

China's Economic and Financial Outlook

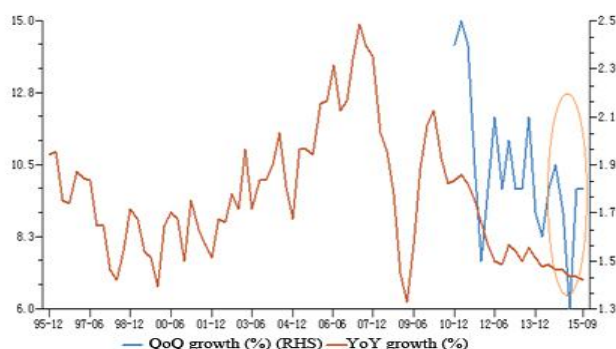
2016 Annual Report (Issue 25)

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Highlights

- In 2015, China faced multifold challenges in the stabilization of economic growth and prevention of risks, due to sluggish global economic recovery, sustained differentiation of major economies and their monetary policies, insufficient driving force for domestic economy with weak growth, as well as continuous accumulation and exposure of various financial risks. However, owing to the generally stable economic operation, China's GDP is expected to rise by about 6.9% in 2015, and CPI is likely to increase by 1.4% around.
- The year of 2016, the beginning of China's "13th Five-Year Plan", will still face grim economic situation, including more intricate problems and contradictions. As China's economic development stays in a critical period characterized by change of stage, structural shift, model reconstruction and risk release, a pattern of low growth, low inflation and high leverage will appear. It is forecasted that GDP will grow by about 6.8%, slightly slower than that in 2015; and CPI will edge up 2% or so.
- For the purpose of realizing switchover of growth engines and ensuring stable operation of economy and finance, macroeconomic policy will remain accommodative by and large. While expanding domestic demands, greater importance should be attached to the management and reform of supply side, with the focus on accelerating reform, releasing system dividends, promoting tax cuts, reducing production costs of enterprises, strengthening innovation and improving product quality, so that the new supply mechanism can meet new demands.

China's GDP Growth Trend



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Reform of Supply Side will Boost Switchover of Growth Engines

—— China's Economic and Financial Outlook (2016)

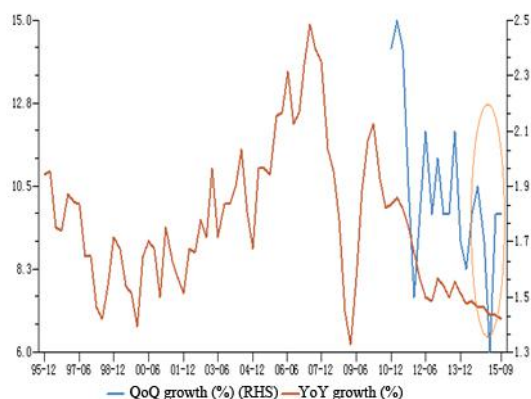
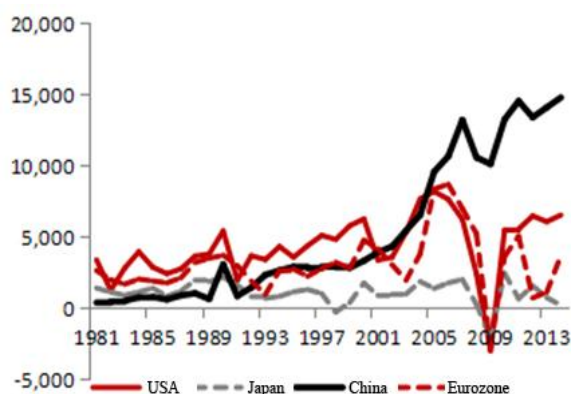
In 2015, China's economy entered a "new normal" state due to sluggish global economic recovery and sustained differentiation of major economies and their monetary policies. The interweaving of de-capability, destock and deleverage, insufficient growth engines and obvious downward pressure gave rise to the aggregation and continuous exposure of various financial risks, which brought about great challenges against steady economic growth and risk prevention in China. On the whole, economic operation presented the characteristics of "three declines and three improvements". It is forecasted that China's GDP might rise about 6.9% and its CPI is likely to increase by 1.4% around in 2015. The year of 2016, the beginning of China's "13th Five-Year Plan", will still face a grim economic climate, including more intricate problems and contradictions. As China's economic development stays in a critical period characterized by change of stage, structural transformation, model reconstruction and risk exposure, a pattern of low growth, low inflation and high leverage will appear in general. GDP is estimated to grow by about 6.8%, slightly slower than that in 2015; and CPI will increase by 2% or so. For the purpose of realizing switchover of growth engines and ensuring stable operation of economy and finance, macroeconomic policy will remain accommodative by and large. While expanding domestic demands, greater importance should be attached to the management and reform of supply side, with the focus on accelerating reform, releasing system dividends, promoting tax cuts, reducing production costs of enterprises, strengthening innovation and improving product quality, so that the new supply mechanism can meet new demands.

I. 2015 Economic Review and 2016 Outlook

I.1 Main characteristics of economic operation in 2015: "three declines and three improvements"

In 2015, China's economy entered a "new normal" state, with the further slowdown of economic growth and the characteristics of "three declines and three improvements". "Three declines" indicate the slowdown of economic growth, decline of commodity price and drop of economic benefits, while "three improvements" mean the structural improvement, increased employment, and more-than-expected energy conservation and pollution reduction.

"Decline 1": slowdown of economic growth. Weak global economic recovery, continued destock, de-capability and deleverage in terms of domestic economy as well as declined economic benefits of enterprises all suggested the rising pressure caused by economic downturn. In the first three quarters of 2015, China's GDP increased by 6.9%, down 0.4 percentage points year-on-year; and it is expected to rise about 6.9% for the whole year (Figure 1). Such growth rate was 0.3 percentage points lower than the forecasted 7.2% at the end of 2014, mainly attributable to the restrictions on "people" and "money", the less-than-expected effect of growth stabilisation policies, and the global economic and trade growth weaker than the expected. However, the connotation of 7% GDP growth nowadays is totally different from that in the past; even calculating at a growth rate of 6.9%, the increase in China's GDP would reach USD714.8 billion in 2015, approximately 1.65 times of the USA's GDP increment in the same year, and almost equivalent to China's GDP in 1995.

Figure 1: China's GDP Growth

Figure 2: GDP Increment of Different Countries based on PPP


Sources: Wind, BOC Institute of International Finance

From the demand side, the substantial slowdown of export and investment resulted in the notable shift left of total demand curve. In which, the decline of export was mainly related to global economic malaise and reconstruction of world trade pattern, while investment slowdown was primarily caused by the restrictions on sources of funds, real estate adjustment and inactive development in some regions. Particularly, the financial crisis knocked out the conventional global economic cycle, that is, the developed economies in the Europe and America kept up spending by borrowing, and the Eastern Asian region relied on a great amount of savings to expand production and export, backed by the energy sources supplied by the Middle East, Latin America, Russia and Australia, thus giving rise to the drastic shrink of effective demand in the international market and the severe overcapacity in traditional manufacturing sectors including steel, nonferrous metals and mechanical equipment. As a result, related industries in China slowed down considerably and even presented negative growth from the supply side, with the capacity utilization rate far lower than the normal level. For example, the capacity utilization rate of float glass stood at 70% only, down 8 percentage points over the same period last year; coking enterprises only reported a 70% rate of operation, down 10 percentage points from the end of previous year; and the blast furnaces in the country had a capacity utilization rate of 77%, down from 91.6% last year.

“Steadiness” was another prominent feature of economic operation in 2015, namely, little volatility of growth between different quarters. The GDP growth in the first, second and third quarter reached 7%, 7% and 6.9% respectively. It is estimated to be 6.9% in the fourth quarter. The quarterly growth difference in the year is only 0.1 percentage points, which is extremely rare since China’s reform and opening up and also could be hardly seen in other economies. Under the backdrop of great economic downward pressure, such steady economic growth was mainly attributable to the government’s steady growth policies (reflected by the rapidly growing infrastructure investment and strategic emerging industries) and the supportive role of consumption (reflected by the stable, fast increment of consumption), which could increasingly boost economic growth.

“Decline 2”: decline of commodity price. Commodity price manifests the general relationship between demand and supply in the economic operation. The low consumer prices and falling production prices in 2015 not only exposed the problems of stagnant aggregate demand and protrudent contradiction between supply and demand, but also demonstrated the development dilemma faced by traditional industries including energy and raw materials during the period of economic restructuring and growth engine switchover. The commodity price movement this year could be characterized as two key words: “low” and “fall”.

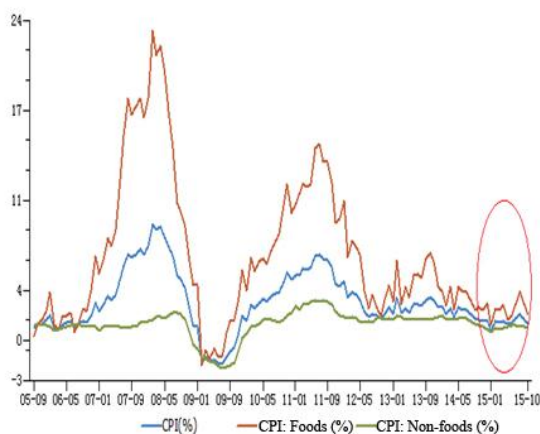
Table 1: Top Five Categories of Goods and Services in the CPI Bucket

Top five increase	Increase (%)	Top five decrease	Decrease (%)
Household devices and services	6.78	Vehicle fuel and spare parts	-16.5
Tobacco	3.78	Communication tools	-3.1
Education	2.94	Water, electricity and fuel	-2.1
Clothing	2.92	Vehicles	-1.59
Use and maintenance of vehicles	2.90	Tourism	-0.68

Sources: Wind, BOC Institute of International Finance

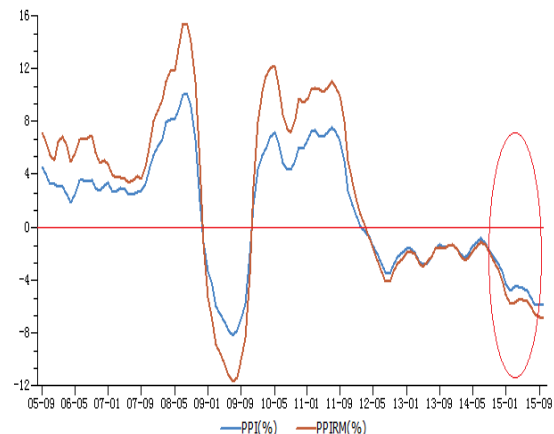
“Low” means that consumer prices kept increasing or decreasing at a low level. In the first ten months of 2015, CPI went up 1.4% accumulatively, down 0.7 percentage points year-on-year; in most months, the index increased by less than 2% (Figure 3). In terms of structure, consumer prices endured ups and downs; in which, the prices of goods and services closely related to the life quality of urban and rural residents rose higher (2.1%), for example, household services, processing and maintenance prices grew by 6.8%, educational service prices increased by 3%, and the growth rate of Chinese medicine, western medicine and medical care prices exceeded 2%. The prices of traditional goods, nevertheless, grew at a relatively low rate (1.2%), for instance, the prices of durable consumer goods almost unchanged (nearly 0), that of communication services declined by 0.2%, and communication tool prices dropped by 3% (Table 1). The ups and downs of consumer prices imply that, as a result of economic development and increased household income in China, the consumption structure of urban and rural residents is upgrading constantly, with the increasing rise and proportion of development and enjoyment-oriented consumer demand, while the survival and guarantee-oriented consumer demand grows slower relatively with a falling proportion. Moreover, it manifests the transformation from absolute surplus of labour supply to relative shortage due to the change in population structure, hence bringing about more price hike pressure on labour force as well as labour-intensive goods and services.

Figure 3: CPI Hovers at Low Level



Sources: Wind, BOC Institute of International Finance

Figure 4: PPI Keeps Declining



“Decline” means that producer prices showed a downward trend in 2015, with both monthly growth and month-on-month growth presenting negative results. In the first ten months, PPI declined by 5.1% accumulatively, and its month-on-month growth had been negative for 44 consecutive months, without any probability of turning positive in the near term. This was also the longest time for a lasting negative PPI growth since China's reform and opening up. On the surface,

the continuous decline of PPI was caused by economic slowdown and inadequate aggregate demand at home and abroad; behind the apparent reasons, however, it reflected the excessively “burdensome” and “out-of-date” economic structure, deficient and tardily upgraded supply structure, mismatching with the continuously upgrading demand structure, and the increasingly prominent dislocation of supply and demand in the country. For example, with the progress of China’s urban construction, the wire and cable industry develops fast, which ranks among the best in terms of annual output value in the world; while middle and low-end products including medium-voltage power cables and wiring cables stay in a surplus state. Since the beginning of 2015, the prices of these products have dropped by about 20%, in contrast to the high-end products such as high-voltage cables and special cables which still require a large number of imports. Under the “new normal” state, the expanding decrease in the prices of industries including coal mining and washing, oil and gas exploration, and ferrous/non-ferrous metal smelting and rolling could strongly affect the PPI trend (more than 20%, see Table 2). These industries play a significant role in the national economy, though the prices are easily to be affected by domestic and overseas markets, showing certain price elasticity. The adverse impact of sustained negative PPI growth is obvious, which not only influences the desire of enterprises for production and investment, but also affect corporate earnings and employees’ income.

Table 2: YoY Change in Prices of Important Capital Goods and Consumer Goods in Jan.-Oct. 2015 (%)

Month	1	2	3	4	5	6	7	8	9	10	1-10
Capital goods	-5.6	-6.24	-5.93	-5.92	-5.95	-6.24	-6.95	-7.66	-7.72	-7.60	-6.6
Coal mining	-13.0	-13.1	-13.0	-13.0	-14.0	-15.4	-15.1	-15.6	-15.4	-15.8	-14.3
Oil & gas exploration	-32.9	-42.4	-39.3	-38.7	-36.1	-32.4	-34.6	-37.9	-40.6	-39.9	-37.4
Ferrous metal smelting & rolling	-20.5	-21.0	-21.4	-22.9	-22.5	-20.1	-20.1	-20.4	-19.9	-18.5	-20.8
Non-ferrous metal smelting & rolling	-3.0	-4.2	-5.8	-4.9	-4.6	-4.7	-7.7	-10.3	-10.0	-9.8	-6.5
Consumer goods	-0.15	-0.13	-0.14	-0.23	-0.29	-0.23	-0.28	-0.33	-0.25	-0.40	-0.2
PPI	-4.32	-4.80	-4.56	-4.57	-4.61	-4.81	-5.37	-5.92	-5.95	-5.90	-5.1

Sources: Wind, BOC Institute of International Finance

“Decline 3”: drop of economic benefits. Economic benefits indicate the comparison of capital occupancy, cost and productive results. In 2015, enterprises faced lots of difficulties in the process of business transformation and upgrading, due to demand slowdown and overcapacity; besides, rising cost of production factors including labour force and land led to the substantive decline of enterprises’ profitability and capability. In the first ten months, the main business income of industrial enterprises gained a growth of 1% only, and their profits slipped by 2%, both of which went down 8.7 percentage points year-on-year; the losses of loss-making enterprises increased by 26.9%, up 13.3 percentage points year-on-year; and the number of enterprises suffering loss grew by 15%, up 8.9 percentage points year-on-year. Affected by the declined economic benefits of enterprises, the corporate income tax in the financial revenue ascended by only 4.7%, down 4.5

percentage points over the same period of last year (Table 3).

Table 3: Continuous Decline of Economic Benefits of Industrial Enterprises

Year	Growth of main business income of industrial enterprises (%)	Profit growth of industrial enterprises (%)	Loss growth of industrial enterprises (%)	Growth of loss-making enterprise number (%)	Growth of corporate income tax (%)
2012	11.0	5.3	32.7	22.3	17.3
2013	11.2	12.3	5.2	4.3	14.1
2014	7.0	3.3	22.5	12.2	9.9
2015 (1-10)	1.0	-2.0	26.9 (1-9)	15.0 (1-9)	4.7

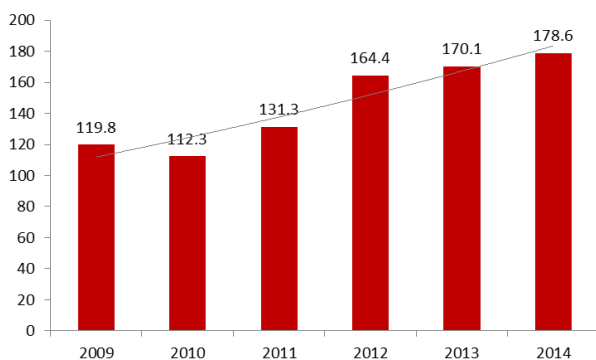
Sources: Wind, BOC Institute of International Finance

“Improvement 1”: structural improvement. China's economy has entered a “new normal” state, with an outstanding manifestation of obviously accelerated restructuring and upgrading. The stable consumption with fast growth and rapidly developing tertiary industry have turned into two major engines for driving supply and demand and stabilizing economic growth. In the first three quarters of 2015, consumption contributed more than 60% to economic growth, while the value-added of service industry represented over 50% of GDP. More importantly, the trend of shift, differentiation and switching between new and old industries, business formats and growth engines was quite distinct, with respect to both demand structure and internal supply structure. For example, traditional manufacturing industries presented a downward momentum, upstream and mid-stream industries such as energy and raw materials were confronted with relatively tough operation and production, while high-tech and emerging industries maintained fast development, e.g. new energy vehicles, intelligent manufacturing, high-end devices and information technology.

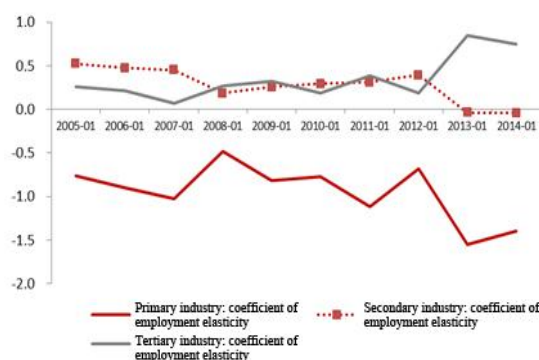
“Improvement 2”: increased jobs. In the first three quarters of 2015, new jobs covered 10.66 million persons in the cities and towns, hence the annual task was fulfilled three months in advance. As we have analyzed in the Q4 report of 2014, the employment was generally stable despite of the downward economy, owing to the risen total economic output and the transformed economic structure. In 2014, every 1 percentage point of GDP growth would create 1.79 million jobs, 59% higher than that in 2010 (Figure 5); in the first three quarters of 2015, the proportion of tertiary industry was raised to 51.4% (obviously higher than the targeted 47% in the “12th Five-Year” Plan), an increase of 3.3 percentage points compared with 2014. As the coefficient of employment elasticity of tertiary industry was significantly higher than that of primary and secondary industries (Figure 6), the accelerated growth and raised proportion of service industry in recent years remarkably strengthened the stimulating effect on employment.

“Improvement 3”: more-than-expected energy conservation and pollution reduction. The energy consumption per unit of GDP dropped by 5.4% in the first three quarters of 2015, marking an unprecedented decline; meanwhile, PM2.5 and PM10 also decreased substantially.

On the whole, the employment was generally stable in 2015, commodity price hike stayed at a low rate, and restructuring progressed smoothly, in spite of the expanding downward pressure on economic growth, operational difficulties and falling profits of enterprises; besides, emerging powers were under development, new products, business models and formats sprang up unceasingly, and some industries including online sales, new energy vehicles and robots developed at a fantastic speed, showing an overall stable development momentum.

Figure 5: Employment Driven by 1 Percentage Point of GDP Growth


Sources: Wind, BOC Institute of International Finance

Figure 6: Coefficient of Employment Elasticity of Three Major Industries


I.2 Main judgments on economic situation in 2016

I.2.1 It is hard to be optimistic about China's economy due to the still tough external environment

2016 is the start year of China's "13th Five-Year" Plan and also the first year for the crucial period of comprehensively building a well-off society. However, it is hard to be optimistic about current situation due to the coexistence of challenges and opportunities. In terms of economic development, China currently stays in a critical period characterized by change of stage, structural transformation, model reconstruction and risk exposure, presenting the overall characteristics of low growth, low inflation and high leverage. From the perspective of external environment, global economy is still confronted with old and new challenges, including lingering deflation risk and diminished effect of the demand stimulus policies. The structural adjustment and technological innovation for the supply side haven't developed a kind of leading force which can drag the economy out of the doldrums. As economic globalization has entered a consolidation phase, major economies have seen differentiation in the economic growth and macro-economic policies, with the accelerated reshaping of international economic and trade rules. In particular, some events occurred recently such as the downing of a Russian warplane by Turkey, European refugees and terrorist attacks have casted more shadows on the fragile global economy.

With regard to domestic market, the steady growth policy in the earlier period is exerting its effect, future policy might remain accommodative, consumption is growing steadily with frequent occurrence of hot issues, and real estate market maintains an overall stable momentum, all of which will contribute to the soundness of macro-economic operation. Meanwhile, the expectations of the entire society towards the economy, politics and society are being stabilized gradually under the "new normal" state, so that economic entities can be promoted to carry out economic activities. Nevertheless, China will still face many challenges and difficulties with respect to the export sector, due to the weak recovery of global economy, conclusion of the agreement on the USA-led TPP, and the negotiation on TTIP in progress. Plus the inactive aggregate demand as before, continued overcapacity and poor corporate profits, it might be difficult to strongly push forward industrial investment. Besides, the financial risk arising from local bonds, exchange rate and international capital flows is still worthy of attention. All these factors will bring about uncertainties to the steady and fast economic growth. In 2016, GDP is estimated to grow by 6.8% around, slightly lower than that in 2015.

In 2016, the overall commodity price is likely to hover at a low level. Firstly, the remained economic downward pressure and weak aggregate demand suggest that there is no macro-economic foundation for the soaring of commodity price; secondly, there is limited room for the further rise of pork price and food price after the rapid price hike in the previous period; thirdly, under the backdrop of sluggish global economic recovery, commodity price is unlikely to pick up substantially; fourthly, the continued negative growth of PPI still imposes a downward pressure on CPI. In 2016, CPI is forecasted to climb 2% or so.

I.2.2 Overcapacity will drag on industrial production and the contribution of service industry to economic growth will further improve

In 2016, overcapacity will still be the primary problem restricting the development of real economy. As industrial economy currently stays in a critical period of de-capacity and deleverage, with the increased pressure on the operation of enterprises, structural differentiation will continue to be the main characteristic. Affected by the depressed real economy and tumbled stock market, the growth rate of service sector will remain almost the same with the previous year, despite of the improved service development environment.

(1) Industrial production tends to decline while maintaining stable, with structural differentiation

In face of the complex domestic and international environment, industrial situation is still a bit bleak. On one hand, a new round of technological and industrial revolution is on the rise across the world, bringing about rare historic opportunities for China's industrial transformation and upgrading, innovation-driven development and integration with global value chain; on the other hand, the international industrial structure has changed profoundly, owing to the "re-industrialization" initiated by developed countries, continuous manifestation of developing countries' advantages in the cost, infrastructure and environment, and the phenomenon of "high-end reflux and mid-range shunt" found in the industrial development of China; and the progress of negotiations on free trade agreements concerning TPP and TTIP will probably further weaken China's industrial competitiveness. In addition, global trade will remain stagnant in 2016, plus the USA's withdrawal of quantitative easing (QE) policy, certain impact might be imposed on emerging economies, hence the driving force of external demand for industrial production will be relatively limited.

With regard to domestic environment, industrial production faces both favourable development environment and great challenges. On one hand, the implementation of some measures adopted by the government, such as streamlining administration and delegating power to reduce corporate cost, will be strengthened, the strategic promotion of the "Belt & Road" initiative will propel the development of industries including transport, capital construction, equipment and energy, the easing monetary policy will contribute to the reduction of corporate financing cost, while the introduction of campaigns like the "mass innovation and popular entrepreneurship" and "Made in China 2025" will help upgrade traditional industries and boost emerging ones. On the other hand, the overall cost of enterprises will remain high due to the inevitable rising trend of factor prices including land and labour force as well as stricter environmental protection policy; and the slowdown of investment in real estate and infrastructure, to some extent, will hinder industrial production. Consequently, the restructuring of overcapacity industries will continue.

In view of the above factors, the industrial production in 2016 is expected to present the characteristics of structural differentiation and tending to decline while maintaining stable. Under the situation that commodity price remains low, the growth of added value of the mining industry will continue to go down, and that of the overcapacity industries including steel and construction

materials will suffer the same fate as these industries stay in the burdensome de-capacity stage. Such industries as energy conservation and environmental protection, information communication, and high-end equipment will maintain fast growth, but some emerging industries including medicine, computer communications, instrumentation and other manufacturing industries, due to their relatively small size, which account for only 10.7% approximately in terms of output value, far lower than that of the mining industry and six major energy-intensive industries (representing about 38%). Hence, it is difficult to offset the “drop-down” effect of traditional industries in the short term. As it takes time to see the effect of innovation, the mismatched supply structure, i.e. surplus of middle and low-end products and shortage of high-end products, will continue to exist. Generally, the industrial added value is expected to ascend by about 6%.

(2) The livelihood service industry grows in an accelerated manner, though the productive service industry to be retarded by the sluggish real economy

In recent years, the government attaches great importance to the development of service industry by successively releasing supportive policies. In 2015, the Central Government established the service development fund specially for the support of modern commodity circulation and establishment of a public service system. In the proposal to the “13th Five-Year” Plan, the objective and requirement on “further raising the proportion of service industry” is clearly put forward. It is expected that the development environment for the service industry will continue to improve in 2016.

Traditional service industries including wholesaling, retailing, accommodation and catering considered as livelihood services will maintain steady growth, while some key policy-supported industries including culture, pension and tourism will keep rapid growth. Thanks to the relatively loose policy environment, the real estate market might see a little recovery, with the continuous differentiation in different regions; tier-3 and tier-4 cities will be confronted with greater de-stock pressure, so the value added of real estate industry is estimated to rise slightly. The guidelines issued by the State Council in November 2015 require speeding up the development of livelihood services, hence this industry is very likely to grow in an accelerated way in 2016.

With respect to the productive service industry, weak industrial growth might hinder the growth of cargo transportation and warehousing industry. Affected by the factors including declined stock market turnover and stagnant real economy, the financial industry will continue to slow down in 2016; while such key industries as information, research technology, leasing and commercial services and logistics will maintain fast development. Overall, the growth rate of productive service industry might be somewhat lower than that of previous year.

Based on the above analysis, the service industry in 2016 is estimated to grow at the same rate with that of last year, which is still higher than industrial growth, thus the contribution of service industry to GDP growth will further ascend.

I.2.3 Moderate expansion of aggregate demand, business transformation driven by new consumer products, growth decline due to investment, and rebound of imports and exports

In 2016, insufficient effective demand will continue to impede economic growth. In which, the contribution of consumption to economic growth will keep at a higher level; investment especially manufacturing investment is very likely to maintain a downward trend as a result of poor earnings and sales; while imports and exports might nudge up owing to the low base in 2015.

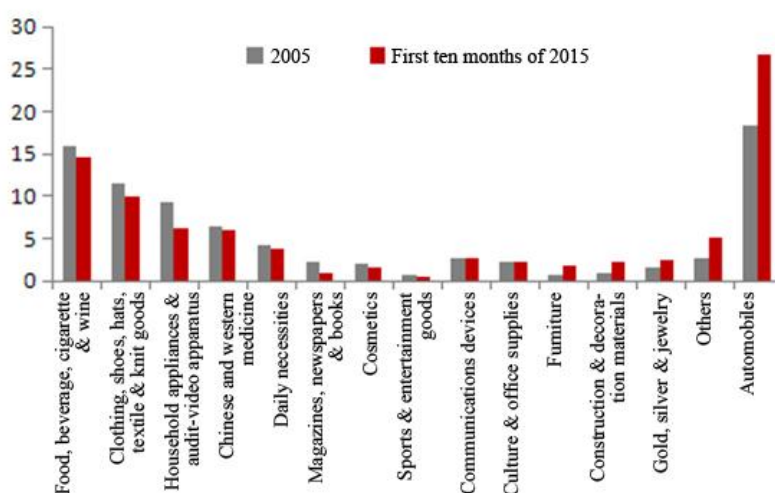
(1) New consumer products will lead to the transformation and upgrading of economic structure

First, sustainable and fast growth of residents' income will facilitate the expansion of new

consumer products. Since 2012, the actual growth of per capita disposable income of residents in China has exceeded GDP growth for four consecutive years, with the actual growth rate of 7.7% in the first three quarters of 2015, 0.8 percentage points higher than the GDP growth rate in the same period. With the increase of income, residents' savings and deposits also maintain rapid growth, which rose by 12.7% in the first three quarters of 2015, up 3.7 percentage points over the same period of last year. Besides, the fast growth of income also lays a sound foundation for the extension of new consumer products to cover culture, sports, entertainment, information and tourism.

Second, residents have a strong desire to purchase new consumer products and services and accept new consumption patterns and formats. So far, online shopping has developed into a consumption growth engine that cannot be ignored. In the first ten months of 2015, online sales of goods and services grew by 34.6% year on year, representing 12.1% of total sales of social consumer products. Moreover, benefiting from the continuous introduction of new products by manufactories, the communication devices such as smart phones kept selling like hot cakes, which increased by 35.9% in the first ten months of 2015 (Figure 7); and the recovery of real estate market also propelled the consumption of building decoration materials, furniture and household appliances.

Figure 7: Change in the Proportion of Goods in the Sales of Above-Limit Companies (%)



Sources: Wind, BOC Institute of International Finance

Third, the government will make more efforts to ameliorate the consumption environment and further improve the satisfaction of consumers. Since 2015, the Customer Satisfaction Index has stayed above 100, changing the previous situation of being less than 100 for more than three years. It is forecasted that consumer confidence will continue to lie in the expansion interval.

Next, the government will pay more attention to the guiding role of new consumer products, ensure the supply of such new products by cutting taxes, reducing cost of living and operation, encouraging innovation and entrepreneurship, and accelerating the development of logistics industry, and meanwhile promote the enhancement of product and service quality. In 2016, consumption will remain stable growth, which is expected to have a growth rate of 10.8% around in the year.

(2) Slowdown in investment growth will continuously increase the downward pressure

First, the growth of private investment in fixed assets will continue to decline. As the main force for investment in fixed assets in China, privately-run enterprises, which primarily make investment

decisions based on profit outlook, contribute nearly 2/3 of such investment. Since there is a big probability that China's economy will maintain a downward trend in 2016, most privately-run enterprises have a pessimistic expectation on profit, thus they will be more cautious in making additional investment; even these enterprises hope to do so, they will probably face tighter funding constraints for the following reasons: firstly, the proprietary funds available for investment are contracted due to profit decline; secondly, the rise of both NPL ratio and NPLs results in prudential bank lending; thirdly, a series of default events raise the cost and difficulty of debt financing.

Figure 8: Decrease of Growth Rate of Investment in Manufacturing Segments (%)



Sources: Wind, BOC Institute of International Finance

Second, the investment in the manufacturing industry will slow down continuously, real estate investment is expected to bottom out, while infrastructure investment will keep rapid growth. As the manufacturing industry still stays in the process of sustained de-capacity, some industries will, as before, face an arduous task of abating overcapacity, and the areas attracting investment at a faster speed will be concentrated in culture, sports and entertainment supplies, textile and garment, furniture, computer and communications, and waste utilization (Figure 8). Benefiting from sales

pick-up and price rise, real estate investment is likely to edge up after touching the bottom. Besides, the government will also make more investment in the areas including railway, water conservancy, urban traffic and underground pipeline network in the central and western regions as well as rural infrastructure.

Third, investment growth will be stagnant relatively in most provinces, while some regions are expected to achieve fast growth. In the first ten months of 2015, the investment growth of more than 3/4 provinces declined, particularly, the investment of Liaoning Province even decreased by 22.3% year on year. Nevertheless, the provinces including Fujian, Xinjiang, Tianjin and Chongqing will maintain fast investment growth comparatively, owing to the “Belt & Road” initiative, collaborative development of Beijing, Tianjin and Hebei, and advancement of development strategies in some new regions covering the Yangtze River Economic Belt.

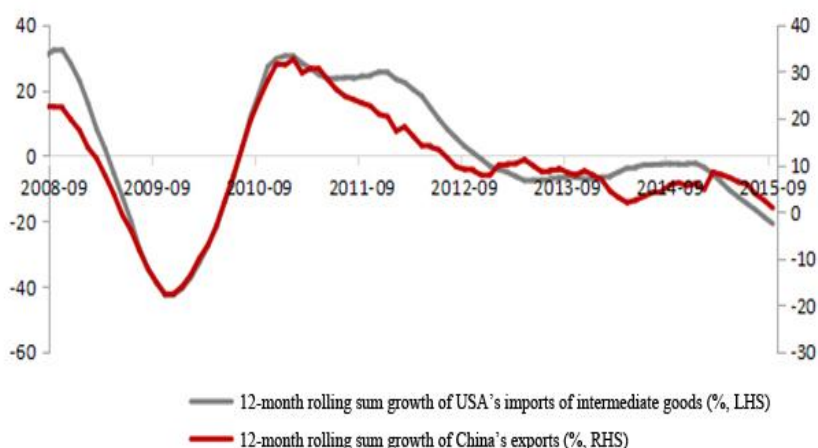
In addition, the broader preferential scope for accelerated depreciation of fixed assets and the smaller proportion of capital for major transportation projects will be conducive to promoting investment growth. In summary, the investment growth will continue to slow down in 2016, with an estimated annual growth rate of 8.5% around.

(3) Goods trade and import & export will usher in a turning point

China's trade in goods keeps deteriorating. In the first ten months of 2015, total imports & exports, export volume and import volume fell by 8.5%, 2.5% and 15.7% respectively, compared with the growth of 3.8%, 5.8% and 1.6% a year earlier. In contrast to the decline in goods trade in 2009, periodic factor was not the main reason this time; instead, it was attributable to multiple structural factors, e.g. overseas migration of labour-intensive enterprises due to the rising cost of domestic production factors, and replacement of imported spare parts with home-made ones caused by industrial transformation and upgrading. Meanwhile, the global industrial chain and trade structure are undergoing profound changes. Sharp deterioration in the trade of intermediate goods could be found in major economies, which has impacted the global trade demand on the production side and thus exaggerated China's output pressure. In the first nine months of 2015, the USA's imports of intermediate goods plunged by 25.8%, far lower than the 8% growth of imports of consumer goods in the same period; and the EU's imports of intermediate goods slipped by 4.1% in the first eight months, still far lower than the 11.4% growth of imports of consumer goods in the same period. Historically, the deterioration would last one year to 18 months or so, and then a rebound cycle would appear. The trade in goods export is predicted to have an upward turning point in mid-2016, with an annual growth rate of about 3%; affected by commodity price, such turning point for imports might be laggard relatively, with an annual growth rate standing at 1.5% approximately.

Different from the sluggish trade in goods, China's trade in services grows fast in 2015. In the first nine months of 2015, total volume of service trade increased by 15.9% year on year; if disregarding the transportation services significantly impacted by the goods trade, the growth rate of service trade exports and imports would reach 38.8% and 43.9% respectively, showing a favourable momentum for the development of service trade. In 2016, China will continue to expand the service sector to the outside world, particularly, encourage service companies to “go global” more quickly. The executed free trade agreements will also come to fruition gradually. Therefore, the service trade is expected to remain fast growth.

Figure 9: Linkage between China's Exports and USA's Imports of Intermediate Goods



Sources: Wind, BOC Institute of International Finance

I.3 Economic issues worthy of attention in 2016

In 2016, with the further increase of economic downward pressure, such problems as overcapacity, high production and operating costs of enterprises as well as excessively fast economic decline in some provinces will be more prominent, and such economic issues as deflation will emerge.

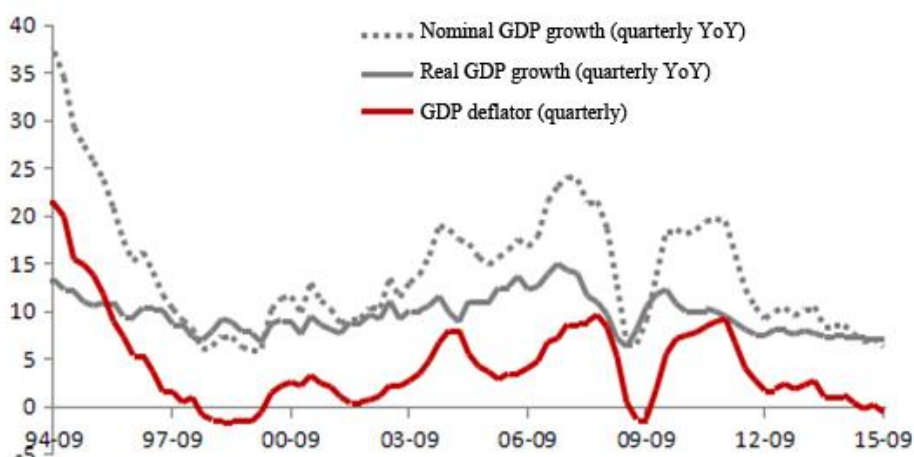
I.3.1 A high risk of deflation

For more than a year, the price rise in China has remained low by and large. On one hand, CPI fell below 2%, and even less than 1% in several months; on the other hand, PPI growth continued to be negative, indicating an intensified momentum of production price deflation. Consequently, whether China will suffer deflation is one of the concerns in the market.

In terms of CPI, a representative indicator used to measure the general price level of consumer goods, China hasn't stepped into the deflation range. In the first ten months of 2015, China's CPI rose by 1.4% year on year, suggesting certain distance from the deflation range. It should be noted that CPI growth fell back for two straight months in September and October 2015; and the prices of grain, edible oil and pork have been falling since November, implying the further downward pressure on China's CPI. Considering the incessant improvement of consumer goods and service quality, it is generally believed, once CPI growth declines to less than 1%, the risk of inflation should arouse attention and vigilance.

As indicated by the GDP deflator (the most comprehensive indicator to measure the general price level of a country) and PPI, the general price level and production price of China has been caught in a deflation. In the first three quarters of 2015, China's GDP deflator was reported at -0.3%, and the index in the first and third quarter stood at -0.3% and -0.7% respectively, both of which were already in the deflation range (Figure 10). The GDP deflator in the second quarter was only 0.1%, a little gap from the deflation range. PPI, a representative indicator used to measure the general price level of production field, had declined for 44 months as of October 2015, indicating a high deflation level.

Figure 10: China's GDP Growth and GDP Deflator (%)



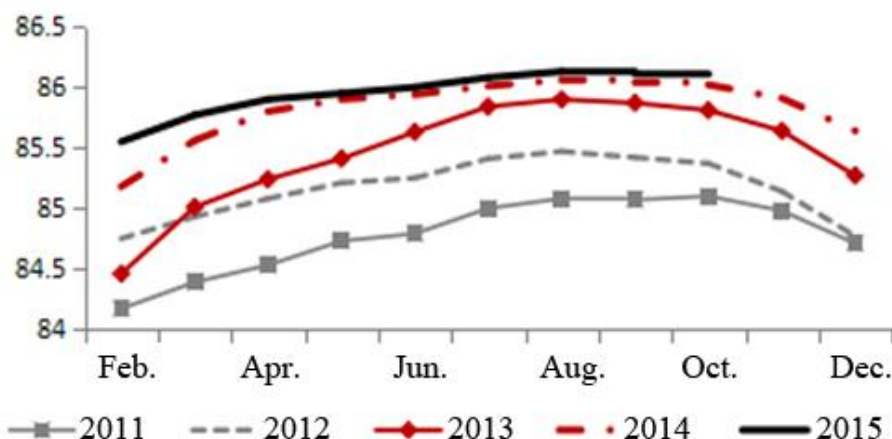
Sources: Wind, BOC Institute of International Finance

According to historical experience, once the economy is trapped into deflation due to the coexistence of severe overcapacity and insufficient effective demand, it is very likely to sustain for a certain period of time. In 2016, the de-stock on the supply side and sluggish demand side will continue to lower general price level in China, with the risk of deflation on the whole.

I.3.2 Too fast rise of enterprises' production cost

In recent years, the overall cost of Chinese enterprises rises rapidly. In October 2015, main business cost of industrial enterprises accounted for 86.09% of their main business income, up 0.07 percentage points over the same period of last year, which was the highest compared with the same period of past years (Figure 11). Specifically, wages rose faster than labour productivity growth, enterprises borne a heavy burden of social security contributions, tax burden didn't significantly decrease, taxes and surcharges of industrial enterprises (6.5%) grew faster than revenues (1.2%), and non-tax revenues including governmental administrative fees and gains from fines and confiscations grew faster (with the growth rate ascending from 14% in 2014 to 29% in October 2015); housing price, land price and rents soared, which not only pushed up the operating cost of enterprises directly, but also raised their labour cost indirectly; compared with other countries, logistics costs remained high due to the outstanding problems of redundant circulation links and arbitrary charges; and the problem of difficult and expensive financing faced by SMEs could also be found. Too fast cost rise will excessively reduce the profits of enterprises, increase debt burdens and weaken their competitiveness, particularly when wage growth is much higher than labour productivity growth and tax revenue grows faster than business income, thus bringing about more difficulties to China's economic restructuring and upgrading and realization of sustainable development.

Figure 11: Cost per RMB100 of Income from Main Business

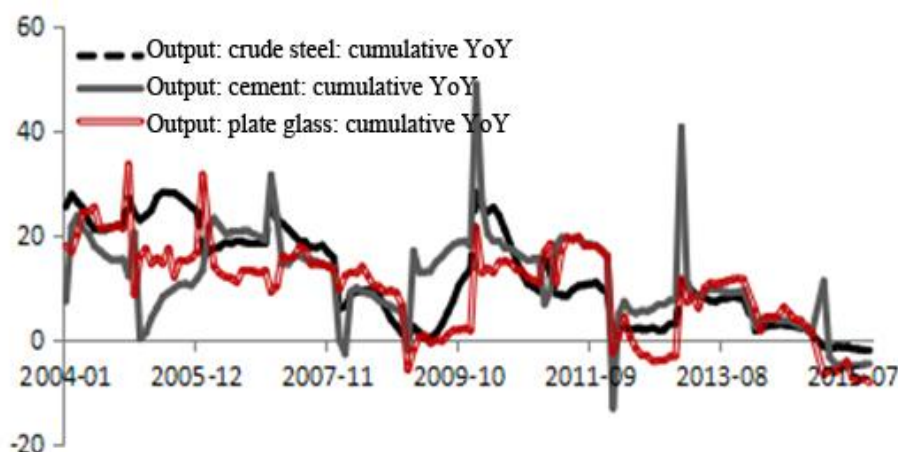


Sources: Wind, BOC Institute of International Finance

I.3.3 Severe overcapacity

Overcapacity, on one hand, occupies a large number of social resources; and on the other hand, it leads to the decreased profits and investment capability of enterprises, affects employment, residents and financial revenue, and increases economic downward pressure. Affected by rapid expansion of production capacity in the previous periods, sluggish real estate industry, weak external demand and change in domestic demand structure, the problem of overcapacity has been persistent and spreading since the financial crisis. According to the government's objective of phasing out backward production capacity, 18 industries including electricity, coal, steelmaking and iron refining are the main targets. Currently, the capacity utilization rate of blast furnace, float glass and coking enterprises remains low, the output of crude steel, cement and plate glass maintains negative growth (Figure 12), and some enterprises of related industries still stay at a passive destock status due to substantial decline of profits. It is forecasted that overcapacity will be a significant challenge faced by China in the next period of time.

Figure 12: Output Growth of Overcapacity Products (%)



Sources: Wind, BOC Institute of International Finance

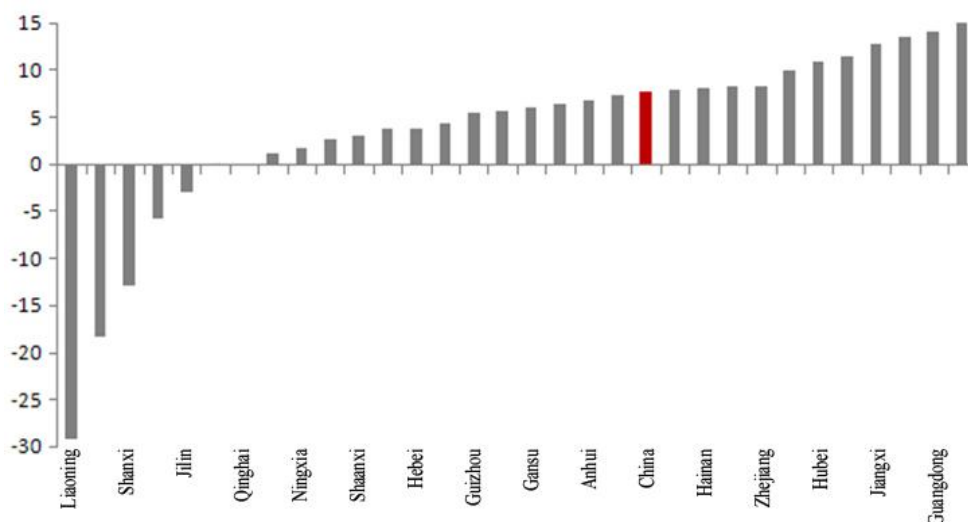
I.3.4 Further slowdown of economic growth in some provinces

Since the beginning of 2015, some provinces have suffered more difficulties with respect to economic growth, with the continued and considerable slowdown of GDP growth, negative growth

of fiscal revenue, and increasing rise of regional economic downward risk and even “stall” risk.

The most significant economic downturn goes to Liaoning and Shanxi. In the first three quarters of 2015, Liaoning's GDP grew by merely 2.7% year on year, down 3.5 percentage points over the same period of last year, while its GDP growth in 2014 was 2.9 percentage points lower than that in 2013. In the same period, Shanxi's GDP growth was just 2.8% year on year, a decrease of 2.8 percentage points from the same period of previous year; in 2014, its GDP growth was four percentage points lower compared with 2013. Thought other provinces published a GDP growth of over 5.5%, the actual situation might be more severe, which could be found from their fiscal and investment indicators.

Figure 13: Growth of Provincial Fiscal Revenue in the First Three Quarters of 2015 (%)



Sources: Wind, BOC Institute of International Finance

As indicated in the figure above, the decline of fiscal revenue and investment growth was even more severe than that of GDP. In the first three quarters of 2015, nearly one fifth of Chinese provinces reported negative growth of fiscal revenue, and the biggest decline could be found in Liaoning (-29.3%), Heilongjiang (-18.4%) and Shanxi (-13%); compared with the same period of last year, Liaoning, Xinjiang, Tibet and Heilongjiang saw the largest drop (above 20 percentage points) in terms of growth of fiscal revenue (Figure 13). In the first ten months of 2015, Liaoning's investment tumbled by 23.8% year on year, and the investment growth of Inner Mongolia and Heilongjiang was less than 3%; compared with the same period of last year, Liaoning, Inner Mongolia, Gansu, Ningxia and Xinjiang presented the largest decline (above 10 percentage points) in terms of investment growth.

A negative feedback loop chain has taken shape during the economic downturn of these provinces, i.e. “investment slump - economic slowdown – reduced fiscal revenue”. Local governments, due to tightened financial strength, are unable to stimulate economy by increasing investment, thus it is difficult for them to get out of the trouble of growth slowdown. For that reason, some provinces are likely to suffer tougher economic situation in 2016.

II. 2015 Financial Review and 2016 Outlook

II.1 2015 Financial review

In 2015, under the complicated situation of aggravated economic downward pressure and financial market volatility, the government paid more attention to stabilizing growth, preventing risk and

promoting reforms in the implementation of monetary policy. The RRR (reserve requirement ratio) and bank deposit and loan interest rates have been cut for five times, the ceiling on bank deposit interest rates has been removed, and the RMB/USD intermediate exchange rate mechanism has been improved. The on-going reform is greater than expected. At present, the control of bank deposit and loan interest rates has been basically removed, and the intermediate exchange rate formation mechanism is more market-oriented. Driven by the accommodative keynote and expedited reforms, ample liquidity is available in the banking system, alongside the rapid growth of monetary credit and improvement of financing environment for enterprises. Economic downturn, overcapacity and weak demand for corporate loans, among others, have inflicted upon the size of social financing which shows a downward trend instead of the expected rise. In addition, increased financial risks, intensified exchange rate volatility and more bond defaults should also arouse our attention, especially after the stock market rollercoaster.

II.1.1 Fast growth of money supply and improved financial environment

The effect of loose monetary policy is more apparent step by step, and the money supply maintains rapid growth. At the end of October 2015, M1 grew by 14% to the highest level since February 2013; M2 increased by 13.5%, up 0.9 percentage points over the same period of last year, and faster than expected at the beginning of the year (Figure 14). It was not only attributable to the monetary policy driving economic stability, risen monetary multiplier under the background of RRR cuts and strengthened money creation capability of the banking system, but also related to the exertion of the role as the “lender of last resort” by the Central Bank to stabilize the excessive financial market volatility under the fluctuation of stock market. In 2015, M2 is expected to ascend by about 13.3%, and new RMB loans are likely to arrive at RMB11.5 trillion or so.

With the ease of monetary policy and manifestation of effect, the financial environment for enterprises tends to be better. In the first three quarters of 2015, the weighted average interest rate of RMB loans of financial institutions stood at 5.7%, the lowest level since 2011; and the loans in the upper floating range of benchmark interest rate accounted for 66.8%, down 4.46 percentage points over the same period of last year.

RMB loans increased substantially, with the proportion in the total social financing scale rising significantly. In the first ten months of 2015, new RMB loans rose by RMB1.3 trillion compared with the same period of last year to RMB9.5 trillion, accounting for 77% of total social financing scale, up 16.1 percentage points over the same period of last year. The fast growth of new RMB loans was primarily attributable to the inclusion of off-balance sheet businesses on the balance sheet under the regulation of interbank business and the repayment of old loans with new borrowings by some of the enterprises, which should not be construed as the fundamental improvement of real economy. On the contrary, many signs indicate that enterprises still have no strong desire for long-term investment, and financing demand is not so optimistic for the following reasons: firstly, the proportion of medium and long-term loans slipped: from January to October 2015, new medium and long-term loans amounted to RMB5.5 trillion approximately, representing 52.7% of new RMB loans, down 6.1 percentage points over the same period of last year; secondly, the proportion of loans granted to residents and non-financial enterprises declined: in the first ten months of 2015, such loans accounted for 90.7% of new loans, down 9.3 percentage points from the same period of last year.

Figure 14: Money Aggregates Grow Rapidly

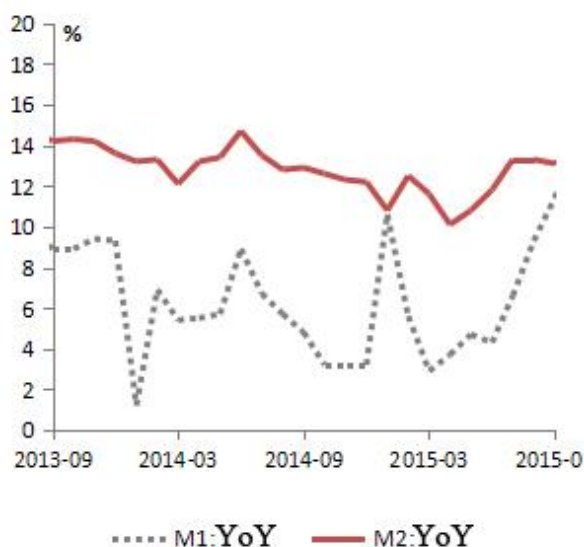


Figure 15: Declining Social Financing Scale



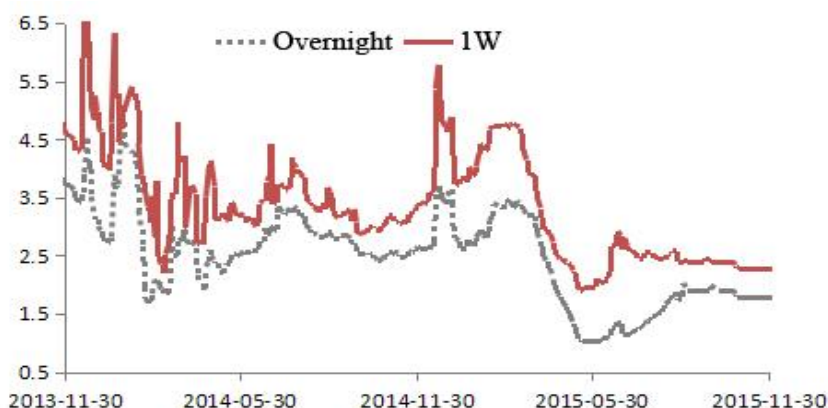
Sources: Wind, BOC Institute of International Finance

Increment of social financing scale decreased, and share of off-balance sheet businesses kept shrinking. In the first ten months of 2015, the increment of social financing scale was reported at RMB12.4 trillion, a decrease of RMB1.1 trillion compared with the same period of last year. The less-than-expected increment was mainly caused by the downturn of real economy, stagnancy of corporate financing demand and downsize of shadow banking. In which, new undiscounted banker's acceptance bills, entrusted loans and foreign-currency loans declined fast, down RMB834.1 billion, RMB777.7 billion and RMB701.6 billion respectively from the same period of last year (Figure 15). Off-sheet businesses including banker's acceptance bills and entrusted loans kept shrinking, mainly because the regulator strengthened regulation of the interbank business. Meanwhile, affected by two-way exchange rate fluctuation and spread decrease at home and abroad, enterprises gradually reduced their foreign-currency debts, resulting in the drop of foreign-currency loans.

II.1.2 Downward money market rate and generally ample liquidity

Under the loose monetary policy, the money market rate kept falling. Despite of the upward overnight and 7-day SHIBOR due to the stock market volatility and currency fluctuations since Q3 2015, the partial liquidity squeeze in the money market was eased following the basic stabilization of the stock market and exchange rate market and the fifth RRR and IR cuts, and then SHIBOR of different maturities restarted the downward trend. At the end of November, the overnight and 7-day SHIBOR stood at 1.79% and 2.29% respectively, down about 185 bps and 260 bps from the beginning of the year, reaching the lower level in the recent four years (Figure 16).

Figure 16: Trends of Overnight and 7-day SHIBOR (%)



Sources: Wind, BOC Institute of International Finance

II.1.3 A rising bond market with the increase of bond defaults

In 2015, the year of bond market reform, bond issuance conditions continued to be relaxed, the opening up of bond market was further accelerated, and local governments sped up debt replacement. Benefiting from the accelerated bond market reform and relatively ample liquidity, the bond market picked up steadily. Besides, the substantial fluctuation of stock market further highlighted the hedging function of bond market, leading to a bullish bond market as well as rising bond insurance and market value. On November 30, 2015, the ChinaBond Composite Index reached 164.8 points, up 9.5 points from the beginning of the year; from January to October, the bonds issued amounted to RMB11.3 trillion, an increase of RMB3.57 trillion compared with a year earlier (Figure 17); as at the end of October, the market value of bonds totalled RMB34.7 trillion, increasing by RMB5.6 trillion around over the same period of previous year.

Although the bond market was turning better on the whole, the differentiation of credit bond market kept aggravating. On one hand, bond defaults increased, with the frequent occurrence of credit events, e.g. “Hunan-Hubei Bond”, “Tian Wei Bond”, and “Zhongfu Bond”; on the other hand, the risk of investment in medium and long-term bonds declined a little bit. The interest rate term structure curve maintained a flat trend following an “abrupt slope” at the end of Q2, and the yield spreads of 10-year and 1-year T-bonds fell to 50 bps at the end of November from the highest 200 bps (Figure 18).

Figure 17: ChinaBond Composite Index and Bond Issuance

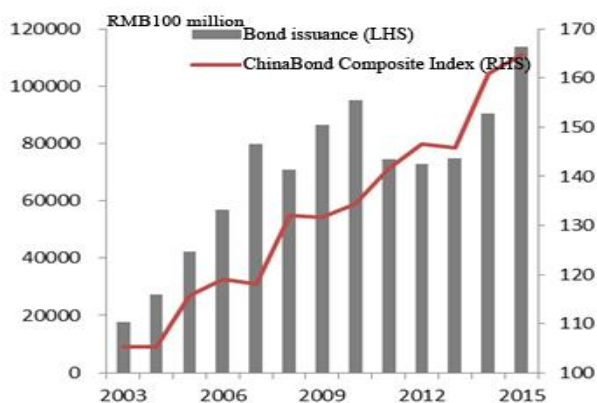
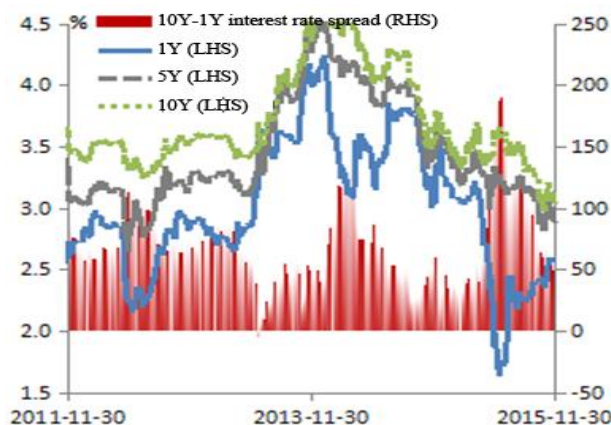


Figure 18: Changes in Yield Curve and Interest Spread of T-bonds



Sources: Wind, BOC Institute of International Finance

II.1.4 Gradual restoration of investor confidence following the stock market rollercoaster

In the first half of 2015, the stock market skyrocketed with the SSE Composite Index climbed by 53% to the highest 5121 points in mid June from about 3350 points in the beginning of the year. Due to excessive leverage and too fast rise, among others, the stock market plunged after the end of June. With the release of a range of bail-out measures, investors' panic was tempered. Driven by a series of favourable factors (e.g. RRR and IR cuts, acceleration of SOE reforms and the "13th Five-Year" Plan proposal) in the fourth quarter, investors started to regain their confidence, hence the stock market edged up. On December 1, the SSE Composite Index closed at 3456 points, up 3.6% from the beginning of the year (Figure 19). At the same time, following the adjustment of previous overvaluation, the Shanghai and Shenzhen stock markets began to repair their valuation. At the end of October, the average P/E ratio of SZSE was 45.08, a decrease of 16.3 compared with the highest level in May, and an increase of 13.09 over the same period of last year (Figure 20).

Figure 19: Violent Movements of SSE Composite Index and SZSE Component Index

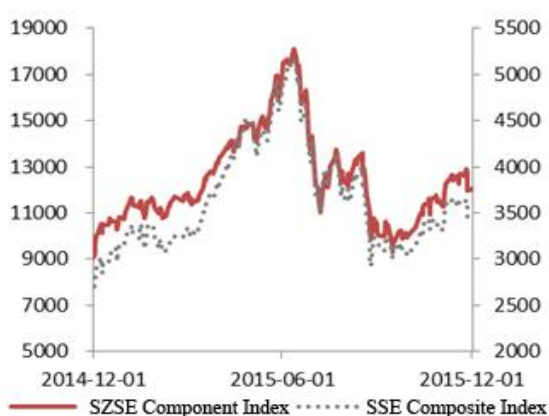
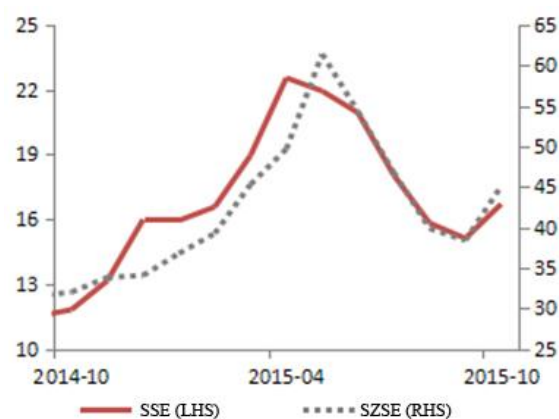


Figure 20: P/E Ratios of SSE and SZSE

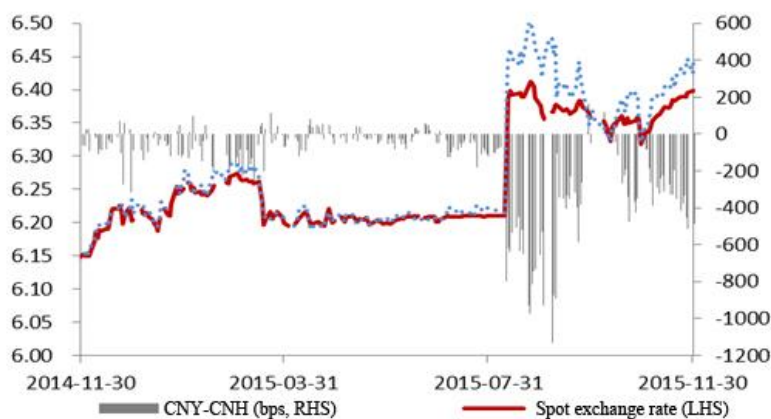


Sources: Wind, BOC Institute of International Finance

II.1.5 Apparent characteristic of two-way fluctuation of RMB/USD exchange rate, with narrowed exchange difference at home and abroad

In 2015, RMB exchange rate presented a clearer characteristic of two-way fluctuation. After a slight decline in Q1, the trend of RMB exchange rate tended to be stable in Q2. Since the new round of exchange rate liberalization reform commenced on August 11, RMB exchange rate had experienced significant depreciation due to stronger expectation on Fed rate hike and previous expectation of RMB depreciation, among others. After that, RMB exchange rate was gradually stabilized with the progressive mitigation of market panic. At the end of November, USD/RMB spot exchange rate was announced at 6.398, depreciating by about 2.9% from the beginning of the year; the exchange difference (CNH-CNY) at home and abroad was 265 bps (Figure 21), up 178 bps compared with that at the beginning of the year, but far lower than the highest level (about 1130 bps).

Figure 21: Movements of RMB/USD Exchange Rate



Sources: Wind, BOC Institute of International Finance

II.2 Main judgments on financial situation in 2016

II.2.1 Abundant money supply on the whole, and steady growth of credit and social financing scale

Money supply will be abundant by and large, and regulatory flexibility of M2 will be enhanced further. In 2016, the factors conducive to the growth of money supply mainly include: firstly, monetary policy will remain loose because of the great economic downward pressure; secondly, with the advancement of debt replacement by local governments, deposit-taking companies' investment in local government bonds will be increased, and the ability to derive money through the banking system will be improved. Adverse factors primarily include: the USD interest rate hike cycle, will sustain downward pressure on RMB, and funds outstanding for foreign exchange will continue increase slower and slower or decrease. Meanwhile, in the context of almost-completed interest rate liberalization, the central Bank might gradually weaken the role of M2 as the intermediate target of monetary policy in the future so as to further improve the money policy control framework, thus giving more flexibility to M2.

Credit will maintain fast growth, to support economic restructuring, transformation and upgrading. In 2016, the first year for the implementation of the "13th Five-Year" Plan, commercial banks will have lots of credit growth opportunities. Firstly, the switchover of growth engines will generate more business growth poles, e.g. the constantly expanding new areas like the "the Belt & Road" initiative, Yangtze River Economic Belt and collaborative development of Beijing, Tianjin and Hebei, emerging business formats such as marine economy and Internet economy, and steadily stronger new industries covering energy saving, environmental protection, intelligent manufacturing and high-end equipment; secondly, the new open economic pattern will push forward the great development of cross-border businesses; thirdly, green finance is expected to become a new market for future development. Some adverse factors, however, will affect credit growth: firstly, weak market demand at home and abroad and overcapacity of some industries will restrict credit growth; secondly, it will be difficult for enterprises to recover their desire for investment quickly due to the generally declined profitability; thirdly, continuous rise of NPL amount and ratio leads to more prudential loan offering in the banking sector.

The proportion of direct financing is expected to rise further, with the overall stabilization of social financing scale. In 2016, the growth of social financing scale will face with both positive conditions and negative factors. Positive conditions include: firstly, gradual stabilization of stock market and recovery of IPO will be conducive to restoring the financing function of stock market;

secondly, owing to the opening up of bond market and strengthened innovation, new bond products including securitized NPAs and high-yield bonds are expected to be launched and developed more quickly, thus further exerting the financing function of bond market. Negative factors include: firstly, with the progress of debt replacement by local governments, the financing-vehicle debts originally included in the social financing scale will be converted into the government debts excluded from the statistical scope; secondly, affected by the continued RMB depreciation pressure and contracted interbank business, the proportion of foreign-currency loans and off-balance sheet financing is likely to go down. In 2016, the social financing scale is forecasted to maintain overall stability, and the proportion of direct financing might reach around 23%, up 2 percentage points over 2015.

II.2.2 Maintenance of moderate liquidity, and money market rate likely to maintain a low level

In 2016, USD will continue its strong performance, while RMB is expected to depreciate; the interest spreads between RMB and the USD will be narrowed, with increasing pressure on capital outflows and certain pressure on monetary liquidity. Considering that the domestic loose monetary policy will remain unchanged in the near term, the central Bank will, by flexible use of monetary policy instruments such as open market operations, refinancing, rediscounting, SLO and SLF, regulate both monetary aggregates and prices, and optimize policy combination, to put a curb on the short-term fluctuation arising from IPO, seasonal factors and other types of factors. Therefore, substantial volatility is unlikely to occur in the money market, and interest rates of different terms will remain low. Thanks to the stable expectation on relaxed market environment, the 3-month, 6-month and 1-year interest rates are more likely to stay steady at low levels.

II.2.3 Continuity of low interest rate age, and slight upward trend of bond market despite of volatility

In 2016, bond market will continue to improve on the whole, but focus should be put on the rising default risk and short-term fallback pressure. In details, firstly, monetary policy is necessarily to be more accommodative due to the downward economy and available conditions; the low interest rate age will continue, pushing the bond market to pick up. Secondly, as RMB has been successfully acceded to SDR, overseas institutions will have increasing demand for RMB assets and especially high-grade bonds like T-bonds. Thirdly, as a result of deteriorating credit ratings of low-grade bonds, the bond defaults will continue to increase. As the economy slows down, more and more enterprises will suffer operational difficulties and go bankruptcy, and default risk will further rise, including low-grade bonds and some high-grade bonds. Fourthly, affected by the previous correction of stock market and exchange market as well as over-allotment of some low-grade bonds and short and medium-term bonds, the correction and fallback pressure might appear in the future. In general, the bond market will slightly move upward during the fluctuation, with the upward speed and range lower than that in 2015.

II.2.4 Stock market to be corrected and further reformed

In 2016, the stock market development will not only face the opportunities brought about by the accelerated reforms, but also encounter great challenges resulted from underperformed real economy and exaggerated external impact. Generally speaking, it depends on the speed of economic stabilization, the intensity of reform and the restoration of investors' confidence. With respect to positive factors, the acceleration of a series of reforms on stock issue registration system and construction of a multi-level capital market, etc. will help build up investor confidence and substantively improve investment efficiency in the stock market; besides, the expedited reforms of state-owned enterprises will generate new development opportunities for asset securitization, M&A and reorganization. As for negative factors, there are not so many highlights at the macroeconomic

level, and enterprises still face great profit pressure, which is difficult to drive the full rise of the stock market. Meanwhile, the accelerated liberalization of capital account, collaborative intensification of domestic and overseas capital markets, aggravated influence of external impact on domestic financial market and particularly uncertainty of the Fed's interest rate hike policy will affect the tendency of stock market.

II.2.5 Continued depreciation pressure on RMB/USD in the short term, with moderate and controllable range

In 2016, accompanied by the intricate domestic and international economic and financial situation, a downward pressure on RMB/USD will remain in the short term, but it will be moderate and controllable. Firstly, domestic economic growth will continuously slow down, with the emergence of economic and financial risks. Secondly, domestic monetary and financial environments tend to be stable and loose, while the narrowed interest spreads between RMB and the USD will intensify the expectation on RMB depreciation. Thirdly, due to the strong performance of USD, emerging markets and developing countries will face more pressures on capital outflows and home currency depreciation. Considering the sluggish global economic growth and differentiation of major countries' monetary policies, USD interest rate will not be raised substantially in the initial period, and RMB depreciation range will be controllable. In the long run, China's economic fundamentals will remain positive, current-account surplus will remain large, and RMB internationalization process will be accelerated, to shore up the strong currency status of RMB. In addition, the "811 Exchange Rate Reform" will boost the reform on market-oriented RMB exchange rate formation mechanism into a new stage, hence RMB exchange rate elasticity will be strengthened in the future, with obvious two-way volatility characteristics and stable operation based at a reasonable and balanced level.

II.3 Financial risks worthy of attention in 2016

Affected by de-capacity of real economy and de-bubble of real estate industry, various recessive risks are exposing at a faster speed. Due to the severe overcapacity of traditional industries, reduced return on investment and even large-scale losses suffered by enterprises, the probability of being involved in the risk of "debt--deflation" will rise; continuous destock of real estate market in tier-3 and tier-4 cities and sustained reduction of proceeds from land transfer will impose more debt repayment pressure on local governments; risks of abnormal stock market and exchange market fluctuation will remain, and bond market correction pressure will also increase, thus resulting in higher liquidity risk in the financial system. Besides, as the task of NPL risk prevention and mitigation will be more arduous, the issues regarding adherence to the risk bottom line should arouse wide concern, including:

First, enterprises will be impacted by the triple factors including "debt increase – profit decline – and deflation rise". The rapidly rising NPLs of Chinese commercial banks cannot be separated from the deteriorating operating performance and increasing debts of enterprises. In 2014, the debt ratio of China's non-financial corporate sector (balance of debts/GDP) was 114.7%, up 6.1 percentage points compared with 2009, also significantly higher than that of the USA (77%), Germany (54%) and Japan (101%), etc. In contrast to the rise of overall corporate debt level, corporate profitability shows a declining trend. In the first ten months of 2015, the profits of industrial enterprises above a designated size dropped by 2%, and that of state-owned enterprises fell by 9.8% year-on-year. Listed steel companies suffered large-scale losses, with the weighted ROE tumbling to -8.3%. In addition to that, the sign of deflation had appeared, which would impose more repayment pressure on enterprises. According to the calculation results based on the 4.35% 1-year bank lending rate and RMB7.5 trillion debts of non-financial institutions owed to other deposit-taking companies, the annual interest to be paid will reach RMB3.2 trillion,

representing about 33% of new loans in 2014.

Second, sluggish demand for loans in the real economy will restrict the effect of monetary policy transmission. Due to the multiple factors including slowdown of corporate profit growth and increase of repayment pressure, enterprises present weak demand for loans, thus restricting the effect of monetary policies in transmission. At the end of September, the loan demand index of large-scale, medium-sized and small & micro enterprises was 51.9%, 53.4% and 59.1% respectively, the lowest level since relevant data were available, in which, the loan demand index of medium-sized and small & micro enterprises declined the most by 11.7 and 8.6 percentage points respectively compared with the same period of last year.

Third, the decreased NPL coverage ratio will weaken banks' ability to resist risks. When the NPLs of a commercial bank grow, its provision coverage ratio falls. As of the end of September 2015, the balance of NPLs of commercial banks amounted to RMB1.18 trillion, an increase of RMB419.4 billion over the same period of last year; and the NPL ratio was 1.59%, up 0.43 percentage points compared with the same period of last year. The provision coverage ratio of commercial banks kept declining from 273% in 2014 to 191% at the end of September 2015; worse still, the provision coverage ratio of some banks was about 160%, close to the regulatory warning line (i.e. 150%).

Fourth, it should be noted that the rising NPLs and the enhanced reluctance to lend will give rise to a negative feedback loop. As indicated by scenario analysis results, about 2% NPL ratio of commercial banks is likely to trigger regulatory warning. Assuming that the growth rate of total loans is 10%, original NPL ratio is 1.59% and the provision coverage ratio is 191%, 27% -a quarterly growth rate of NPLs would result in the rise of NPL ratio to 1.84% and decline of provision coverage ratio to 150%, reaching the regulatory warning line. It should be noted that the rise of NPLs will encroach a bank's profit, and make it reluctant to lend and tighten up credit, hence accelerating the exposure of NPLs. If the NPLs continue to grow at the rate of 50% on a quarterly or monthly basis, the NPL ratio will ascend to 2.5%, and about RMB1.1 trillion will have to be set aside additionally for the purpose of maintaining 150% provision coverage ratio, which would almost eat up the combined profits of commercial banks in three quarters.

Table 4: Forecasts on China's Main Economic and Financial Indicators in 2015 and 2016 (%)

Indicator	2013	2014	2015					2016 (F)
			Q1	Q2	Q3	Q4 (E)	2015(E)	
GDP	7.7	7.3	7.0	7.0	6.9	6.9	6.9	6.8
Industrial added value	9.7	8.3	6.4	6.3	5.9	6.1	6.1	6.0
Investment in fixed assets	19.6	15.7	13.5	10.3	8.8	9.3	10.0	8.5
Retail sales of consumer goods	13.1	12.0	10.6	10.3	10.7	11.0	10.7	10.8
Exports	7.9	6.1	4.5	-2.9	-6.2	-6.3	-3.2	3.0
Imports	7.3	0.4	-17.8	-13.8	-14.5	-14.7	-15.2	1.5
CPI	2.6	2.0	1.2	1.4	1.7	1.3	1.4	2.0
PPI	-1.9	-1.9	-4.6	-4.7	-5.7	-5.7	-5.1	-3.0
M2	13.6	12.2	11.6	11.8	13.1	13.3	13.3	13.0

Source: BOC Institute of International Finance

III. Macroeconomic Policies

In 2016, as economic growth remains stagnant, more efforts should be made to the implementation of “steady growth” policy. In order to realize the smooth switchover of growth engines and ensure basically stable operation of economy and finance, macroeconomic policies will persist on the loose orientation. While expanding domestic demands, greater importance should be attached to the management and reform of supply side, with the focus on accelerating reforms, releasing system dividends, promoting tax cuts, reducing production costs of enterprises, expanding corporate investment and residents’ consumption, strengthening innovation and improving product quality, so that the new supply mechanism can meet new demands.

III.1 Fiscal and monetary policies

III.1.1 Deficit expansion and substantial tax cut will be taken as the new tools for the implementation of fiscal policy

Considering that the effectiveness of monetary policy tends to fall and the task of financial risk prevention and mitigation is more arduous, the macroeconomic policies of 2016 will pay more attention to the role of positive fiscal policy in stabilizing economic growth.

First, fiscal deficit ratio will be raised. In 2015, the deficit ratio was around 2.3% (the actual was about 2.7%), lower than the international warning line of 3%. Actually, the requirement that deficit

ratio should be less than 3% is one of the constraint conditions imposed by the EU on its member countries, and there is no scientific calculation. Historically speaking, China's deficit ratio still has room for improvement as well, which is expected to reach about 3% in 2016.

Second, tax cut will be strengthened. As an important part of “supply side” management, the tax cut for emerging industries and consumer sectors will be intensified in 2016, to facilitate the emergence of new industries and expand new consumer demands. The issued preferential tax policy towards “agriculture, rural areas and farmers” as well as small & micro enterprises will take effect; more tax support will be primarily given to the advanced manufacturing, services and emerging industries as well as “mass innovation and popular entrepreneurship”; the personal income tax reform plan reflecting the combination of comprehensiveness and classification will be worked out in an accelerated manner, to manifest the differences of each household and practically abate the tax burden of salary-earners.

Third, a relatively high growth rate of financial expenditures will maintain. In 2016, the government will speed up the investment, construction and completion of major projects covering hydraulic engineering, railway construction and shantytown reconstruction, with energetically providing better and diversified public products and services. Local governments at different tiers will be promoted to continuously cement budget execution and management, enhance the supervision and investigation over major projects, and accelerate the activation and planning of existing fiscal deposits, for the purpose of improving the efficient use of public funds.

Fourth, a variety of measures will be taken to ease capital constraints. In 2016, the central government will raise the size of new local government bonds, and further promote the local government debt replacement. Policy banks will be continuously encouraged to issue special financial bonds and prop up local infrastructure and people's livelihood projects in the form of project capital investment and equity investment. The PPP mode will be promoted, to improve the infrastructure investment and financing mechanism; and the PPP financing support fund will be established and generalized, in parallel with the quicker promotion of emerging industry venture capital guidance fund and national SME development fund, in order to bring the social fund mobilization function of public funds into full play.

III.1.2 Accelerate the establishment of a new "interest rate corridor" framework under the monetary policy, and pay more attention to interval control

In 2016, the monetary policy will continuously keep the balance between growth stability and risk prevention. In response to the increased pressure of cross-border capital flows and bigger probability of “debt-deflation”, the monetary policy will be more forward-looking, flexible and pertinent as emphasized, to speed up the building of a new monetary policy framework, focus more on elastic regulation and interval control, and improve the efficiency of existing financial asset turnover.

First, a new "interest rate corridor" framework will be established, so that stable money market rates can be maintained steady at low levels. In consideration of the factors including downward commodity price, rising risk of “debt-deflation” and intensified financial market volatility in 2016, monetary policy will put more emphasis on the prevention of risk and deflation. As an important system arrangement for risk prevention, the establishment of “interest rate corridor” will be conducive to the abatement of money market volatility, which is also a common practice adopted by most countries during the transformation of quantity-based monetary policy operation framework to a price-based one. The possible approach adopted by China for establishment of “interest rate corridor” includes: regulating and controlling short-term benchmark interest rates by intensified use of structured instruments including SLO and SLF, with the interest rate for standing credit facility as the ceiling and the deposit rate for excess reserves as the floor.

Second, interval control will be attached more attention, with the focus on both quantity and price. Considering the normalized reduction of foreign exchange holdings, declined velocity of money due to the risk of “debt-deflation” and efficient collaboration for the implementation of positive fiscal policy, monetary policy will continue to focus on both quantity and price, and pay more attention to interval control and quantity supplementation. Stabilization of interest rates will be emphasized, to push forward the steady operation of market interest rate in a reasonable interval; right time will be selected continuously to lower requirement reserve ratio (RRR), so as to make up the monetary base gap resulting from the decrease of funds outstanding for foreign exchange; besides, as benchmark interest rate has hit the historical low, there is not much further room for interest rate cuts. In 2016, new RMB loans are estimated to reach about RMB12 trillion, M2 is likely to increase by approximately 13%, and RRR might be lowered by around 200 bps, with about one interest rate cut.

Third, the securitization of NPAs will be sped up, and the foreign exchange market from excessive volatility risks will be prevented. Rising NPAs and the accompanying prudential lending behaviour have become the key factor and main risk that restrict the exertion of monetary policy functions; in addition, as the negative impact of exchange rate changes on monetary policy has been more obvious, prompt measures must be taken to mitigate internal and external risks. It is expected to: further expand the scale of asset securitization, ease restrictions on asset securitization varieties, speed up the NPA securitization pilot, and adopt more means to mitigate the risk of financial institutions; speed up the innovation of high-yield bonds and other products, improve the bond market openness, and practically exert the positive role of bond market in promoting SME financing, perfecting monetary policy transmission and elevating currency internationalization; extend the trading hours for foreign exchange market, enrich trading entities, and raise the cost of shorting RMB.

III.2 Industrial policy will focus on cracking the contradiction of ineffective oversupply and lack of effective supply

In terms of overcapacity, ineffective supply will be reduced by absorbing, transferring, integrating and eliminating ineffective capacity supply. Firstly, the constraint functions of indicators regarding environmental protection, safety, energy consumption and quality will be reinforced, to restrict the access of unqualified production capacity; secondly, under the guidance of fiscal capital and reasonable credit policies, support will be given to the advantageous enterprises to reorganize the ones with lagging production capacity by means of merger and acquisition, and leading enterprises will be properly bolstered to accelerate technology reconstruction and product upgrading by virtue of borrowing and bond issuance; thirdly, the enterprise bankruptcy & exit mechanism will be bettered for the orderly withdrawal from “zombie” companies, with properly arranging their employees.

With respect to the reduction of corporate cost, effective supply mechanism that can meet new consumer demands will be developed as quickly as possible. In which, the following tasks are likely to be accomplished: further reducing the matters requiring administrative examination and approval, cleaning up and standardizing administrative fees; providing more tax preferences for micro, small and medium-sized enterprises; broadening the financing channels for micro, small and medium-sized enterprises, encouraging and guiding commercial banks to increase the credit supply to these enterprises, improving the guarantee system and social credit system, and accelerating the development of small and medium-sized financial institutions, such as community banks and private banks; strengthening the management of logistics market, and strengthening the rectification of unauthorized checking posts, arbitrary charges and fines.

With regard to real estate, the policies will vary in different regions. For the tier-1 cities where

housing price rises fast, the restrictions on housing purchase will be strictly followed; and meanwhile some tier-2 cities and all tier-3 and tier-4 cities will be regarded as the main targets for destock. Firstly, the policy support concerning tax cut and credit will be intensified; secondly, the policies on shantytown reconstruction and affordable housing will be flexibly adjusted based on local inventories, and subsidies or acquisition of commercial housing will be used as a supplement; thirdly, the regional economic integration will be accelerated, and the people-oriented urbanization will be advanced by means of accelerated reform on household registration system, so that migrant workers can settle down in towns.

III.3 Consumption policy will focus on the cultivation of new consumption hotspots

New consumer goods are considered as the primary direction for the upgrading of future resident consumption structure, and also the key area to create a new driving force for growth currently. In 2016, consumption policy will pay more attention to the creation of a benign consumer environment, support enterprises to expand the supply of new consumer goods, and ameliorate the fiscal and taxation systems for the support of new consumer goods.

First, a safe, honest, quality and convenient consumer environment will be fostered. With the focus on developing assured products and providing quality services, the standards and criteria on agricultural products, food, medicine, housekeeping and pension will be improved, the establishment of a whole-process quality and safety traceability system for daily necessities and services will be explored, and a national consistent, shared and open credit information network platform will be built, to enhance the role of the government and third-party organizations in the quality regulation and supervision, and bolster the role of social organizations such as the consumers' association in the protection of consumers' rights and interests.

Second, the industry and enterprise cluster supporting new consumer goods supply will be developed. Social capital will be encouraged to target at new consumer demands, with the promotion of traditional consumer goods and service upgrading, and the simplification of business start-up process for new consumption industry, so as to lower the threshold for business start-up and comprehensively apply the rules on “integration of three business license, organizational code certificate and taxation registration certificate, and issue of business license with unified social credit code”. In addition, the areas of education, health care, culture and pension will be promoted in an expedited manner to open up internally and externally, and the import of daily necessities will be properly expanded to enrich the goods available for the selection of consumers.

Third, powerful fiscal and taxation policies to buttress the new consumer goods development system will be formulated. The scope of halved income tax for small & micro enterprises will be further expanded, and the thresholds of VAT and business tax collected from small & micro enterprises and the self-employed will be raised, so that more market participants can enjoy the dividends from tax cut, thus stimulating the supply of new consumer goods. Besides, the amount of personal income tax exemption will also be raised, and taxpayers' family burden will be gradually included in the deduction factors, to enhance the consumption capacity of medium-income group.

III.4 Investment policy will focus on playing the leading role of government investment

Government investment is supposed to maintain certain growth at the time of economic downturn, to play its leading role, with achieving the great by doing little. In 2016, except guiding enterprises to make additional investment, investment policy will put more focus on promoting government investment by selecting some influential projects, to maximize its multiplier effect.

First, a batch of major infrastructure projects covering information, transportation, water conservancy and energy will be implemented. The construction of a quick transportation network consisting of high-speed rails, inter-city railways, highways and civil aviation airports will

be accelerated, and the synchronous building of large warehousing logistics centres and nearby transportation hubs will be boosted. In addition, the construction of inter-basin water transfer projects and water engineering projects will also be promoted, plus the construction of high-level inland waterways and ports, to systematically renovate river and lake basins.

Second, the construction of urban and regional communal facilities and public welfare facilities will be facilitated. It is expected to reinforce the reconstruction of urban shantytowns and dangerous houses, keep a certain amount of affordable housing construction, and solve the living problem for migrant population in a planned manner. The facilities covering urban public transportation, underground utility pipe network, flood control and waterlogging prevention will be constructed in an intensified manner; reasonable urban planning and parking lot construction will be combined to speed up the construction of electric car charging piles. In addition, more investment will be made in the central and western regions as well as the northeast, so as to achieve desirable effect from major projects regarding the “the Belt & Road” initiative, collaborative development of Beijing, Tianjin and Hebei, and the Yangtze River Economic Belt.

Third, the PPP models will be innovated. The laws and regulations on Public-Private-Partnership (PPP) will be promoted for improvement, with the definition and standardization of related rights, responsibilities and interests, to stabilize the private capital expectations, encourage and attract private capital to participate in the investment in infrastructure and public services sector. Moreover, local institutions will be encouraged to expand the PPP platform corporate financing channels by exploring the forms of fund injection and investment subsidies.

III.5 Foreign trade policy will strive to expand new growth space

In 2016, by taking the opportunities from the “the Belt & Road” initiative and cooperation on international production capacity and equipment manufacturing, beneficial trade rules will be strived for in the foreign trade policy, to promote the trade rebound and form the benign interaction between trade, investment and rules.

First, the favourable external environment will be grasped, to further expand exports. Driven by a series of positive diplomatic activities, and by grasping the development opportunities from the infrastructure investment in the countries alongside the “the Belt & Road” and Asian Infrastructure Investment Bank, the exports of large-size complete equipment and related goods and services will be expanded.

Second, the trade in services will be vigorously developed, to create a new source for China's foreign trade growth. By relying on the existing development zones and pilot free trade areas, a batch of featured service export bases will be planned and built, to fully exert the gathering function of modern services and services trade. With the all-around reform on converting business tax to VAT, a mechanism on export rebate or free export for the service trade will be established and improved, to develop the fiscal and taxation support policy which can comply with the WTO rules and international development experience.

Third, the formation of G20 trade minister meeting mechanism will be promoted, to improve the global trade governance system. China's foreign trade and investment has a broad interest in the whole world, while G20 is an important platform of global economic governance. Therefore, the formation of G20 trade minister meeting mechanism should be positively promoted, to make it an annual meeting, and improve the global trade governance system, thus facilitating international economic and trade rules to change in a direction conducive to development.

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