on-year basis in July and August respectively, in a sharp contrast with the negative growth of last year and the low growth of the first half year. According to preliminary estimation, the rising pork price drove CPI by around 0.5 percentage point in July and August. However, we must note that this round of pork price rise was pushed mainly by supply side instead of demand side. Due to economic downturn, market demands for pork didn't increase but decreased. Meanwhile, due to extreme weather etc., price of vegetables soared by 15.9% in August, the biggest monthly increase since 2014, increasing the monthly CPI by 0.46 percentage point. Pork and vegetables contributed 1 percentage point to the 2% CPI growth in August. Opposite to the surge of pork and vegetable prices, prices of egg, fruits, mutton etc. went by 11.2%, 8.1% and 6%, respectively in August. Different from the big ups and downs of food prices, non-food prices maintained a steady growth of 1.1% in August, the biggest rise in tobacco and alcohol (3.8%) and the smallest rise in transportation and communications (-2.1%).

Table 1: Changes in Increases of the Eight Categories of Goods and Services in the CPI Basket (%)

Year	CPI	Of which, foods	Tobacco, alcohol and supplies	Clothing	Household devices	Health care	Transportation and communications	Entertainment, education and culture	Housing
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 (Jan.-Aug.)	2.2	3.4	-0.6	2.4	1.2	1.2	0.2	2.2	2.4
2015 (Jan.-Aug.)	1.4	2.3	1.3	2.9	1.1	1.8	-1.7	1.5	0.7

Sources: Wind, BOC Institute of International Finance

Second, PPI decline expanded mainly because of a substantial decrease in prices of capital goods. Since Q3, PPI dropped further by a larger margin, due to a new round of falling prices of commodities in the international market and continued sluggish domestic demands. PPI went down 4.9% in the first eight months, 0.3 percentage points larger than the first half year. Specifically, prices of capital goods representing 76% of the PPI basket had a big drop, which was the main cause for the expanding decrease in PPI (Table 2). In particular, PPI of the mining industry fell by nearly 20%. It is estimated that capital goods industry pulled PPI down by 5.8 percentage points, while consumer goods industry only drove PPI down by 0.1 percentage point. By light/heavy industry, heavy industry fell bigger than light industry: PPI of heavy industry went down 7.7% in August, 6.4 percentage points higher than light industry (-1.3%).

Table 2: Categorized Changes in PPI (%)

Year	PPI	Capital goods	Capital goods			Consumer goods	Consumer goods			
			Mining industry	Raw materials industry	Processing industry		Foods	Clothing	General daily necessities	Consumer durables
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	-3.0	-1.8	0.0	0.2	0.7	0.1	-0.8
2014 (Jan.-Aug.)	-1.6	-2.1	-4.9	-2.3	-1.7	0.0	0.2	0.8	0.0	-0.9
2015 (Jan.-Aug.)	-4.9	-6.3	-19.3	-8.9	-3.9	-0.2	0.0	0.6	-0.6	-0.8

Sources: Wind, BOC Institute of International Finance

I.1.3 Consumption grew steadily and investment growth continued to slow down

Consumption growth kept increasing. Thanks to continued growth of residents' income and rising prices etc., consumption in Q3 remained stable and rose slightly. Nominal consumption went up 10.5% in the first eight months, 0.1 percentage point higher than the first half year. Especially in August, consumption grew by 0.4 percentage point faster than the first seven months. When consumption growth remained steady overall, some new changes emerged: First, hot sectors of consumption rotated. Communications devices kept a rapid growth of 35% in the first eight months, 11.4 percentage points higher than the equivalent period last year; online consumption grew by 36.5% and Chinese and western medicine, cultural and office supplies etc. all had a growth rate of over 15%. Second, benefited from the recovering housing market, consumption of construction & decoration materials and furniture sized up quickly and the growth rate exceeded the same period last year by 3.4 and 1.7 percentage points, respectively. Third, traditional consumptions showed divergent trends. Consumption of food, beverage, tobacco & alcohol grew rapidly by 13.4%, 14.8% and 11.5% in the first eight months, respectively; consumption of automobiles rose by 4.4% during the same period, down 5.1 percentage points on a year-on-year basis.

Figure 5: Consumption of Communications Devices Grew Rapidly

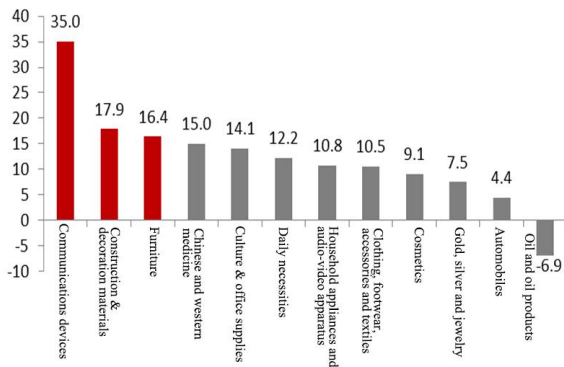
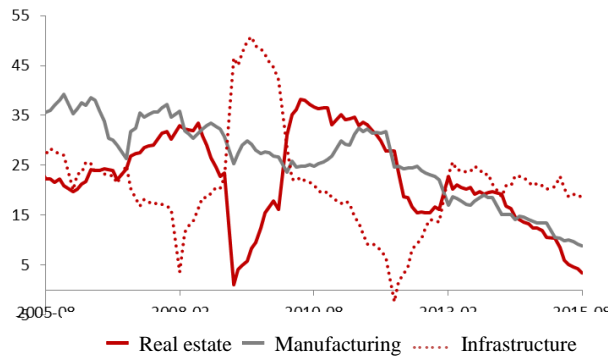


Figure 6: Growth of Three Categories of Investment Slows down Simultaneously (%)

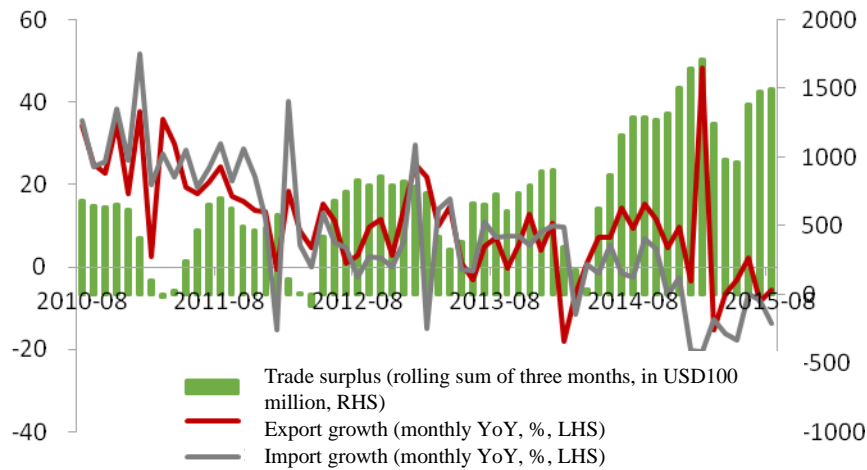


Sources: Wind, BOC Institute of International Finance

Investment growth continued to slow down. In the first eight months, investment cumulatively grew by 10.9%, 0.5 percentage point lower than the first half year. It was still dipping to the bottom. Among the three categories, investment in real estate had the biggest slowdown with a 3.5% growth rate in the first eight months, 9.7 percentage points lower than the same period last year (13.2%) and 1.1 percentage points lower than the first half year; investment in manufacturing increased by 8.9%, 5.2 percentage points lower than the equivalent period last year and 0.8 percentage point lower than the first half year; comparatively speaking, investment in infrastructure maintained a rapid growth of 18.8% cumulatively in the first eight months, down 0.4 percentage point from the first half year (Figure 6), which could be ascribed to the government’s policies for stabilizing growth and stimulating infrastructure investment. Growth rate of investment in construction & transportation and warehousing & postal service slowed markedly in the first eight months, with year-on-year growth rates 4.9 and 2.3 percentage points lower than that of the first half year, respectively.

Imports and exports still grew negatively and trade surplus hit a historic high. In the first eight months, exports cumulatively dropped by 1.4%, 0.7 percentage point down from the first half year; growth of exports to the US, Europe, Japan, South Korea, Taiwan and ASEAN slowed down. Imports decreased by 14.5% on a year-on-year basis with the decrement 1.2 percentage points lower than the first half year (Figure 7). In spite of the negative growth, China’s exports still outperformed other export-oriented economies. Market share of our exports to the US and the EU picked up 4 percentage points year on year in the first eight months. The big year-on-year drop of imports was connected with the sharp decrease of commodity prices. IMF Global Primary Commodity Price dropped from 122 in June to 103 in August, much lower than 180 in the same period last year. Due to sluggish domestic demands and the falling price of bulk commodities, imports remarkably slowed down. In the first eight months, trade surplus made a record high to USD365.5 billion. In July and August alone, trade surplus exceeded USD100 billion.

Figure 7: Imports, Exports and Trade Surplus



Sources: Wind, BOC Institute of International Finance

I.1.4 Consumer goods and high-tech industry drove the industry slightly up but the foundation of recovery was quite weak

The industry slowed down in general but showed signs of recovery. In the first eight months, added value of industrial enterprises with annual revenue of RMB20 million or more from their main business operations went up 6.3% year on year, maintaining the level of the first half year but down 2.2 percentage points from the same period last year. In August, industrial value added increased by 6.1% year on year, slightly up 0.1 percentage point from the previous month (Figure 8). PMI dropped to 49.7 in August, and PMI of new orders was lower than 50 for two consecutive months starting from July. Given the high base of industrial growth of September last year, the foundation for industry recovery is still weak. We expect a 6.2% growth of the industry in Q3.

Figure 8: Industry Edged up (%)

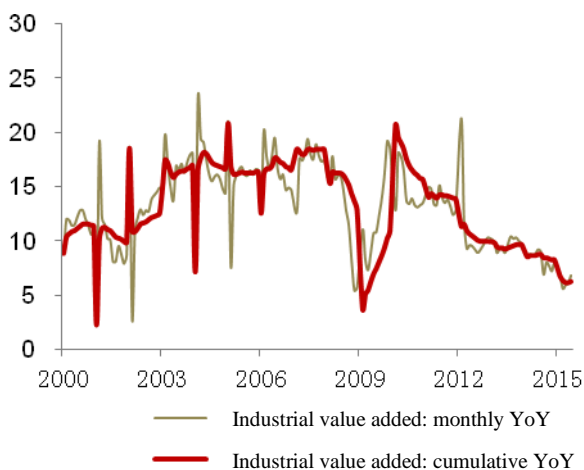
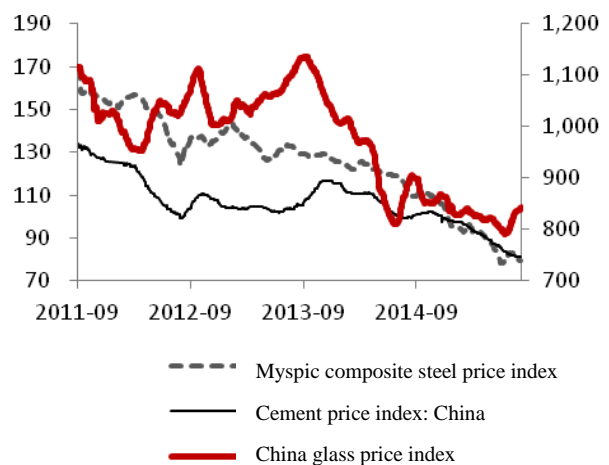


Figure 9 Price Indices of Iron & Steel, Cement and Glass



Sources: Wind, BOC Institute of International Finance

By sector, consumer goods and high-tech industries were the main driving force of the industrial growth. Growth of major traditional consumer goods manufacturing like processing of agricultural

foods and textiles picked up 5.5% and 7.3% from January to August, up 0.6 and 0.2 percentage point from the first half year, respectively. Emerging consumer goods manufacturing sectors such as cultural, educational, sports and entertainment products maintained a rapid growth of 11.7% in August, 1.2 percentage points up from July. High-tech industry grew rapidly by 10.5% in August, 0.9 percentage point higher than July and 4.4 percentage points higher than industrial enterprises with annual revenue of RMB20 million or more from their main business operations. Specifically, manufacturing of electronic products and communications devices gained a 12.6% growth.

Among over-capacity industries, though capacity utilization rates of coking enterprises, blast furnaces of steel plants, float glass making etc. were lower than the same period last year and outputs of crude steel, cement and flat glass remained in a negative territory, some sectors showed signs of recovery. Price of iron and steel started to pick up since early July, capacity utilization rate of blast furnaces rallied to over 80%, glass price recovered since the end of July (Figure 9) and capacity utilization rate of coking enterprises started to recover in September.

The central bank cut interest rate and lowered reserve requirement ratio several times this year, bringing down capital cost of industrial enterprises. In July, the percentage of financial expenses in income from principal businesses continued to dip, down 0.03 percentage point from the same period last year (Figure 10). The percentage of interest expense in income from principal businesses also decreased since June, the same level with the same period last year (Figure 11). As a series of measures designed to relax enterprises' financial burden have been taken such as lowering social insurance rate, canceling and regulating unreasonable charges, lowering price of industrial and commercial electricity and reducing resource tax levied on iron ore, cost per RMB100 income from principal businesses saw a smaller growth than the same period last year, but was still higher than that period (Figure 12).

In parallel with slower economic growth, enterprises also suffered income growth slowdown with a 1.3% cumulative growth of income from principal businesses in July, down 0.1 and 7.5 percentage points from the first half year and from the equivalent period last year. Enterprises was still under heavy pressure to make profits, with profit cumulatively down 1% in July, 0.3 percentage point higher than the first half year, and profit margin of principal businesses down 0.04 percentage point from the first half year (Figure 13).

Figure 10: Financial Expenses/Income from Principal Businesses

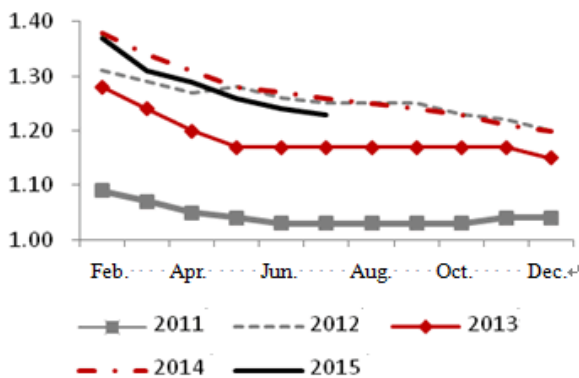


Figure 11: Interest Expense/Income from Principal Businesses

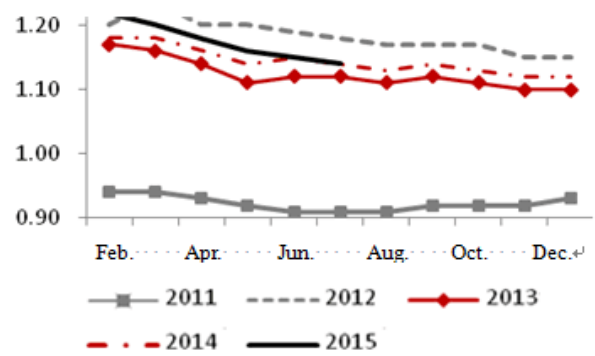


Figure 12: Cost per RMB100 of Income from Principal Businesses

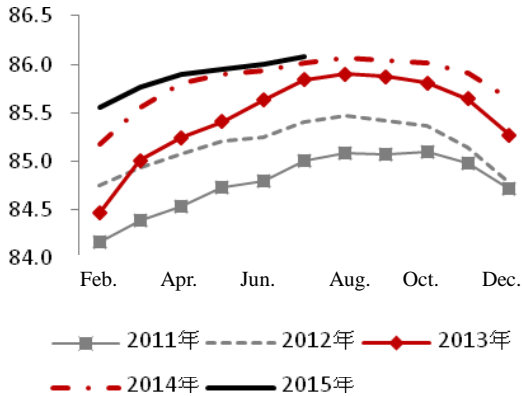
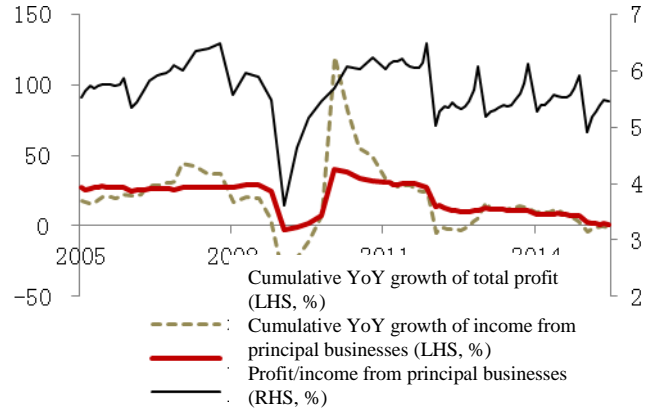


Figure 13: Income and Profit of Industrial Enterprises



Sources: Wind, BOC Institute of International Finance

I.1.5 The real estate market continued to recover on an unsteady foundation

In Q3, the easing policy and loose credit environment further made the real estate market recovering further though at varied paces in different regions. First, the Q3 housing sales were featured by increase in both sales volume and price, compared with increased sales volume and stable price in Q2. In the first eight months, China's sold floor areas went up 7.2% year on year, 3.2 percentage points quicker than the end of Q2. Commercial housing sales volume increased by 15.3% on a year-on-year basis, up 5.3 percentage points from the end of Q2. 100 monitored cities' housing price index witnessed a year-on-year rise of 0.2%, halting the downward trend in the last 10 months (Figure 14). Second, recovery paces varied vastly from region to region. Housing price in tier-one cities had a substantial increase for six consecutive months; that in tier-two cities reported a moderate growth for four consecutive months; that in tier-three cities just rallied (Figure 15). Third, financing environment for real estate enterprises was improved. Financing sources for real estate development and investment ascended by 0.9% year on year in the first eight months, up 0.8 percentage points from the end of Q2. The better financing environment was mainly ascribed to the rapid increase of residential mortgages. However, year-on-year reduction in real estate development loans was expanding still.

Figure 14: Increased Sales Volume and Housing Price on Real Estate Market (%)

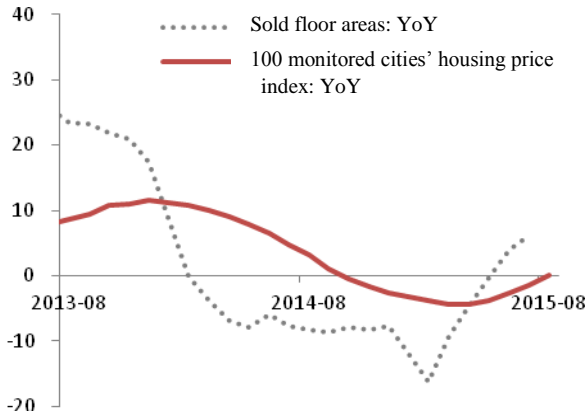
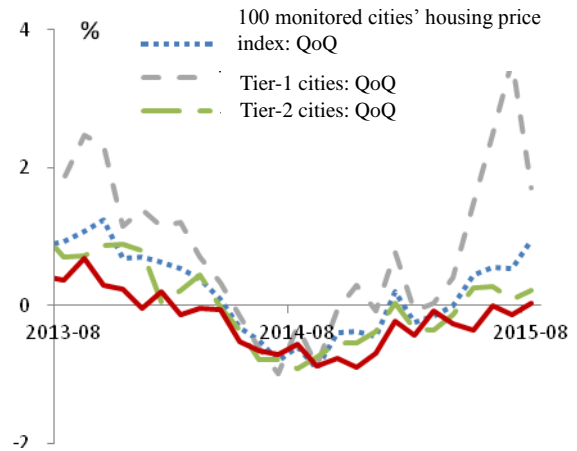


Figure 15: Divergent Trends of Housing Price in cities



Sources: Wind, BOC Institute of International Finance

Various signs indicate that the foundation of real estate market recovery is unstable and the driving power is feeble. First, real estate investments continued to drop. Increase in sales and price failed to stabilize real estate investments. Real estate investments in the first eight months grew by only 3.5%, down 1.1 percentage points from the end of Q2; the growth rate of real estate investment slipped to the second low in history (it hit bottom in February 2009). Second, leading indicators of the real estate industry were less satisfactory. New construction areas descended by 16.8% year on year in the first eight months, 1 percentage point higher than that at the end of Q2; purchased land areas fell by 32.8%, 1.7 percentage points down from the end of Q2. Third, increasing volatility in the financial market added to the uncertainty of recovery of the real estate market.

I.2 Q4 economic outlook

I.2.1 Economic growth stabilizes, and CPI rises more aggressively

Looking into Q4, we expect the growth-stabilizing policies to continue showing effects, constraints from “people” and “money” on investments to gradually ease and the real estate market to keep recovering. In Q4, with a low base, economic growth is expected to stabilize, GDP growth rate edging up from Q3 to around 7%. The yearly GDP may grow by around 7%, 0.3 percentage point down from last year. In the medium and long run, China is going through the crucial stage of switchover of growth engines, restructuring, phase shift and risk mitigation, when new growth engines are being nurtured but still in small scale and traditional engines are adjusting and fading. China’s economy is expected to run at the bottom of the boom cycle for a while.

In Q4, CPI is expected to remain stable and even rise slightly, given the continuing pork cycle, the looming boom season of pork consumption, upward pressure of vegetable prices in winter etc. The Q4 CPI is predicted grow by around 2%, up 0.1 percentage point from Q3. The yearly CPI may rise by around 1.6%, down 0.4 percentage point from last year. With little possibility of robust economic rebound in the near future, sluggish demands and downward pressure of international price of bulk commodities as a result of USD appreciation, PPI will remain in a negative territory

in the short run. We expect the Q4 PPI down 5.5%, 0.2 percentage point smaller than the Q3 drop, and the yearly PPI down about 5.1%, 3.2 percentage points bigger than last year.

I.2.2 Consumption still grows steadily and investment deceleration diminishes

First, consumption growth may pick up in a limited range. The cumulative real growth rate of disposal income per capita reached 7.6% in the first half year, down 0.5 percentage point from Q1 and down 0.8 percentage point from a year earlier. CCI (consumer confidence index) of this July was 104.5, down 5.4 and 1.0 percentage points from May and June, respectively (Figure 16). Both income and consumer confidence provide little impetus for acceleration in consumption growth. However, price rise is expected to rally, plus possible rapid growth of information consumption and housing consumption, which is good for stabilizing consumption growth. Q4 consumption is expected to grow slightly faster at a rate of about 11%.

Second, funds available and planned investments grow more quickly, and reduction in actual investment may narrow down. Funds available went up 6.8% cumulatively year on year in the first eight months, 0.5 percentage point higher than the first half year. In particular, growth of budgetary investment funds picked up 2.5 percentage points. Planned investments in construction projects and newly started projects this year augmented cumulatively by 5.1% and 2.7% on a year-on-year basis, up 1.4 and 1.1 percentage points from the first half year, respectively (Figure 17). Given the rallied housing sales fail to pull investments in the short run, manufacturing is cutting capacity and deleveraging and potential for infrastructure growth acceleration is limited, we expect investment growth to continue slowing in Q4 with a growth rate of around 9.3%.

Figure 16: Falling CCI

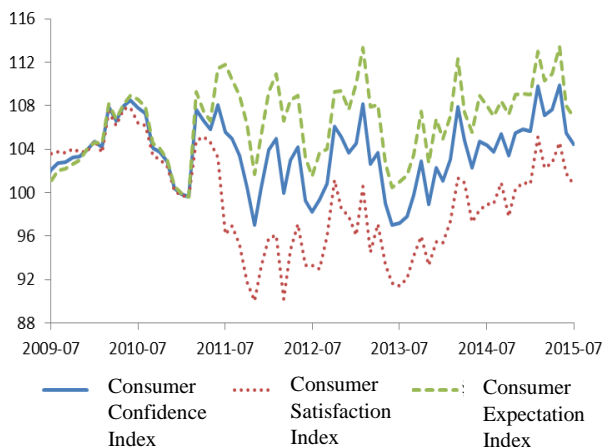
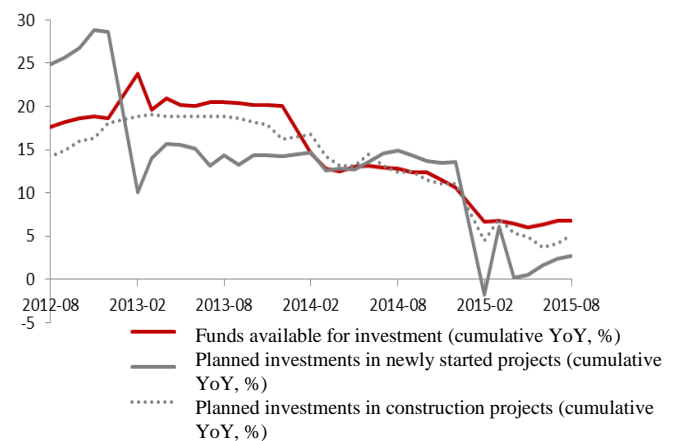


Figure 17: Growth of Funds Available for Investment and Planned Investment Amount

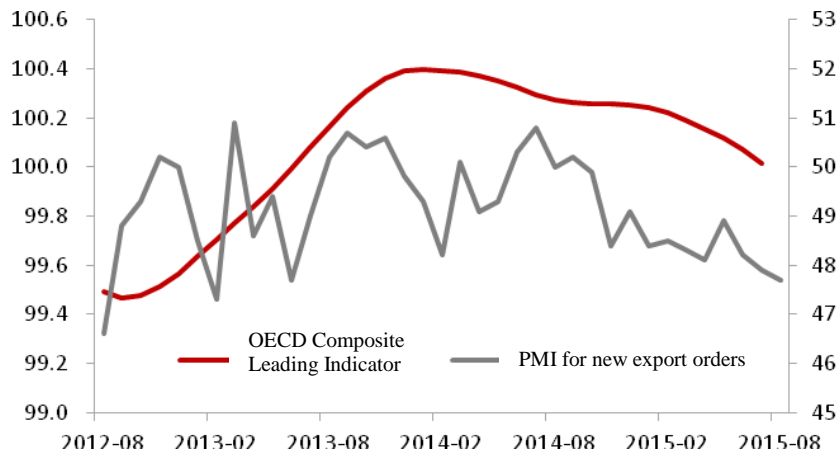


Sources: Wind, BOC Institute of International Finance

Third, both global and domestic economy continues to be sluggish while imports and exports face great difficulties. In terms of global economic climate, both OECD Composite Leading Indicator and China's official PMI for new export orders and foreign trade leading indicators were on the decline in July and August (Figure 18). RMB depreciation produces limited positive impacts on exportation, because it is offset by other depreciating currencies and global value chain. Meanwhile, in the light of the big downward pressure on domestic economy, we expect the Q4 exports and imports to decline by about 6.6% and 9.5%, respectively, bringing down China's

foreign trade dependence to the lowest level since the financial crisis.

Figure 18: Sluggish Economy at Home and Abroad



Sources: Wind, BOC Institute of International Finance

I.2.3 The industry is under restructuring and faces big operation pressure

Looking into Q4, industrial enterprises will still be under big stress in operation. First, domestic downward economic pressure is heavy, external economy is largely uncertain, demands are sluggish and PPI remains negative. Second, the central bank has cut interest rate and lowered reserve requirement ratio four times this year, so liquidity is quite ample in the market, further cutting down the enterprises' financing cost. However, as risks of the industry, some traditional industrial sectors in particular, are accumulating, industrial loans, especially medium and long-term loans will see a growth slowdown. The industry is deleveraging painstakingly. Third, pressure of environmental protection is still increasing. As a whole, industrial structure is reshuffling, traditional industries are challenged by transformation and upgrading, while high-tech and emerging industries are strengthening. Meanwhile, the government continues to streamline the administration and delegate power to lower levels, increase supports for small and medium-sized enterprises through tax/fee cuts and step up efforts in stabilizing economic growth. In addition, given the low base of Q4 last year, the Q4 industrial growth is expected to be around 6.3% on a year-on-year basis.

I.2.4 The real estate market is sure to recover and real estate investment is expected to stabilize

The real estate market will face a more favorable policy environment as well as some adverse conditions in Q4. On the one hand, the policy environment is the loosest in history. Since the end of August, the government has further lowered the required minimum percentage of down payment for the second house purchased on housing provident fund, and relaxed restrictions on access of foreign investors to the Chinese real estate market. These policies help release more demands and propel further recovery of the real estate market. On the other hand, the latest correction of stock market and volatile foreign exchange market produce undesirable effects on the real estate market. The plummeting stock market has made residents' wealth decrease and impaired their property purchase ability; subject to potential RMB depreciation, value of RMB-denominated properties

will drop accordingly. On the whole, in the context of favorable policies and an increasingly volatile financial market, recovery of the real estate market is further guaranteed, which will exert stimulation effects on real estate investment at the yearend. Thus, the Q4 real estate investment is expected to stabilize. Thanks to the eased restrictions on housing purchase by non-locals, tier-one and tier-two cities will see housing price to rally, but there will be no drastic or soaring increase.

Table 3: Forecasts on China's Main Economic and Financial Indicators in 2015Q4 (%)

Indicator	2012 (R)	2013 (R)	2014 (R)	2015				
				Q1(R)	Q2(R)	Q3(E)	Q4(F)	2015(E)
GDP	7.7	7.7	7.3	7.0	7.0	6.8	7.0	7.0
Industrial value added	10	9.7	8.3	6.4	6.3	6.2	6.3	6.3
Fixed asset investment	20.6	19.6	15.7	13.5	10.3	9.5	9.3	10.5
Retail sales of consumer goods	14.3	13.1	12.0	10.6	10.3	10.8	11.0	10.5
Exports	7.9	7.9	6.1	4.5	-2.5	-7.0	-6.6	-3.4
Imports	4.3	7.3	0.4	-17.8	-13.5	-11.0	-9.5	-13.0
CPI	2.6	2.6	2.0	1.2	1.4	1.9	2.0	1.6
PPI	-1.7	-1.9	-1.9	-4.6	-4.7	-5.7	-5.5	-5.1
M2	13.8	13.6	12.2	11.6	11.8	13.2	13.2	13.2

Source: BOC Institute of International Finance

II. Financial Review and Outlook

II.1 Q3 financial review

II.1.1 Policies were loosened and money and credit grew rapidly

Monetary aggregates grew rapidly. At the end of August, balance of broad money supply (M2) increased by 13.3% year on year to RMB135.7 trillion, representing a growth 1.5 and 0.5 percentage points higher than the end of June and a year earlier, respectively (Figure 19). M2 growth rate firmed up rapidly, which could be mainly ascribed to the emerging effects of such monetary policies as IR and RRR cuts. Balance of narrow money supply (M1) went up 9.3% year on year to RMB36.3 trillion, representing a growth rate 5 and 3.6 percentage points higher than the end of June and a year earlier, respectively.

Loans of financial institutions maintained a steady growth in general. At the end of August, balance of financial institutions' loans increased by 15.4% on a year-on-year basis to RMB91.1 trillion, 2

percentage points up from the end of June. Specifically, incremental RMB loans of the first eight months recorded RMB8.8 trillion, up RMB2 trillion from the equivalent period last year. The growth of medium and long-term RMB loans was divergent: Growth of medium and long-term RMB loans of non-financial corporations slowed down with an increment of RMB121.7 billion in August, RMB119.1 billion less than the same period last year. This indicated less enthusiasm of enterprises for investments and weak credit demands. This year's new property policies have stimulated the rise of requirements for residential mortgages. Residents' medium and long-term RMB loans increased quickly by RMB285.5 billion in August, RMB96.5 billion more than the same period last year.

Social financing scale had a steady growth. Existing social financing scale stock hit RMB133.4 trillion at the end of August, representing a year-on-year increase of about 12.3%. Social financing increment from January to August was RMB10.6 trillion, RMB1.2 trillion less than the increment in the same period last year (Figure 20). Structurally, the percentage of indirect financing sized up substantially. Increment in RMB loans went up RMB1.1 trillion from January to August year on year, accounting for 75.2% of social financing increment during the same period, 17.2 percentage points higher compared with the same period last year. Increment in off-balance-sheet financing slowed down sharply. Entrusted loans, trust loans and undiscounted banker's acceptance bills totaled RMB379.5 billion from January to August, representing an increment RMB2 trillion less than the same period last year and accounting for 3.6% of total social financing increment during the same period last year. Direct financing witnessed a steady growth, of which, domestic bonds and stocks of non-financial corporations increased by RMB80.1 billion more than the same period last year to RMB1.95 trillion from January to August, taking up 18.5% of total social financing increment during the same period last year.

Figure 19: Money Aggregates Grew Rapidly

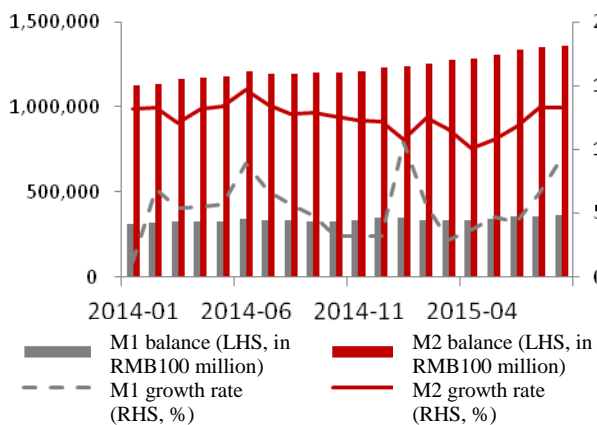
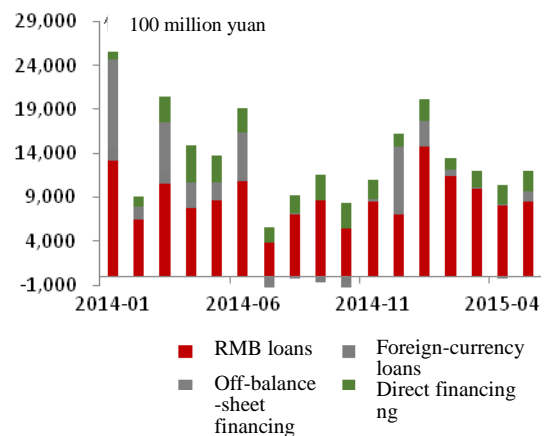


Figure 20: Social Financing Scale Sustained a Steady Growth



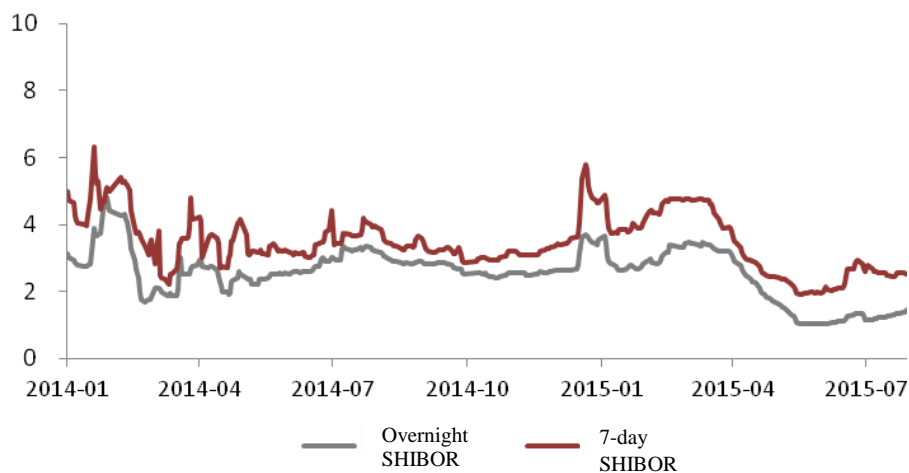
Sources: Wind, BOC Institute of International Finance

II.1.2 The money market liquidity was ample overall and interest rates stayed low in the year

Since Q3, the central bank has employed multiple monetary policies to keep generally ample liquidity. On August 25, the central bank announced it would lower the reserve requirement ratio for RMB deposits of financial institutions by 0.5 percentage points as of September 6 so as to fill

the gap of liquidity resulting from foreign exchange fluctuations. Besides, it conducted some open market operations (OMO) such as reverse repo and time depositing of Treasury cash. On August 27, it reduced the reserve repo interest rate by 0.15 percentage points again to 2.35% in addition to such new-type monetary policy instruments as SLO and MLF. All the efforts assured market expectations for loose monetary policy. As effects of IR and RRR cut policy emerged, interest rates of the money market maintained a low level, but interest rates of different maturities showed divergent trends. On the one hand, overnight SHIBOR edged up to 1.899% on September 14, 64BPs higher than the end of June but 174BPs lower than the year beginning. On the other hand, 7-day, 2-week, 1-month SHIBOR fluctuated downwards after rising to a peak high at the end of June; 7-day SHIBOR fell by 26BPs from the end of June and 249BPs from the year beginning to 2.394% on September 14.

Figure 21: Trends of Overnight and 7-day SHIBOR (%)



Sources: Wind, BOC Institute of International Finance

II.1.3 The bond market remained “slow bull” and interest rate curve flattened.

In Q3, supported by IR and RRR cut policy and bond's function of risk hedging in a volatile stock market, the bond market stayed in a “slow bull” state after temporary fluctuations at the end of June. On September 15, the CSI Aggregate Bond Index went up 2.96 from the end of June to 162.28 (Figure 22). Specifically, the bond market showed the following features: First, short-term interest rates increased. Against a volatile stock market and exchange rate depreciation, financial institutions sold off highly liquid and quality bonds more quickly to replenish liquidity, causing a temporary increase in short-term interest rates. YTM (yield to maturity) of 1-year T-bonds rose from 1.7378% at the end of June to 2.25% on September 15. Second, term structure of interest-bearing bonds tended to flatten. Benefiting from the central bank's IR and RRR cuts, more reverse repurchases and SLO operations, interest rates of medium and long-term T-bonds dropped faster with a narrowed spread between long-term and short-term bonds. Interest rate spread between 10-year and 1-year T-bonds has gradually shrunk from about 200BPs at peak in June to 98BPs (Figure 23). Third, credit spread presented divergent trends, with interest rates of low-rated short-term bonds dropping further. On September 15, 1-year interest rate of low-rated (AA or below) medium-term notes dropped by over 600BPs from the end of Q2; 1-year interest rate of high-rated medium-term notes fell by about 210BPs, while 8-year interest rate went down by about

230BPs.

Figure 22: China Interbank Composite Bond Index

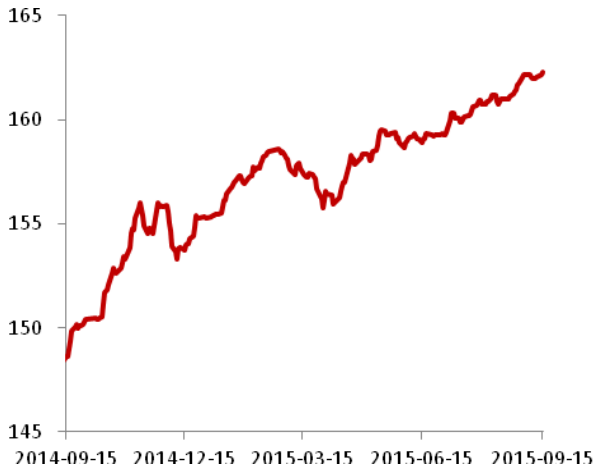
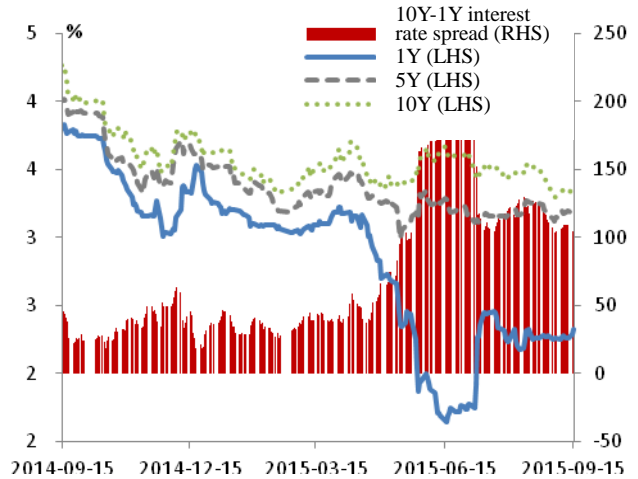


Figure 23: Changes in Yield Curve and Interest Spread of T-bonds



Sources: Wind, BOC Institute of International Finance

II.1.4 Leverage fund caused abnormal volatility of stock market and the government adopted a series of measures to stabilize the market

Since the mid-June, the Shanghai and Shenzhen stock markets have suffered two rounds of abnormal volatility, witnessing a speed and amount of decline that are rarely seen in history. From June 15 to July 8, the SSE Composite Index and the SZSE Component Index plummeted by 32% and 39% respectively; from August 18 to August 26, the two indices both fell by 27%, nullifying the increment since the end of last year (Figure 24).

These two rounds of big fluctuations have different causes. The first round of volatility was a result of over-development of leverage funds mainly, with prominent market liquidity risk and systematic financial risk. Afterwards, multiple measures were taken to maintain the stock markets' stability such as liquidity injection and regulation of OTC financing. The second round of volatility was mostly related to the violently vibrating global capital market and fragile confidence of investors.

Currently, balance of margin trading has fallen from the peak of RMB2.2 trillion to less than RMB1 trillion (Figure 25). As OTC financing companies were regulated, the stock market bubble caused by high leverage was relieved to some extent, and risks on the stock market were greatly mitigated. Policy adjustments also contained speculation spree.

Figure 24: SSE Composite Index and SZSE Component Index Plummeted

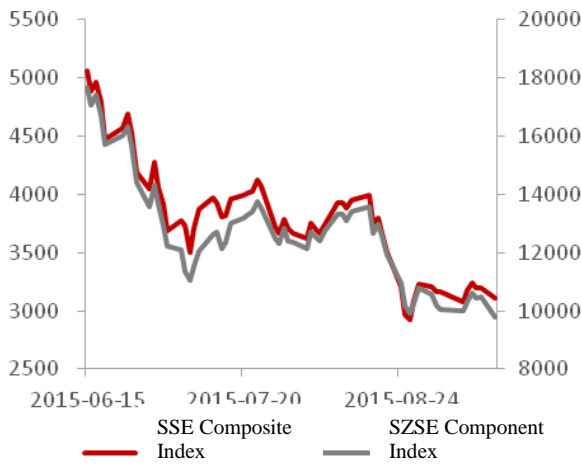
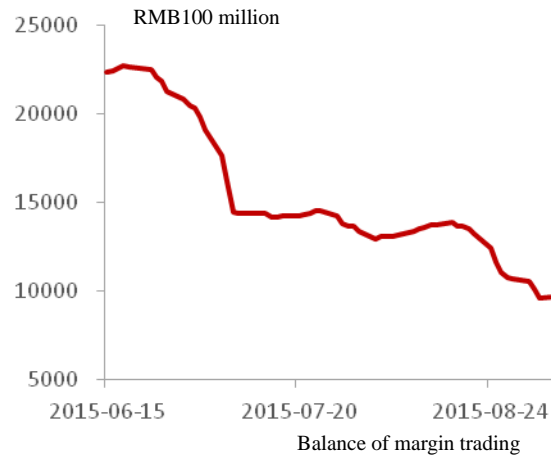


Figure 25: Balance of Margin Trading was Halved Compared with the Peak Period

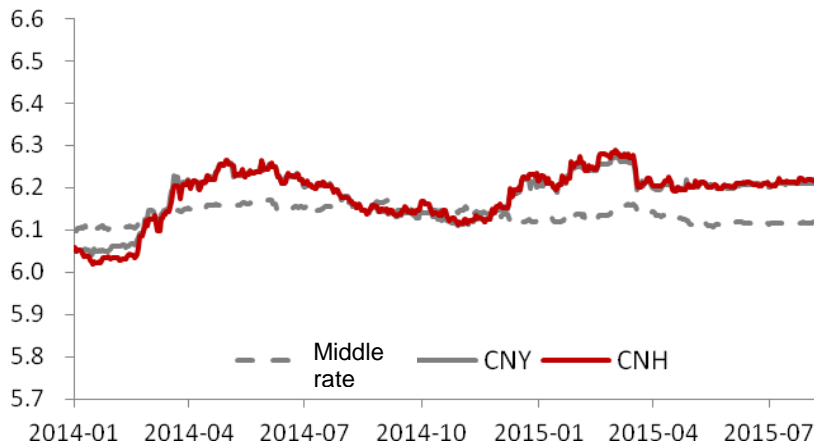


Sources: Wind, BOC Institute of International Finance

II.1.5 RMB/USD had short-term corrections and became increasingly market-oriented

During the first half of Q3, RMB/USD continued a steady trend overall. The middle exchange rate of RMB against USD was reported 6.1162 on August 10, depreciating slightly by 0.04% from the end of June but appreciating by 0.14% from the year beginning (Figure 26). As at the end of July, the nominal and real effective RMB exchange rates strengthened by 2.6% and 3.5% from the year beginning, respectively. With high expectations for USD interest rate hike and marked volatilities in domestic and overseas financial markets during the early period, depreciation pressure of RMB exchange rate was accumulating.

Figure 26: Movements of RMB/USD



Sources: Wind, BOC Institute of International Finance

On August 11, the central bank decided to further improve the RMB-USD middle exchange rate quotation mechanism, resulting in a near 5% depreciation of the middle rate for three consecutive days. Improving the middle rate quotation mechanism is an important step in the exchange rate formation mechanism reform. After a period of corrections, RMB depreciation pressure has been

basically released, and deviation between middle rate and market rate has been revised. The RMB-USD middle rate was reported at 6.3709 on September 16, differing with CNY by only 30BPs.

II.2 Q4 financial outlook

II.2.1 Money and credit will maintain a moderate and steady growth

In Q4, against the backdrop of continued loose monetary policy, M2 is expected to grow rapidly. The potential growth rate of M2 in 2015 is about 12%. In the light of changes in the economic and financial landscapes, the growth rate may go higher to around 13.2%. To better stabilize economic growth, bank loans will keep a moderate and steady growth with new RMB loans possibly at around RMB11.5 trillion in the year. To balance risk prevention and growth stabilization, among other relations, off-balance-sheet financing may keep a stable growth without big ups and downs. Scale of bond financing is expected to expand and social financing scale may stay stable in general due to low-level interest rates and growth-stabilizing policy.

II.2.2 The money market will remain stable in general with small fluctuations of interest rates at low level

Domestic growth stabilization and LGFV replacement require a loose money and credit environment. Meanwhile, market liquidity is facing certain pressure due to some uncertainties such as looming USD interest rate hike and fluctuating international financial markets. It is expected that the central bank will make efforts to sustain appropriate liquidity through a bundled use of various monetary policy tools in Q4. On the one hand, as funds outstanding for foreign exchange gradually cease to be the main channel of base money supply, the central bank will resort to new-type monetary policy tools such as lowering RRR, OMO, SLF, MLF and PSL to timely fill up the gap of base money supply and maintain reasonable liquidity. On the other hand, the central bank will flexibly inject and recover liquidity according to changes in domestic economic and financial situations to keep appropriate liquidity at different maturities. We expect the money market to remain stable overall with interest rates at different maturities slightly fluctuating at a low level.

II.2.3 The bond market will keep ameliorating and credit spread trend will diverging further

In Q4, the bond market will keep ameliorating with unabated economic downward pressure, basically loose policy and stressing foreign exchange market, but attention should be paid to short-term interest rate rise and deterioration in credit of low-rated bonds. Specifically, first, considering potential interest rate hike by the Fed and short-term depreciation of RMB exchange rate, there is some pressure on short-term liquidity and downward space for short-term yield rate is relatively limited. Second, it is necessary and feasible for monetary policy to further loosen. Value of long-term interest-bearing bonds will prevail under risk aversion and asset scarcity, and medium and long-term interest rates have downward space. Third, credit spread trends may continue diverging. Credit spread between bond products with different terms or different credit ratings is largely subject to liquidity profile and risk factors. With the smooth rollout of the third round local government debt replacement, credit risk of some city construction investment bonds tend to reduce. But given the weak economic fundamentals, NPL ratio will continue to climb and credit of low-rated bonds may deteriorate further.

II.2.4 The stock market is under repair and construction with little possibility of becoming bullish

Though overall valuation of the current stock market is relatively low and the economy may stabilize and recover in the coming period, the market will not see rapid and robust rebound; instead, focus should be placed on restoring investors' confidence and establishing market systems. First, traditional industries are still encumbered with over-capacity and big profitability pressure. Thus, it is hard to see a booming stock market driven by PE ratio improvement. Second, there are no conditions in the market for revaluation. In terms of capital, trade surplus is unlikely to translate into money supply due to low willingness to settle foreign exchange; banks are reluctant to extend loans due to NPL pressure; the China Securities Regulatory Commission's moves in regulating OTC financing will also affect market liquidity. In terms of investors' confidence, the recent rising bond market reflects the accumulating risk aversion of investors, while the stock market is relatively sluggish, requiring some time for corrections.

II.2.5 Two-way fluctuations of RMB/USD will become a normal state without foundation for long-term depreciation

Temporary fluctuations of the foreign exchange market have come to an end, and panic in the market has been soothed. However, given the shaky foundation for the Chinese economy to stabilize and recover plus the biggest monthly fall in foreign exchange reserves in August, it is still possible for offshore RMB exchange rates to devalue. In Q4, with domestic and overseas uncertainties, RMB/USD is likely to fall. As the market-oriented RMB exchange rate formation mechanism continues to improve, elasticity of RMB exchange rate will be further enhanced and two-way fluctuations will become a normal state. In the long run, in the light of a big surplus in our current account, better economic fundamentals in the medium and long run and rising demands for RMB in the overseas markets, there is no foundation for long-term depreciation of RMB/USD.

III. Direction of Macro Policies

III.1 Give fiscal policy a bigger role in stabilizing economic growth

Under sustained economic downward pressure and emerging risks, the government should adopt more robust and proactive fiscal policy to better support growth stabilization in Q4. A key move to implement the proactive fiscal policy is still vigorously advancing major infrastructure construction projects and people's livelihood projects and stepping up efforts to cut taxes/fees. Meanwhile, the following issues should be addressed properly to make fiscal policy more effective and pertinent:

First, “money” constraints should be relieved. Facing economic downturn and a big slowdown in land income, local governments will encounter fiscal pinch and increasing capital constraints. Therefore, local government debt replacement should be accelerated, subsequent credit financing for projects in construction should be increased and market-oriented financing of LGFVs should be promoted.

Second, “people” constraints should be lifted. It is important to build and improve an incentive and punishment mechanism for officials to weed out “dereliction of duty” of some local governments, as well as speed up revitalizing and making good use of fiscal capital stock to help

stabilize economic growth.

Third, innovation in system and mechanism should be conducted. China should accelerate carrying out VC guidance funds of emerging industries, popularize PPP (Public-Private Partnership) financing funds, study and set up national SME development fund, use funds supported by fiscal expenditures to stimulate private investment, channel and encourage more private capital into key fields conducive to growth stabilization, restructuring and people's welfare.

III.2 Maintain basically loose monetary policy with more attention to balancing internal and external liquidity

Given big economic downward pressure, normalization of funds outstanding for foreign exchange decrease, existing RMB depreciation pressure and lingering risk of stock market volatility, monetary policy is expected to play a crucial role in growth stabilization and risk prevention. At present, price rise has not yet constituted inflation pressure; reserve requirement ratio of 18% on large-scale commercial banks is still high in history. These are conditions for monetary policy to stay loose. Future monetary policy will focus more on balance between internal and external liquidity, and there is possibility of IR and RRR cuts. First, greater efforts should be put in OMO and RRR should be lowered in due course to fill gap of base money supply caused by reduced funds outstanding for foreign exchange. Second, the government should guide money market interest rates to run steadily at a low level and may consider taking advantage of the "window period" on the eve of the Fed's interest rate rise to cut interest rates. Third, financial institutions should increase efforts to offer all sorts of financial products with different terms, especially T-bonds that can effectively link short-term interest rate with medium and long-term one, and CD (certificate of deposit). Besides, efforts should be made to speed up building of an effective benchmark interest rate-based conduction system of monetary policy.

III.3 Increase investment in major projects and reinvigorate investors

In Q4, it is imperative to curb further decline in investment and promote stabilization of investment growth with emphasis on further deepening investment and financing system reform, implementing the latest deployments for investment, carrying out key projects, making investment with special construction funds and improving efficiency of public investment. Meanwhile, it is important to reinvigorate investors and encourage private capital investment.

First, funding for major projects under construction or renewed construction should be guaranteed. Window guidance to financial institutions should be strengthened to avoid undifferentiated withdrawal, termination and delay of loans. The government should accelerate advancing of the three initiatives ("Belt and Road", Beijing-Tianjin-Hebei synergetic development and Yangtze River Economic Belt), urbanization, "Popular entrepreneurship & mass innovation" and international cooperation in production capacity, strengthen construction of major project pools and start key projects as soon as possible.

Second, multiplier effect of public funds should be fully utilized and weak links in the initiative of building a well-off society in an all-round way should be improved. The government should strengthen investment and combine PPP model with capital ratio cut to open channels for financial funds to flow to key projects. Moreover, more attention should be paid to enhancing quality and efficiency of investment, and brought the role of public investment into full

play.

Third, the government should further streamline the administration and delegate power to lower levels, balance laissez-faire and regulation and improve its services to reinvigorate market players and fuel self-sustaining engine of economic growth. It is important to further ease restrictions on access to certain industries, expand scope of fixed assets covered by preferential depreciation tax policy, reduce restrictions on investment, mobilize private capital through investment-loan combination, debt-loan portfolio and governmental funds, and expand investments in emerging industries and key fields.

III.4 Focus on stabilizing growth, expanding space and seeking transformation of foreign trade

First, policies should be implemented properly with emphasis on stabilizing growth of foreign trade. This year, the State Council has issued a series of growth-stabilizing documents such as the *Opinions on Promoting Stable Growth of Imports and Exports*, the *Opinions on Improving Port-related Work to Support Development of Foreign Trade*, the *Opinion on Accelerating Nurturing New Competitive Edges of Foreign Trade*, and improvement of export rebate etc. Emphasis should be placed on implementing these policies in Q4.

Second, it is advisable to make use of favorable external conditions to further expand space for exports. With a series of favorable diplomatic conditions, China should seize opportunities brought by national infrastructure construction along the “Belt and Road” and Asian Infrastructure Investment Bank to expand space for exporting complete sets of large-scale equipment and relevant goods and services.

Third, China should actively seek opportunities for transformation and nurture new formats of foreign trade. Active efforts should be made to develop a group of leading comprehensive service providers for foreign trade to provide professional supply chain services for foreign trade SMEs, lower their costs and inject fuel into transformative development of foreign trade.

III.5 Real estate macro-control should focus on stabilizing investment and promoting diversification of financing channels

Though housing sales are picking up, real estate investment is still slowing down. Future real estate macro-control policy should focus on stabilizing investment and promoting steady recovery of the market. First, risk weight of property loans should be adjusted properly and commercial banks should be encouraged to increase lending to real estate enterprises; besides, development of trust funds for real estate investment should be accelerated to diversify the financing channels. Second, it is necessary to expedite regional economic integration, promote regional reconstruction of population, industry and economy and stimulate release of potential demands. Third, differentiated (supportive or restrictive) policies should be taken depending on the situation. Supportive policy should be adopted for regions with a large housing stock such as further cutting tax and reducing fees; restrictive policy on housing purchase and lending should be imposed on regions with housing price rising rapidly. Fourth, efforts should be made to accelerate building a nationwide housing information network to prepare for accurate macro-control and levy on property tax in the next step.

IV. Topical Analysis: Judging on the Trends of Chinese Economy

China has sustained 37 years of rapid economic growth with an annual growth rate of 9.8% since 1978, creating an economic miracle. In recent years, Chinese economy has walked onto the descending track, seeing its GDP growing by 10.6% in 2010 downwards to 7.3% in 2014 and possibly to around 7% this year. Judging from main economic indicators of the recent months, Chinese economy will face great downward pressure in the years ahead. Then, is China's decelerating economy "a trendy downturn" as a result of falling potential growth rate or "a cyclical bottom" of economic fluctuations? Will China's economic growth continue to dip or gradually stabilize and recover in the next five years? Next we are going to discuss on this topic.

It is well-known that Japan and South Korea are two typical major economies which have succeeded in maintaining long-term rapid economic growth after the World War II. Alongside enlarging economic scale and improving development level, both Japan and South Korea reported falling economic growth rates, and failed to return to the previous level. It is significant to draw on historical experiences of Japan and South Korea before and after the turn of their economic growth and meanwhile take into account China's own economic features so as to predict China's future economic trend and cyclic movements.

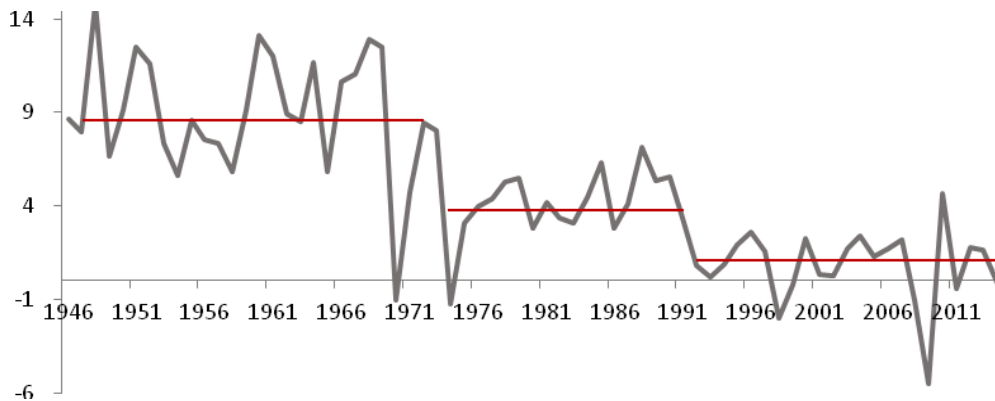
IV.1 Time points and characteristics of the turn of Japan's economic growth

By GDP growth rate, Japan's economic development can be roughly divided into three periods: the rapid growth period from 1950 to 1973, the steady growth period from 1974 to 1991 and the slow growth period from 1992 to 2014. During 1970 and 1973, Japan's economy begun to slacken, from about 9% in the past to around 4% (Figure 27).

When declining to the medium range, the country's GDP per capita was about USD15,000 (in constant price of 2005). The economy showed the following characteristics and changes:

First, the economy was shocked by external factors. The global economy was in recession under the shadow of the first oil crisis in 1973, the 1973-1975 economic crisis and the 1979-1983 economic crisis in the western countries. This dealt a direct blow to Japan's exports. What's more, the external factors led to escalating trade frictions between Japan and the US and European countries, substantially increased pressure of JPY appreciation, in particular a sharp revaluation of JPY in the wake of the signing of the *Plaza Accord* in 1985. In a word, Japan's export capability was severely undermined.

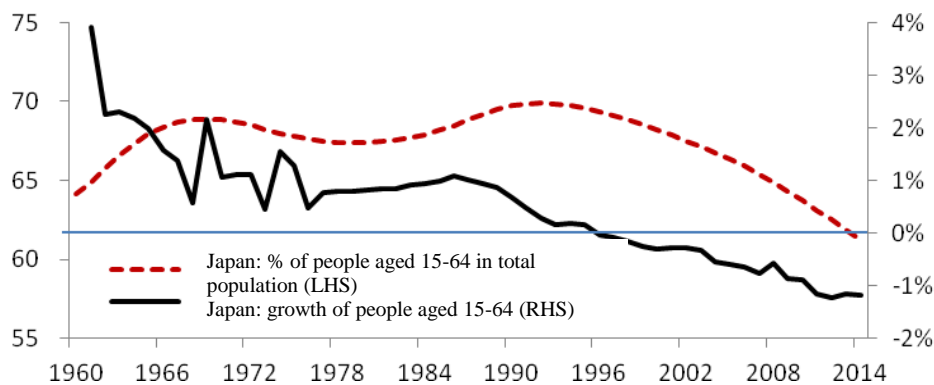
Figure 27: Japan's Economic Growth Rate (%)



Sources: Wind, BOC Institute of International Finance

Second, its population structure was changed. As the population continued to age, proportion of Japanese aged 65 and above reached 7.1% in 1970, exceeding the UN's aging society criterion of 7% for the first time. Meanwhile, proportion of working population between 15 and 64 years old started to drop. Though it rebounded a little bit in the early 1980s, its working population started to shrink again in the 1990s due to the decreasing birth rate. Besides, the absolute number of working population decreased for the first time in 1996, and since then has been on the decline (Figure 28).

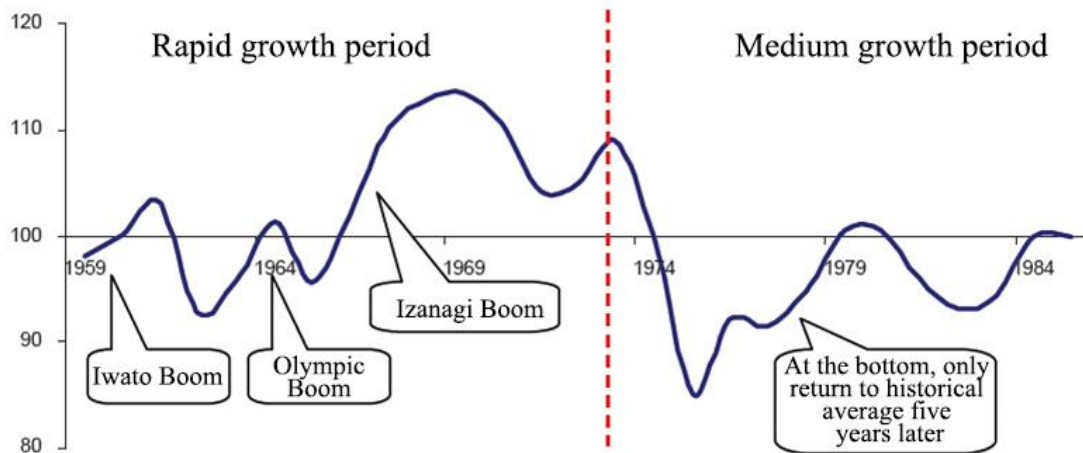
Figure 28: Proportion (%) and Growth of Japanese Population Aged 15-64



Sources: Wind, BOC Institute of International Finance

Third, profound changes took place in the industrial structure. Japan's proportion of industrial value added was on the constant rise during the rapid economic growth period, reaching 40.6% in 1970 (48.6% for the secondary industry). Afterwards, the industry's proportion started to shrink in parallel with a rising proportion of the tertiary industry. At the same time, as the economy shifted from the fast track to the medium-speed track, supplies exceeded demands in the domestic market and enterprises were trapped by over-capacity and substantially falling and then slowly recovering capacity utilization rate. The situation got better until 1980 (Figure 29).

Figure 29: Changes in Japan's Capacity Utilization Rate (%)



Source: P116-117, the *History of Japan's Business and Industry Policies* (Issue 16)

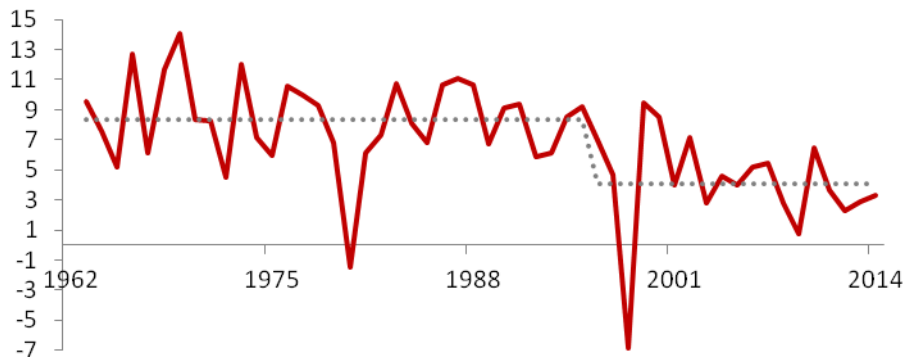
Fourth, urbanization process gradually slowed down. Japan's proportion of urban population climbed from 37.3% in 1950 to 72% in 1970 with an annual growth rate of over 1 percentage points. As the economic growth slowed down after 1970, annual increase in urban population slowed down to 0.8 percentage points, then to 0.1 percentage points after 1976. The urbanization rate hadn't seen a yearly increase of over 1 percentage points until 2001.

Fifth, government debts increased. The Japanese government increased expenditures amidst a slower economy. From 1970 to 1979, government expenditures had an average growth rate of 19% and the T-bond load rate soared up from 3.7% to 25%. With a skyrocketing government debt load rate, the proportion of government debts to GDP broke the internationally recognized divide line of 60% in 1982 for the first time. Slowdown in revenue growth and climbing debts, to some extent, capped the Japanese government's capability of economic intervention.

IV.2 Time points and characteristics of the turn of South Korea's economic growth

South Korea's economy started to flourish in the early 1960s and maintained a rapid growth for 33 years. Its annual GDP growth rate was as high as 8.3% during 1963 and 1995, creating an economic miracle. Many hold that South Korea's economic growth started to slow down since the Asian financial crisis. As a matter of fact, marked slowdown began in 1996, the year before the outbreak of the crisis. Though the 7% GDP growth rate in 1996 was still high, it fell by 2.2 percentage points over 1995. The annual average growth rate between 1996 and 2000 was merely 4.6%, and there was a serious economic recession in 1998 with GDP plummeting by 6.9% (Figure 30). The country's GDP growth rate managed to climb back to 9.5% and 8.5% in 1999 and 2000, but it was merely a natural rebound from a sharp decline in 1997 and 1998. Since 2000, South Korea has never seen its economic growth rate back to 8%; the yearly average economic growth rate was only 4.1% from 1996 to 2014, and only 3.2% during 2008 and 2014 under the shadow of the global financial crisis.

Figure 30: South Korea's GDP Growth Rate 1963 through 2014 (%)



Sources: Wind, BOC Institute of International Finance

When its rapid economic growth turned downward, the country's GDP per capita was approximately USD13, 000 (in constant price of 2005), lower than the level of Japan at the turn. South Korea's economy presented the following characteristics and changes at that time:

First, the economy was dampened by external factors. South Korea went through similar experiences with Japan in the 1970s as the global economy was gloomy due to the 1997 Asian financial crisis, the 2001 American dot-com bubble burst and the 911 terrorist attack.

Second, aging was accelerating. In the 1960s when its economy took off, South Korea's proportion aged 65 and above to the total population remained basically unchanged or even declined. During 1963 and 1995, the proportion of senior population climbed by only 0.1 percentage points annually, and abundant young labor force brought demographic dividend for rapid economic growth. Around the mid-1990s, the country saw accelerating population aging with proportion of senior population rising by 0.4 percentage points on average each year, substantially higher than that during the rapid growth period.

Third, profound changes took place in the industrial structure. Like Japan, South Korea's industrial valued added was on the constant rise during the rapid growth period, soaring all the way from around 20% in the early 1960s to the historic peak of 41.9% in 1995. Afterwards, the industry started to see a shrinking weight, while the weight of the tertiary industry began to go from 51.8% in 1995 to 61.2% in 2008 and then declined a little bit. Productivity of the tertiary industry is generally lower than the industry. This structural change is the main cause of the slowdown in economic growth.

Fourth, urbanization slowed down substantially. In the rapid economic growth period, South Korea's proportion of urban population climbed unceasingly from 29.6% in 1963 to 78.2% in 1995 with an annual increase of 1.5 percentage points, even faster than the speed of Japan in its rapid growth period. After 1996, the country's yearly urbanization increase rate plummeted, with a mere 0.2 percentage points growth during 1996 and 2014.

IV.3 Is China's economic growth at the turn?

Compared with characteristics and changes of Japan's and South Korea's economy at the turn, domestic and overseas economic conditions facing China bear many similarities as well as obvious

differences.

In terms of development level, China's GDP per capita in 2014 was only USD7,594, less than USD4,000 adjusted in constant price of 2005, greatly lagging behind the development level of Japan and South Korea at the turn. This indicates huge potential for exploring and releasing second-mover advantages and further accelerating economic growth.

In terms of demographic structure, China has entered the aging society at a greatly accelerated speed after 2010, with a yearly increase of 0.1 percentage points to 0.2-0.3 percentage points. Proportion of Chinese people aged 65 and above to total population reached 9.1% in 2014; proportion of working population started to fall in 2011 and the number of working population has descended for three consecutive years since 2012.

Table 4: Comparison of Main Indicators of Japan, South Korea and China in Different Periods (%)

	Japan			South Korea		China	
	1950-1973	1974-1991	1992-2014	1963-1995	1996-2014	1978-2011	2012-2014
Average GDP growth rate	8.8	4.1	0.82	8.3	4.1	10	7.6
CPI	—	5.5	0.2	9.4	3.2	5.4	2.4
Growth rate of government expenditures	18	9.6	0.85	—	8.9	15.7	11.6
Growth rate of government revenue	14	8.7	1.5	—	8.3	15	10.6
Government debts/GDP	—	51.3	132.1	11.3 ^d	23.9	37	55
Outstanding T-bonds/GDP	3.9 ^a	30	88	—	18.3 ^h	11.4	15.8
M2/GDP	83 ^b	156	217	29.1	104.1	21.3	13.2
Real interest rate	7.6 ^b	7	2.3	2.1 ^e	4.4	1.8	4
Private sector credit/GDP	89 ^b	148	193	37.6	102.3	91	136
Primary industry/GDP	11.5 ^c	3.9	1.7	16.7	3.6	20.3	9.4
Secondary industry/GDP	45.8 ^c	43	33.5	35.2	37.6	45.2	43.8
Tertiary industry/GDP	42.7 ^c	53.1	64.8	48.0	58.7	34.5	46.8
Consumption/GDP	66.2 ^c	67.6	75.1	70.7 ^f	65.7	59.8	51
Investment/GDP	33.2 ^c	31	24.1	31.8 ^f	31.6	38.2	46.3
Net exports/GDP	0.6 ^c	1.3	0.7	-2.5 ^f	2.8	1.9	2.6
Urbanization rate	69 ^b	76	84	55	808	32	53
People aged 65 or above/total population	6.5 ^b	9.7	18.9	4.1	9.3	6.5	8.9
R&D expenses/GDP	—	—	3.2 ^j	—	2.4 ^j	1.1	2
High-tech product exports/finished product exports	—	24.2 ^g	22.9	20 ^g	28	20.3 ⁱ	26.6

Note: Due to unavailability of data, starting and ending years of some indicators are adjusted. a refers to 1965, b 1960, c 1955, d 1990, e 1980, f 1970, g 1988, h 1999, i 1992 and j 1996-2011.

Sources: Wind, BOC Institute of International Finance

In terms of industrial structure, the weight of China's industrial value added in GDP declined from a high level of 41.8% in 2006 to 35.9% in 2014 with serious industrial over-capacity. The weight

of value added of the service industry in GDP is climbing to almost 50%. This landscape is quite similar to Japan and South Korea when their economies took a downturn.

In terms of urbanization, China's current urbanization rate is only 54.4%, far lower than the level of Japan and South Korea at the beginning of economic slowdown. Meanwhile, China's urbanization rate is rapidly increasing by 1 percentage points each year since 1996. This is quite similar to Japan and South Korea in rapid economic growth.

In sum, we think that accelerating population aging will result in shrinking demographic dividend, and falling weight of the industry and expanding weight of the service industry will slow down productivity. In addition, the global economy is still in recovery from the crisis, hiding many uncertainties. China's local governments and enterprises are busy with de-leveraging; it takes a period of time to absorb over-capacity; switchover between growth engines has not yet been completed. All these factors indicate that China's economy is unlikely to see another ultra-high growth rate of around 10% in the near future and will have a certain degree of slowdown. A large part of the economic slowdown since 2010 is the result of this process.

However, China's current economic development level is quite low, especially in the central and western regions; there is huge space for urbanization expansion in the future with a potential annual increase of 1 percentage points, which means investment and consumption will still grow quickly. Based on earlier studies in potential growth rate and experiences in China's economic cycle fluctuations, we predict China's economic growth will decrement less than Japan or South Korea. Despite economic downward pressure remains great in the upcoming one to two years, it is still possible for China to post an annual growth rate of 6.5% or above in the next five years.

IV.4 Implications and suggestions for China

To better react to complicated domestic and overseas economic conditions and avoid dramatic and large fall in economic growth, China can learn lessons from Japan's and South Korea's economic transformation, take suitable actions according to new characteristics under new normal, make well-targeted efforts, take opportunities to lengthen the medium and high growth periods and take initiatives in striding over "Middle Income Trap" and realizing the strategic "Two Centenary Goals".

First, transformation and upgrading of the industry should be promoted. Rapid industrial growth always echoes a fast growing economy, which can be proved by the ascending proportion of the industry in Japan and South Korea in parallel with rapid economic growth. In the future, China should never overlook development of modern manufacturing when vigorously developing modern services. The government should align with the "Made in China 2025" strategy and the "Internet +" trend, speed up transformation and upgrading of traditional industries, accelerate nurturing and strengthening of new products and new business formats and advance development of medium and high-end industry.

Second, new-type urbanization should be advanced. When a country's urbanization rate is between 50% and 70%, it is going through rapid urbanization and economic growth. While advancing the household registration system reform and the land system reform in urban and rural areas, China should further remove restrictions and bottlenecks on rapid urbanization, make reasonable plans for city layout, effectively guide development of city clusters, encourage healthy

growth of satellite cities surrounding super cities and mega cities, and expedite improving underground pipe networks and aboveground production and living facilities in cities.

Third, consumption potential should be further tapped into. Compared with Japan (about 57%) and South Korea (about 50%), China had a low consumption rate of only 37.7% in 2014. It is necessary to make and refine pro-consumption plans and policies, vigorously increase residents' income, protect and nurture the middle class, improve income distribution, and create favorable conditions for expanding new-type consumptions of information and electronic products, elderly care and health care, tourism and leisure, culture and sports to better improve people's life and promote economic development.

Fourth, entrepreneurship and innovation should be fueled. Entrepreneurship and innovation play a key role in improving productivity and buffering slowdown in productivity growth in the wake of industrial restructuring. China should continue to increase the proportion of R&D expenses in GDP, create a system of investment, financing, tax, fiscal and financial policies that encourage entrepreneurship and innovation and encourage all sorts of enterprises, research institutes and governments to work together to propel innovation.

Fifth, the population aging challenge should be dealt with actively. Preventive actions should be taken to combine improvement of the social elderly care system and development of the silver economy. To realize the 2020 development target of elderly care services, the government should guarantee basic social security, step up efforts in preferential land, tax and subsidy policies, attract more social forces to pitch in, build industrial clusters of elderly care services and stimulate consumption relating to elderly care. Besides, due attention should be paid to elderly care in rural areas, and pilot programs should be launched such as reform on public elderly homes and reverse mortgage pension insurance.

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