Institute of International Finance

China's Economic and Financial Outlook

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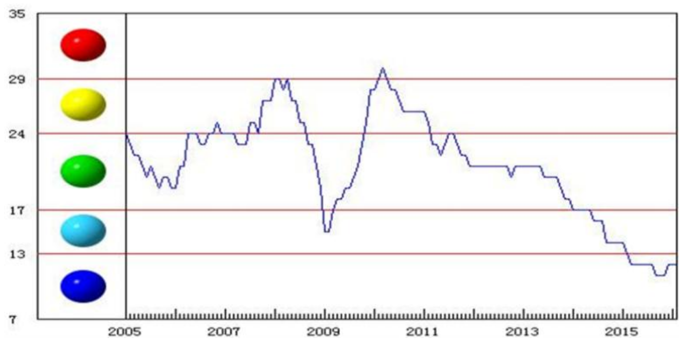
Highlights

● In 2016Q1, China stayed in a critical stage which could be characterized as the "long-short game", with a mixed economic performance. Influenced by the factors including weak external demand, de-capacity of traditional industries and slowdown of consumption, the country was still confronted with great economic downward pressure, though the steadily rallying investment and narrowed PPI decline would facilitate economic stabilization. In Q1, China's GDP is expected to grow by 6.6% approximately.

● Looking into Q2, a number of key projects outlined in the "13th Five-Year Plan" will be launched one by one, and accelerated advancement of Special Construction Fund and PPP Projects will contribute to the growth of investment. Industrial growth, owing to the intensified de-capacity this year, will hover around at a low rate, but industrial structure is likely to keep improving and emerging industries including energy conservation & environmental protection, information communication and high-end equipment are excepted to maintain fast growth. The GDP growth is estimated to reach 6.7% or so, picking up slightly from Q1; hence it is very possible to fulfill the target anticipated by the government, i.e. 6.5%-7%, by the end of the year.

● Currently, special attention should be paid to the coordination between economic policies and reform measures, to prevent the disharmony and even conflict between different policies. Fiscal policy should be taken as the major force to boost steady growth and structural reform on the supply side, while monetary policy can be harnessed to direct the robust development of monetary credit and guard against the contagion of market risks.

China's Macroeconomic Early Warning Index



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A Mixed Start in the Economic Sphere, and To-be-Enhanced Policy Coordination

----China's Economic and Financial Outlook (2016Q2)

In 2016Q1, China stayed in a critical stage which could be characterized as the "long-short game", with a mixed economic performance. Influenced by the factors including weak external demand, de-capacity of traditional industries and slowdown of consumption, the country was still confronted with great economic downward pressure, though the steadily rallying investment and narrowed PPI decline would facilitate economic stabilization. In Q1, China's GDP is expected to grow by 6.6% approximately. Looking into Q2, a number of key projects outlined in the "13th Five-Year Plan" will kick off one by one, and accelerated advancement of Special Construction Fund and PPP Projects will contribute to the growth of investment. Industrial growth, owing to the intensified de-capacity this year, will hover around a low rate, but industrial structure is likely to keep improving and emerging industries including energy conservation & environmental protection, information communication and high-end equipment are excepted to maintain fast growth. The GDP growth is estimated to reach 6.7% or so, picking up slightly from Q1; hence it is very possible to fulfil the target anticipated by the government, i.e. 6.5%-7%, by the end of the year.

Macroeconomic policy will change the previous excessive emphasis on aggregate demand management and pay more attention to the structural reform on the supply side, which will have a profound impact on China's economic development model and motivation mechanism. To contain economic downward pressure, tighten up structural reform on the supply side, guard against cross-sector contagion of financial risks and prevent asset price bubbles, are the main difficulties and challenges faced by Chinese economy. At present, China should put focus on the coordination between economic policies and reform measures, to circumvent the disharmony and even conflict between different policies. In terms of macro policies, fiscal policy should be taken as the major force to boost steady growth and structural reform on the supply side, increase the efforts in tax cuts and fee clearance, improve the supply efficiency of public services, further standardize the management of local government debts, and avoid fiscal and financial risks; monetary policy should be harnessed to enhance the use of structural instruments, and guide the robust development of monetary credit and steady decline of market interest rate by grasping the opportunities brought about by the RRR cut, hence preventing cross-sector spread of market risk. Meanwhile, tailor-made policies should be applied to different cities, to balance the relationship between real estate destock and bubble suppression.

I. 2016Q1 Economic Review and Q2 Outlook

I.1 Main characteristics of economic operation in Q1: mixed performance

In 2016Q1, China stayed in a critical stage which could be characterized as the "long-short game", with a mixed economic performance. Satisfactorily, the "stable growth" policy started to take effect, with the explosive growth of new projects and stabilized investment growth, the prices of energy and raw materials rallied, and PPI decline narrowed. However, troublesomely, the economy showed slower growth of indicators like industrial production and consumption, further decline in exports, weak private investment and unstable foundation for stabilization, suggesting the sustained great downward pressure. Specific characteristics are descried as follows:

Figure 1: China's Quarterly GDP Growth

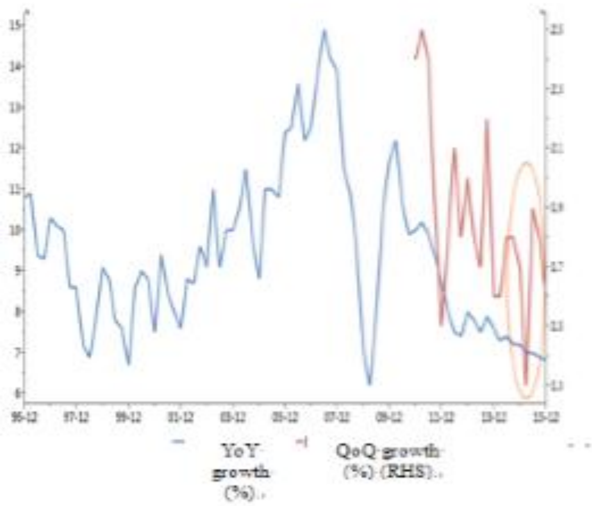


Figure 2: China's Macroeconomic Climate Early Warning System

Sources: Wind, BOC Institute of International Finance

First, investment achieved a "good start", with obvious disparities in the investment structure and explosive growth of new projects. The first two months witnessed a year-on-year investment growth of 10.2% (Figure 3), up 0.2 percentage points from last year, and also significantly higher than the market expectation (about 9%). In the context of economic downturn, the investment recovery would be of great significance for stabilizing economic development and boosting market confidence. Agriculture, infrastructure and strategic emerging industries encouraged by national policies, owing to the differentiated investment structure (Figure 4), presented fast investment growth, while some traditional industries were confronted with great de-capacity pressure, bleak prospect and poor profitability, with the scale of investment contracting continuously. In terms of infrastructure investment, for instance, the investment in water project management and public facilities management increased by 24.7% and 26.5% respectively; compared with 2015, the investment growth (18.5%) of industries including electricity, heat, gas and water production & supply was 1.9 percentage points higher. The investment in equipment manufacturing industry grew by 11.3% year on year, up 1.1 percentage points over last year and 3.8 percentage points higher than that of the entire manufacturing industry; the investment growth of auto manufacturing industry stood at 13.9%, a year-on-year growth of 8.8 percentage points; the investment in textile industry rose by 13.5%, up 4.5 percentage points year-on-year; and a growth rate of 23.8% was reported for the food manufacturing industry, an increase of 13.8 percentage points over the previous year. Meanwhile, the investment in energy-intensive industries presented negative growth under the background of sluggish market demand, de-capacity and deleverage. In January and February, the investment in energy-intensive manufacturing industry declined by 2.5% year on year, compared with the zero growth in last year; among the five major industries (including steel, coal chemical, cement, flat glass and electrolytic aluminium), the investment in four industries went down.

New projects constitute a very important leading indicator for the judgment on investment. Accelerated growth of new projects generally means the acceleration of investment growth in the next period of time. In the first two months this year, the planned total investment in new projects grew by 41.1%, up 42.9 percentage points compared with the same period of last year. Its rapid growth indicated that a series of investment policies issued by the Chinese Government for the purpose of stable growth over the past year, including the “Eleven Major Project Packages[1]", "Three Major Strategies", “Six Consumer Projects[2]" and PPP Projects, have started to take effect, implying the possibly continuous rise of investment growth in the next period of time.

Figure 3: Growth of Investment in Fixed Assets Stabilizes

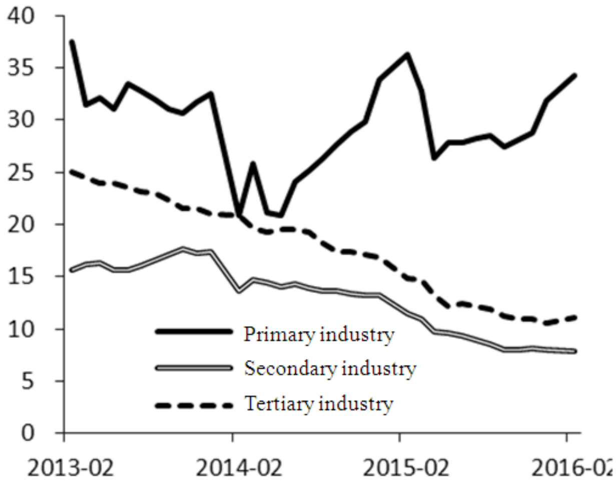
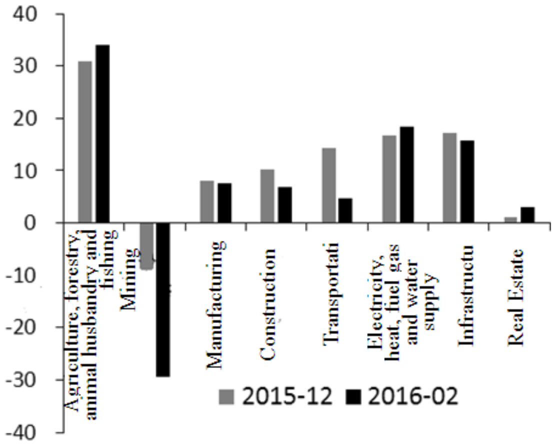


Figure 4: Growth Rate of Completed Investment in Major Industries



Sources: Wind, BOC Institute of International Finance

Second, the obliviously accelerated process of real estate destock and booming sales (“rise of both volume and price”) facilitated the stabilization of front-end land as well as investment and development market, and led to significant changes in the market pattern. Stimulated by some favourable policies, such as reduced proportion of down payment, eased restrictions on housing purchase and loans, RRR and interest rate cuts, domestic housing market has seen sweeping shifts. In the first two months of this year, the growth rates of sales area and sales amount reached 28.2% and 43.6% respectively thanks to the skyrocketing sales, up 44.5 and 59.4 percentage points over the same period of last year. Commercial housing prices also kept rising; in February, the 100-city average housing price increased by 5.3%, with positive growth for eight consecutive months. Driven by the “rise of both volume and price” on the sales side, the real estate investment and development gained steady recovery; in terms of quarter-on-quarter growth rate, the real estate investment turned to positive growth from negative growth. The area of newly commenced housing projects reached 156 million square meters, up 13.7% from a year earlier; while it fell by 14% last year, with a 17.7% drop in the first two months. The rally of real estate investment obviously boosted the recovery of all investment projects. In January and February, the real estate development and investment was estimated to account for 23.8% of total investment (Table 1), up 6.7 percentage points over the last year, and its contribution to total investment growth was reported at 7.5%, an increase of 5.6 percentage points compared with the previous year.

[1] The "Eleven Major Project Packages” cover major networks including information, power grid, oil and gas, ecological environmental protection, clean energy, food & water conservancy, transportation, health care & pension, energy and mineral resource guarantee, urban rail transport, modern logistics, enhancement of core competitiveness of manufacturing industry, and emerging industries. As revealed by a relevant leader from the NDRC, by the end of January this year, the accumulative amount of completed investment in the eleven major projects have reached RMB5,309.6 billion, an increase of RMB253.2 billion compared with that of previous year, and 339 projects were commenced, rising by 13 from the end of last year.

[2] In December 2014, the National Development and Reform Work Conference proposed to vigorously carry out consumer projects in six areas, i.e. pension, health & housekeeping, information, energy conservation & environmental protection, tourism & leisure, housing, and culture, education & sports.

Table 1: Contribution of Real Estate Investment to Investment and Economic Growth

Year	GDP (RMB100 million)	Investment in fixed assets (RMB100 million)	Real estate investment (RMB100 million)	Real estate investment /GDP (%)	Real estate investment/social investment in fixed assets (%)
2007	268019.4	137323.9	25288.8	9.4	18.4
2008	316751.7	172828.4	31203.2	9.9	18.1
2009	345629.2	224598.8	36241.8	10.5	16.1
2010	408903.0	251683.8	48259.4	11.8	19.2
2011	484123.5	311485.1	61796.9	12.8	19.8
2012	534123.0	374694.7	71803.8	13.4	19.2
2013	588018.8	446294.1	86013.4	14.6	19.3
2014	635910.2	512020.7	95035.6	14.9	18.6
2015	676707.8	562000.0	95978.9	14.2	17.1
2016 (1-2)		38008.0	9052.0		23.8

Sources: Wind, BOC Institute of International Finance

Third, new changes were found in the prices of energy and raw materials, with contracted PPI decline and expanded CPI rise. In February, CPI rose in an accelerated manner, causing widespread concern in the market, and even some people warned that the era of inflation was approaching. Upon prudent analysis, however, the CPI rise in February was mainly attributable to the fast rising food price (Figure 5). In which, the fresh vegetable price went up 30.6%, contributing 0.86 percentage points to CPI rise; the pork price ascended by 25.4%, contributing 0.59 percentage points; and the two factors pushed CPI to increase by 1.45 percentage points aggregately, accounting for 63%. The risen fresh vegetable price had a bearing on bad weather, while the ascended pork price was related to the "hog cycle"; namely, the previous plunge and substantial decline of breeding sows resulted in a significant reduction in the supply of pork. In fact, the rise of non-food price did not expand, but contracted. In February, the non-food CPI increased by 1% only, down 0.2 percentage points over the previous month. We believe that the rise of vegetable price will fall back with the improvement of weather and increase of supply. Due to the compensatory growth of pork price, we don't need to worry about the recent CPI inflation; moreover, the accelerated CPI rise should not be considered as a sign of macroeconomic upturn.

Figure 5: CPI Rise Driven by Food Price

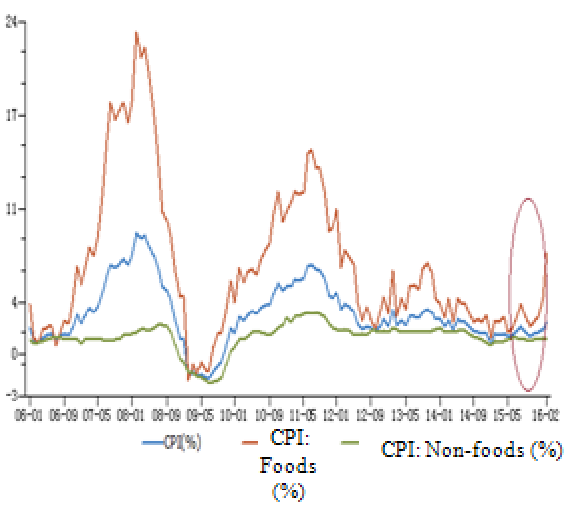
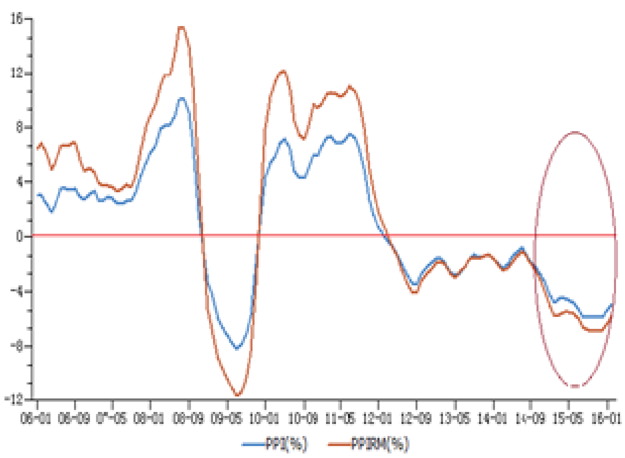


Figure 6: Significantly Narrowed PPI Decline



Sources: Wind, BOC Institute of International Finance

Figure 7: 100-City Housing Price Index

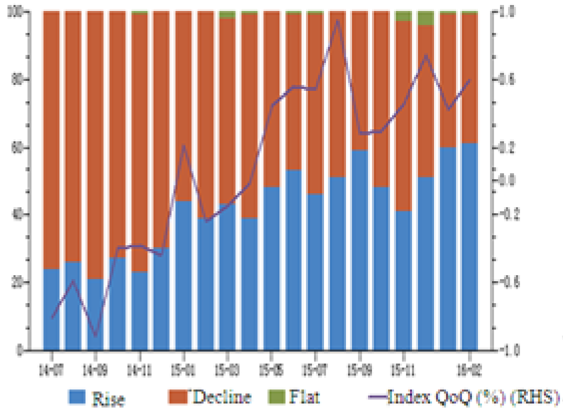
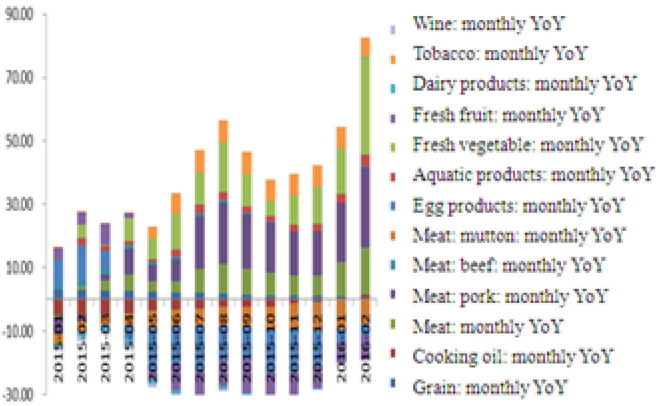


Figure 8 Comparison of Food, Tobacco and Wine Commodities by Price Rise



Sources: Wind, BOC Institute of International Finance

Table 2: Classified Changes of PPI (%)

Year	PPI	Means of production	Means of production			Means of livelihood	Means of livelihood			
			Extractives industry	Raw materials	Processing industry		Foods	Clothing	Daily necessities	Durable consumer goods
2011	6.0	6.6	15.4	9.2	4.6	4.2	7.4	4.2	4.0	-0.6
2012	-1.7	-2.5	-2.4	-2.0	-2.7	0.8	1.4	2.1	0.9	-0.9
2013	-1.9	-2.6	-5.7	-3.1	-2.0	0.2	0.7	1.2	-0.2	-0.9
2014	-1.9	-2.5	-6.5	-3.0	-1.8	0.0	0.2	0.7	0.1	-0.8
2015	-5.2	-6.7	-19.7	-9.5	-4.3	-0.3	0.0	0.7	-0.7	-0.8
2016 (1-2)	-5.1	-6.7	-19.0	-9.0	-4.7	-0.5	0.3	0.7	-1.1	-1.7

Sources: Wind, BOC Institute of International Finance

Currently, of even greater concern is the recent rebound in prices of energy and raw materials, which not only has a bearing on operating rate, operating efficiency and profitability of related enterprises, but also reflects the demand for investment and production conditions. In February, PPI was still declining (-4.9%, Figure 6), but the declining range decreased by 0.4 percentage points and 1 percentage point (Table 2) respectively from January and the fourth quarter of last year. As of March 18, the Bohai-Rim Steam-Coal Price Index (BSPI) stood at RMB389 per ton, up 4.6% compared with the beginning of this year (Figure 9); the settlement price of rebar futures was reported at RMB2,119 per ton, rising by 18.4% from the beginning of the year, and 30% higher than the lowest price on December 1; the settlement price of aluminium futures was also 7% higher than that at the beginning of the year (Figure 10); and the ICE Brent Crude exceeded USD42 per barrel, ascending by nearly 55% compared with the lowest price (USD27.1 per barrel). In short, since 2016, the prices of energy and raw materials including iron & steel, coal, electrolytic aluminium and international crude oil have regained an upward trend; without doubt, it would greatly improve the production and operation of related industries, raise their capacity utilization rate and market expectations.

Figure 9: Bohai-Rim Steam-Coal Price Index (BSPI)

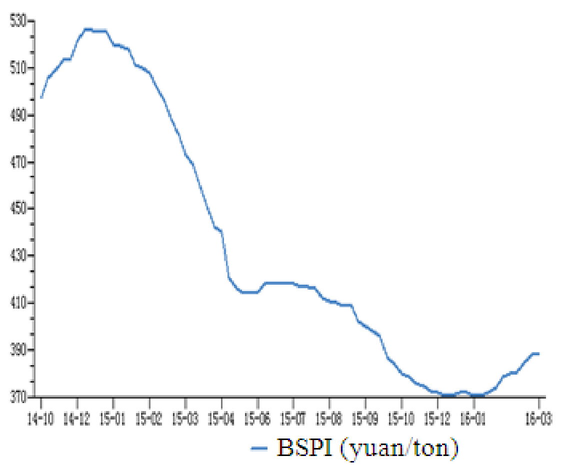
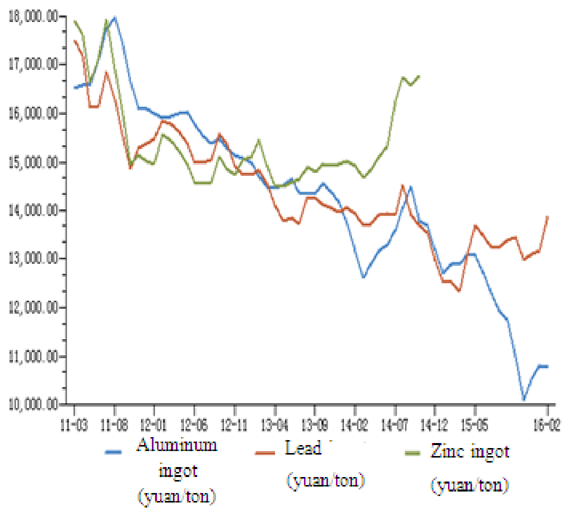


Figure 10: Monthly Average Spot Price of Non-ferrous Metals in Shanghai



Sources: Wind, BOC Institute of International Finance

Compared with the same period of last year, however, a number of important economic indicators kept falling in the first two months of this year, indicating the weak foundation for economic stabilization.

First, due to weak external demand, de-capacity in the overcapacity industries and substantial decline of the tobacco industry, industrial production continued to slow down. The first two months saw an increase of 5.4% only, and the year-on-year growth rate fell by 1.4 percentage points, the lowest level since the same period in 2009. Albeit the declining proportion of industry in GDP (from 41.4% a decade ago to 33.8% in 2015, down 7.6 percentage points), its impact on economic growth is still quite significant.

Second, the slowdown of consumption growth could be attributed to the fallen growth rate of commodities like car and home appliances. In the first two months, the total retail sales of social consumer goods increased by 10.2%, down 0.5 percentage points over the same period of last year, while the actual growth rate dropped more significantly (1.5 percentage points around).

Third, imports and exports declined further. In the first two months, exports fell sharply by 17.8%, with the growth rate dropping by 32.7 percentage points; imports tumbled by 16.7%, a decline of 3.4 percentage points over the same period of last year. Affected by the greater decline in exports, the foreign trade surplus reduced to USD95.9 billion from USD119.8 billion last year, a decrease of nearly 20%.

Fourth, private investment was stagnant, which grew by only 6.9% in the first two months, down 7.8 percentage points year on year, and 3.3 percentage points lower than the overall investment growth in the period. The proportion of private investment in fixed assets also decreased by 2 percentage points (from 63.6% to 61.6%). Especially, the private investment growth was more sluggish in the central and western regions, with the growth rate of 6.7% and 4.1% respectively in the two regions, 1.9 and 4.5 percentage points lower than that of the eastern region (8.6%).

On the whole, China's economic operation was generally stable in the first quarter of this year, with the signs of steady upturn of investment and other economic indicators. Despite of the superimposed effect of de-capacity, destock and deleverage, the foundation for economic stabilization was not solid yet, autonomous growth momentum was still insufficient, and some key economic indicators including industry, investment and consumption slowed down; moreover, the growth of imports and exports slipped sharply, implying the sustained great economic downward pressure. The GDP growth rate of Q1 is preliminarily estimated at around 6.6%, down 0.4 percentage points over the same period of last year; and CPI might rise by about 2.2%, a year-on-year increase of 0.8 percentage points.

I.2 Main judgments on economic situation in Q2

Looking into Q2, a number of key projects outlined in the "13th Five-Year Plan" will kick off one by one, and accelerated advancement of Special Construction Fund and PPP Project will contribute to the growth of investment. Meanwhile, real estate sales and housing price will drive the steady rally of investment. Subject to the decline in revenue growth, the expectations on employment and income are slightly pessimistic, with weak willingness of consumers for spending and consumption, indicating the accelerated growth of consumption in the face of challenges. Industrial growth, owing to the intensified de-capacity this year, will hover around a low rate, but industrial structure is likely to keep improving and emerging industries including energy conservation & environmental protection, information communication and high-end equipment are excepted to maintain fast growth. In view of these factors, the GDP growth is estimated to reach about 6.7% in 2016Q2, picking up slightly from Q1; hence it is very possible to fulfil the target anticipated by the government, i.e. 6.5%-7%, by the end of the year.

I.2.1 On the supply side, de-capacity will contribute to the sustained low growth of industrial production, while the financial sector will encumber the growth of service sector

Industry will lie in the process of de-capacity. Since the beginning of this year, steel prices have rebounded and coal prices have stabilized (Figure 11), due to the markedly declined product supply arising from the production cut plans of enterprises or delayed on-steam as the result of losses. In February, the output of products including crude steel and raw coal fell by 5.7% and 6.4% respectively, up 3.4 and 2.9 percentage points over the previous year (Figure 12). Inventory has been low all along. At the end of February, the steel stocks in the country's major markets decreased by 14.3% year on year, which slightly eased the contradiction between supply and demand in the market. Nevertheless, the short-term demand is still difficult to have a significant improvement. This year the government will focus on the steel and coal industries by strictly curbing new production capacity and resolutely eliminating the backward one, implying that corporate mergers and acquisitions will increase. It is expected that the growth rate of overcapacity industries will continuously fall with the progress of de-capacity in Q2, while the rising prices of energy and raw materials will help to ease the downward pressure.

The emerging manufacturing industry will maintain a rapid growth. Due to the government's efforts to promote the development of high-tech industries, the industries including aerospace manufacturing, electronic communications equipment manufacturing and information chemicals manufacturing maintained fast growth rates of 27.5%, 12.1% and 21.1% respectively in February. This year the government will improve relevant preferential tax policies by deducing the aggregate enterprise R&D expenses; meanwhile, the pilot of "investment-loan linkage" is to be launched. It is estimated that the high-tech manufacturing industries including electronic communications and information will still maintain rapid growth in Q2. Some emerging products in conformity with new consumption direction will also keep fast development; for example, the output of sport utility vehicles (SUV), new energy vehicles and smart phones had a year-on-year increase of 60.4%, 75.9% and 18.6% respectively in February. Generally, the rapid growth momentum of these industries is expected to remain unchanged in Q2.

Overall, the growth rate of industrial added value is estimated to stand at around 5.5% in Q2, an increase of 0.1 percentage points from Q1. Driven by the real estate industry, the added value of construction industry would pick up in an accelerated manner, which grew by 7.3% in 2015Q4, up

1.5 percentage points compared with Q3 rise. The future investment and real estate are still expected to stabilize continuously, and the growth of construction industry is very likely to keep rising. On the whole, the secondary industry would remain stable generally in Q2 and possibly gain a slight recovery relative to Q1.

Figure 11: Iron & Steel and Coal Price Index

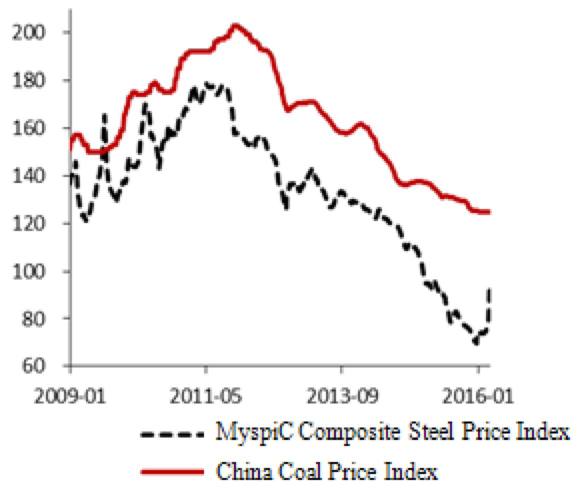
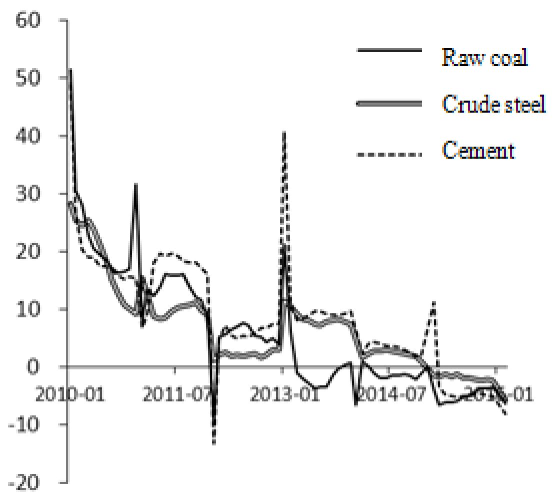


Figure 12: YoY Output Growth of Overcapacity Industries (%)



Sources: Wind, BOC Institute of International Finance

The revival of real estate industry will boost the growth of consumer services. The recovery of real estate industry started since the beginning of this year (Figure 13 and 14) is expected to continue in Q2. Firstly, some of the leading indicators have improved, showing the enhanced confidence of real estate enterprises. In February, the investment in real estate development rose for the first time in the past two years; the accumulative year-on-year growth rate of new housing construction area soared to a positive 13.7% from a negative rate; and the growth rate of land acquisition area significantly dropped to -19.4%. Secondly, due to the relatively accommodative policy environment in the period of destock, fiscal, financial and land policies should be comprehensively utilized to promote the destock of real estate industry, especially in the tier-3 and tier-4 cities. As for other consumer services, traditional accommodation, catering and retail services will maintain a steady growth. Propelled by the transformation and upgrading of social consumption mode, the key industries including pension, culture and tourism will also grow rapidly. Besides, the recovery of real estate industry will significantly stimulate the growth of consumer services, owing to its large proportion in the service industry (about 12%).

Figure 13: Commercial Housing Sales (%)

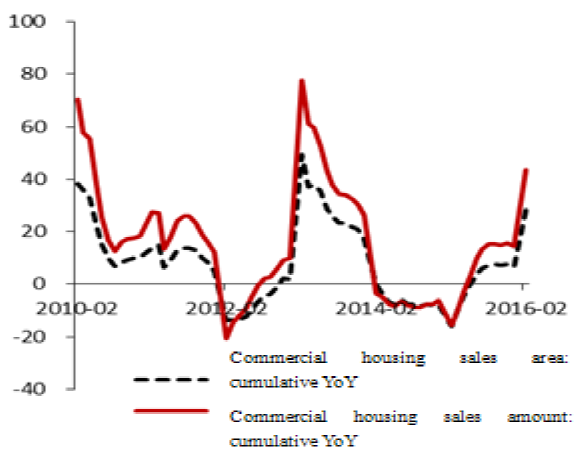
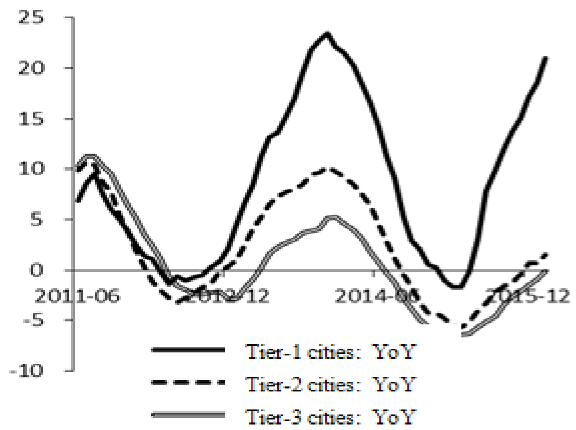


Figure 14: YoY Changes in 100-City Housing Price (%)



Sources: Wind, BOC Institute of International Finance

The slowdown in the financial industry will drag down the producer service industry. In the first half of last year, a sharp rise in the stock market was considered as a significant stimulant for the rapid growth of financial industry. Since the stock market volatility in the second half of last year, however, the growth of financial industry has slowed, with the cumulative growth rate reaching 15.9% in 2015Q4, down 1.1 percentage points from Q3. In January 2016, the daily average stock trading volume of SSE and SZSE amounted to RMB541.1 billion, representing a decrease of 15.2% over the same period of last year. The stock market is expected to remain at the stage of adjustment and difficult to rise substantively, while 2015Q2 saw the peak of stock trading volume (reaching RMB1.7 trillion in June) in the year, with a high base. Therefore, the growth of financial industry might continue to decline in Q2 (Figure 15). Sluggish industrial growth may also impede the industries like transportation, warehousing and postal express delivery. Although the information technology, leasing and scientific research services will maintain a fast growth momentum under the policy support and rapidly growing emerging industries, the producer service industry will slow down to a certain extent (Figure 16), affected by the declined growth of financial industry which accounts for a relatively large proportion in the service industry (about 17%).

Figure 15: Growth of Added Value of Financial Industry and Stock Trading Volume (%)

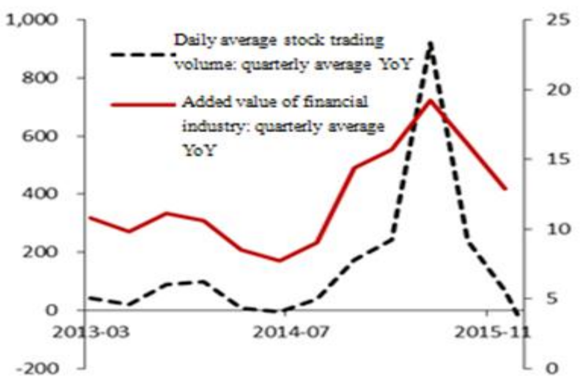
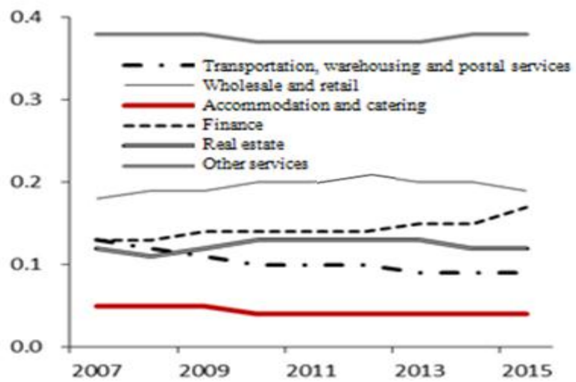


Figure 16: Proportion of Various Sectors in the Service Industry



Sources: Wind, BOC Institute of International Finance

I.2.2 From the demand side, consumption will face challenges for accelerated growth, and investment growth is expected to steadily rally, with the prudentially optimistic attitude towards foreign trade

Despite of overall stability of consumption growth, challenges can be found for further growth. Firstly, the stagnant income growth of residents is not conducive to faster growth in consumption. In the context of economic downturn, a considerable part of industries and enterprises present poor operating performances, resulting in the slowdown of employees' income growth. This year China will intensify de-capacity, which may lead to redeployment and transfer of some employees, including about 1.8 million employees in the industries of iron & steel and coal. They will earn less. In recent years, residents' income growth was faster than economic growth, but it gradually dropped to 7.6% in the first half of 2015 and 7.4% for the whole year from 8.1% in Q1 (Figure 17). All these factors will hinder the expansion of residents' consumption.

Secondly, residents tend to be pessimistic about future employment and income, which directly weakens their consumption desire. From the perspective of consumer confidence, the National Bureau of Statistics announced in 2015Q4 that the Consumer Confidence Index (CCI) was 103.9, down 0.8 over Q3, indicating the lack of consumer confidence. With respect to the expectations on employment and income, the Future Employment Expectation Index for urban depositors, as released by the PBC in 2015Q4, stood at 45.3%, down 1 percentage point compared to Q3, the lowest level since 2009Q2; and the Future Income Confidence Index was 49.1%, a decrease of 1 percentage point from 2015Q3, below 50% for the first time since 2001 (Figure 18).

Figure 17: Slowed Growth of Income of Urban and Rural Residents

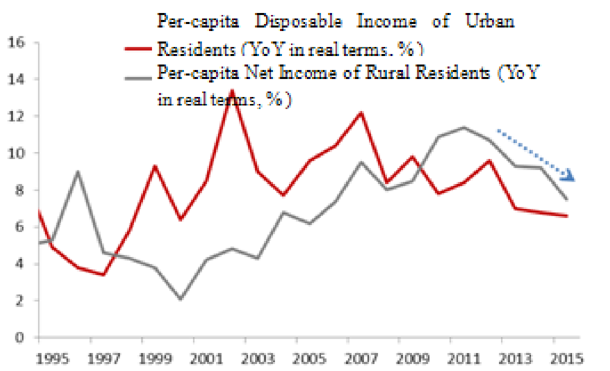
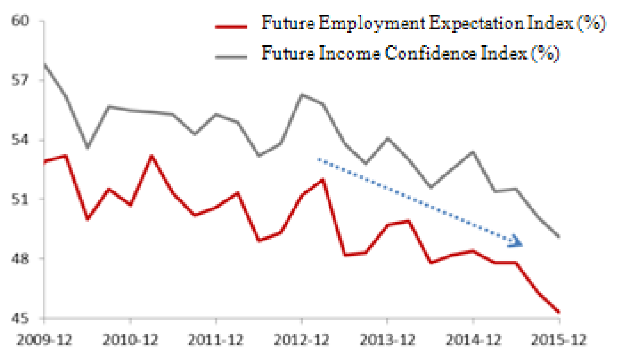


Figure 18: Pessimistic Expectations of Depositors for Employment and Income



Sources: Wind, BOC Institute of International Finance

Thirdly, after undergoing the previous high-speed growth, the sales of some commodities will slip gradually. In 2014 and 2015, the consumption of communications equipment increased by 32.7% and 29.3% respectively, with the contribution to consumption growth rising from 4.5% to 8.8%. However, after two consecutive years of rapid growth, consumers' enthusiasm for and necessity of purchasing related products will decline, thus giving rise to the normal slowdown of growth rate. Taking 4G mobile phone as an example, 440 million of smart phones were sold in 2015, an increase of 1.57 times compared with 2014. But it was unlikely to maintain such a high growth rate. In the first two months of 2016, the year-on-year growth was only 17.9%. Similarly, the growth of new consumption patterns would also be slowing down. In January and February 2016, the retail sales of online goods and services grew by 27.2% year on year, decreasing by 6.1 percentage points over the previous year.

Without doubt, the government will make efforts to optimize consumption environment in the next step, to strengthen the supervision over consumer goods, enhance the quality of consumer goods, and encourage enterprises to increase the supply of new consumer goods; the consumption credit company pilot will be extended to the whole country, hence providing consumers with a new way for obtaining consumer loans; besides, the rebound of housing sales will drive the growth of livelihood related consumption. All of these factors will contribute to consumption. Accordingly, the total retail sales of social consumer goods are expected to increase by about 10.5% in 2016Q2.

Investment is very likely to edge up, while the growth of investment in real estate and services is substantial. Firstly, the strong growth momentum of new projects will be conducive to further stabilization and recovery of investment in Q2. The ratio of planed investment in new projects to that in projects under construction is 0.057, the highest level over the same period since 2007 (Figure 20). For instance, the number of new projects included in 11 categories of major project packages increased by 13 in January 2016, and the amount of completed investment rose by RMB253.2 billion. A sign of stabilization and recovery could also be found in the planned investment in the projects under construction. In the first two months of 2016, a year-on-year increase of 13.9% was recorded, up 9.4 percentage points from the same period of last year.

Secondly, the rebounded investment in the real estate and service industries will boost the investment growth in Q2. Since May and June 2015, the growth rate of real estate sales volume and area has been positive successively. As a consequence, the growth rate of new and second-hand housing prices in 70 large and medium-sized cities in the country has also been positive since November and December 2015. Besides, since the beginning of 2016, such recovery effect has spread to the areas of land transactions and real estate investment. In the first two months of 2016, the land transaction prices increased by 0.9% year on year, a positive growth for the first time in the recent year; the investment in real estate development rose by 3% year on year, 2 percentage points over last year. In the same period, both real estate sales volume and area achieved rapid growth, which would facilitate the rebound of real estate investment through the channel of "sales recovery - price hike - investment rise".

The investment in the tertiary industry is expected to maintain a high growth rate, which will strongly prop up the steady rise of investment. In recent years, the tertiary industry has played an increasingly important role in Chinese economy; in 2015, its proportion exceeded more than 50% for the first time. Either the accelerated upgrade of consumer structure or more reliance of production on start-up innovation requires fast investment growth of modern service industry and producer service industry. In the first two months of 2016, the investment in the tertiary industry presented a growth rate of 11.1%, 0.5 percentage points higher than that in the previous year and 3.2 percentage points higher than that of the secondary industry. In which, compared to the same period of last year, the growth rate of investment in public management, social security and social organizations climbed by 32.3 percentage points, the investment in education increased by 9.2 percentage points, and that in water conservancy, environment and public facilities management rose by 7.3 percentage points.

Thirdly, some restrictive factors might be available in the continued investment recovery, of which, the biggest problem lies in the source of funds. In the first two months of 2016, the growth rate of investment funds in place was significantly decreased (Figure 19), especially, that of the self-raised funds dropped by 14.1 percentage points, reflecting the limited investment capacity and weak investment desire of enterprises. Due to the relatively high proportion of self-raised funds in the investment funds (70.5% in 2015), the negative growth of such type of funds would obviously generate adverse impact on the rebound of investment growth. Even the funds available for real estate investment which has started to pick up is not so optimistic. A year-on-year reduction of 1% was recorded in the first two months of 2016, falling by 2.6 percentage points from the same period of previous year. In addition, de-capacity is likely to lower the investment growth of manufacturing industry, and deleverage will also restrict the investment capability of some enterprises, which is unfavourable to the growth of investment.

Albeit that the 2016 budget of the central government for investment only increases by 4.7% compared to previous year, the amount of special construction funds is estimated to exceed RMB1 trillion;. As a new tool in the investment policy, the special construction funds will be primarily used for the transformation and upgrade projects with right investment direction, favourable return and no excess capacity. With respect to social capital investment, RMB180 billion of PPP guidance funds will play an important role. As of the end of February 2016, the country launched a total of 7,116 PPP projects in different places. In addition, a number of key projects outlined in the "13th Five-Year Plan" will also be commenced. All of these factors will propel investment growth. Based on the above analysis, the investment in fixed assets is expected to grow by about 11% in Q2

Figure 19: Growing Investment Funds and Projects

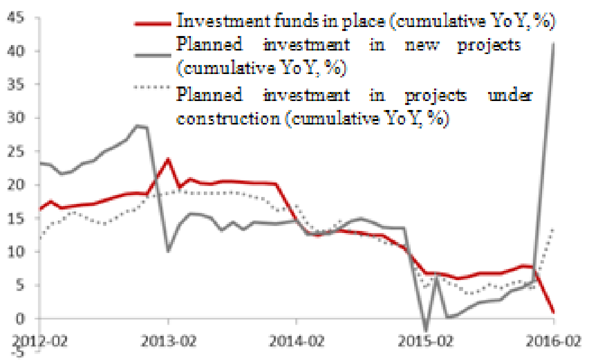
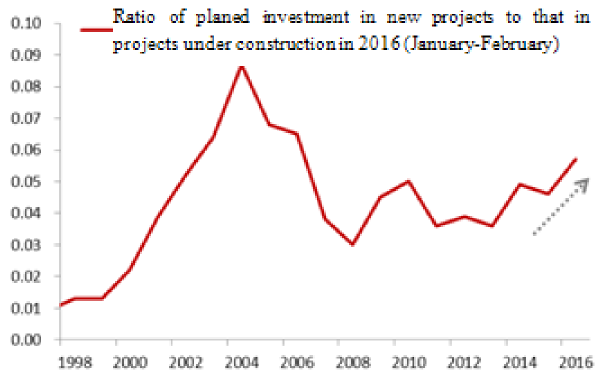


Figure 20: Ratio of Planed Investment in New Projects to That in Projects under Construction



Sources: Wind, BOC Institute of International Finance

The export will be impeded by the sluggish external demand, while import is to be boosted by the improved domestic demand. In Q2, the export trend will be cautiously optimistic. On one hand, the seasonal factors resulting in a sharp decline of exports will fade off. The cargo trade exports fell sharply in January and February, the largest decline since the global financial crisis in 2009, which was mainly attributable to seasonal factors (Figure 21). It is estimated that in February exports dropped considerably by 25.4%, while seasonal factors contributed 78% of the decline. It could be also estimated, due to the impact of seasonal factors, the export growth would be significantly improved in March. On the other hand, the rising downward pressure on global manufacturing industries will restrict the rapid rise in exports. In the past four months, the world's major economies reported weak manufacturing PMI in succession, of which, the JP Morgan Global Manufacturing PMI dropped from 51.2 in November last year to 50 in February this year (Figure 22).

Owing to the recovered domestic demand and commodity prices, the declining range of imports is expected to narrow. Despite of the continued substantial drop of trade imports in the first two months this year, it was still better than that in the same period of 2015. In February, the seasonally adjusted imports in February tumbled by 11.3% year on year, lower than the 12-month average decline in last year. Firstly, the demand for investment in infrastructure and real estate has improved; secondly, the risen commodity prices have led to the rise of import prices. Both the factors will jointly give rise to the narrowed declining range of imports.

Figure 21: Impact of Seasonal Factors on Export Growth

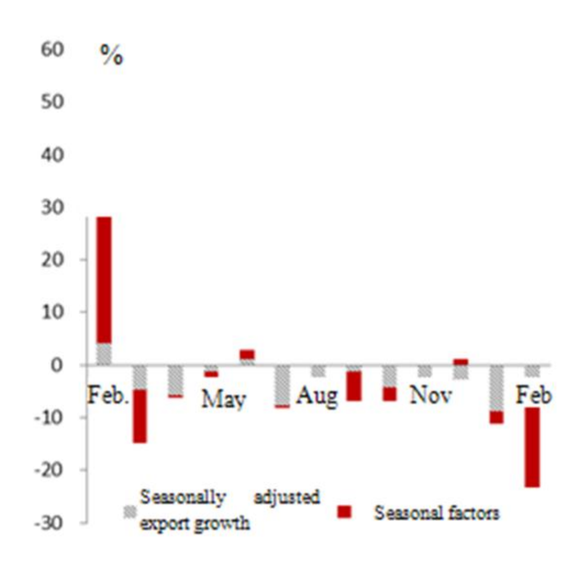
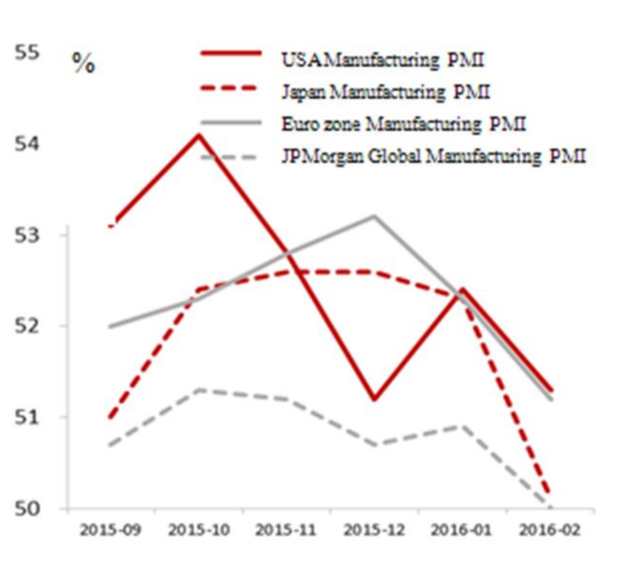


Figure 22: Sluggish Global Manufacturing PMI



Sources: Wind, BOC Institute of International Finance

II. 2016Q1 Financial Review and Q2 Outlook

In 2016, against the background of increased economic downward pressure, the start of Fed's interest rate hike cycle and more turbulent financial situation at home and abroad, monetary policy pays more attention to steady growth and risk prevention. A range of actions have been taken successively, including the initiation of Macro-Prudential Assessment System (MPA), more frequent open market operations, RRR cut, and reduction of down payment. In this way, the accommodative monetary policy has made some achievements, such as the fast growth of monetary credit, return of social financing activities to the expansion channel, and downward financing costs for enterprises. However, due to the global economic and financial turmoil, imbalanced development in the real estate market and other factors, some new problems have been found, e.g. heightened violability in the stock market, excessive rise of real estate market in first-tier cities, and fund flows from real economy to virtual economy. Future monetary policy needs to deal with the conflict between destock and suppression of bubbles as well as that between risen credit demand and insufficient sources of funds, hence creating stable monetary and financial conditions for the promotion of reform on supply side.

II.1 2016Q1 financial review

II.1.1 Monetary credit presented fast growth, and total social credit returned to the expansion channel

Money supply maintained rapid growth, with the rise of monetary activity. On February 29, the Central Bank launched the first round of RRR cut in 2016. With several rounds of interest rate and RRR cut in previous periods, a rapid growth of monetary credit was maintained in the first two months of this year. At the end of February, the broad money supply (M2) grew by 13.3%, up 0.8 percentage points over the same period of last year. In the meantime, monetary activity rose obviously. At the end of February, M1 ascended by 17.4% year on year, reaching the highest level since 2011 (Figure 23). The rise of monetary activity was mainly related to the following factors. **Firstly,** the ease of economic downward pressure brought about the recovery of monetary demand. In 2015Q4, a survey by *The Banker* magazine showed that the loan demand index was 56.8%, up

0.1 percentage points from the end of Q3. **Secondly,** the real estate prices rose faster in the first-tier cities, channelling more funds to virtual economy from real economy. Some short-term loans might flow into the real estate market in the name of consumer loans, and part of private financing, such as down payment loans and P2P, might also flow into the real estate market. In the first two months, the sources of funds for investment in fixed assets increased by only 0.9%, and its gap with investment growth reached a record high since 2001, implying the phenomenon of fund flowing to virtual economy from real economy.

Steady growth of social financing made the financing activities of the whole society return to the expansion channel. With the gradual restoration of monetary demand in the real economy, the scale of social financing began to expand, changing the continued tightening state since 2015. In the first two months of this year, the scale of new social financing reached RMB4.2 trillion, a year-on-year increase of RMB793 billion (Figure 24). The increase of new social financing mainly had a bearing on the factors such as rise of new RMB loans, accelerated development of direct financing and renewed growth of trust and entrusted loans. Affected by the risk exposures of some notes at the beginning of the year and reduction of foreign currency liabilities by enterprises under the expectation on exchange rate depreciation, new bank acceptance bills without discounting and foreign currency loans kept declining, down RMB373.5 billion and RMB236.2 billion respectively over the same period of previous year.

RMB loans increased a lot mainly due to real estate boom and loan conversion. In the first two months, RMB loans rose by RMB3.3 trillion, RMB733 billion more than the increment a year earlier, which accounted for 79.5% of new social financing scale in the same period, up 2.7 percentage points over the same period of last year, thus becoming the main driving force for the growth in the scale of social financing. Rapid credit growth was primarily attributed to the following factors: **first,** real estate market transactions rose faster in the first-tier and second-tier cities, leading to the growth of medium and long-term loans to residents. In the first two months, new medium and long-term loans amounted to RMB2.2 trillion, representing 66.4% of total new loans, up 7.9 percentage points compared to the end of 2015. **Second,** under the expectation on RMB depreciation, the impact of decreasing USD debts by enterprises was one of the factors. In the first two months, foreign exchange loans fell by 9.6%, and the fall was 3.8 percentage points higher than the end of previous year. **The third** was the seasonal factor of "fast return for early investment". From 2013 to January 2015, new RMB loans accounted for 12.1%, 13.5% and 12.5% of total new loans granted in the year. In February, affected by the factors such as macro-prudential supervision and strengthened liquidity management of commercial banks, the credit scale returned to the normal level, and RMB726.6 billion of new loans were granted in the month.

Figure 23: Rapid Growth of Money Aggregates

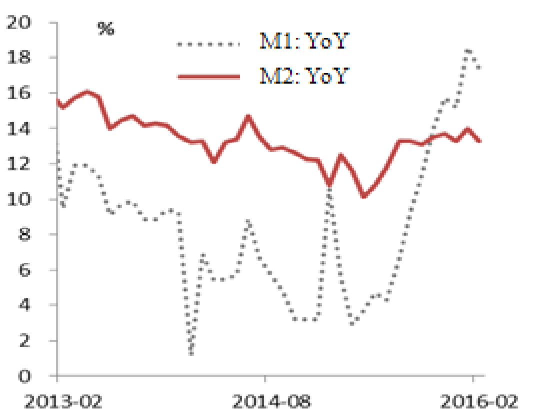
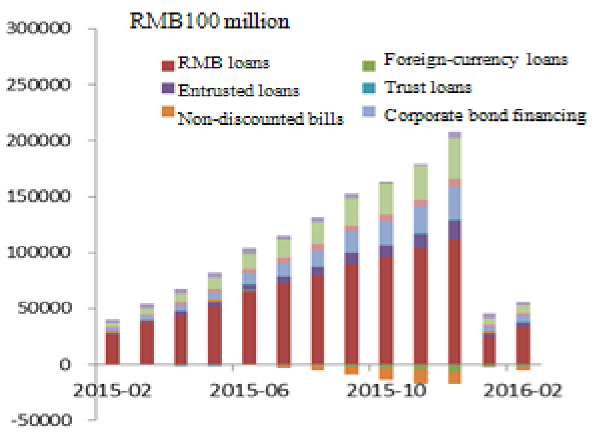


Figure 24: Steadily Growing Social Financing Scale



Sources: Wind, BOC Institute of International Finance

II.1.2 Money market rate declined after rising, and capital interest rate of the whole society kept falling

Since the beginning of the year, the funds outstanding for foreign exchange have continued to decline sharply, with the collection of required reserves in foreign currency and rising demand for cash before the Spring Festival, thus leading to the short-term liquidity squeeze in the money market. From January 21 to 23, the overnight rate of SHIBOR exceeded 2%, a rate which had existed since 2015Q3 (Figure 25). With the release of RRR cut policy at the end of February, the money market rate slipped once again, resulting in a falling capital interest rate of the whole society. Overall, compared to Q4 of last year, the money market operation showed the following characteristics: **firstly,** the centre of interest rate was basically stable. As of March 25, the overnight SHIBOR stood at 1.98%, up 0.13 percentage points over the previous quarter, but still lower than 2%. **Secondly,** volatility declined. The standard deviation for overnight lending rate of SHIBOR was 0.049, down 0.17 compared to the previous quarter. **Thirdly,** the capital rate of the whole society showed a downward trend. In March 2016, the loan prime rate (LPR) was reported at 4.3%, decreasing by 100BPs compared to the same period of last year; the issuance rates of corporate bonds, medium-term notes and SME private placement notes (PPN) fell by 62BPs, 61BPs and 43BPs respectively from the end of 2015Q4 (Figure 26); meanwhile, the composite interest rate of private financing in Wenzhou was 18.7% on average, down 7BPs compared with that at the end of the fourth quarter of previous year.

Figure 25: Trends of Overnight and 7-day SHIBOR

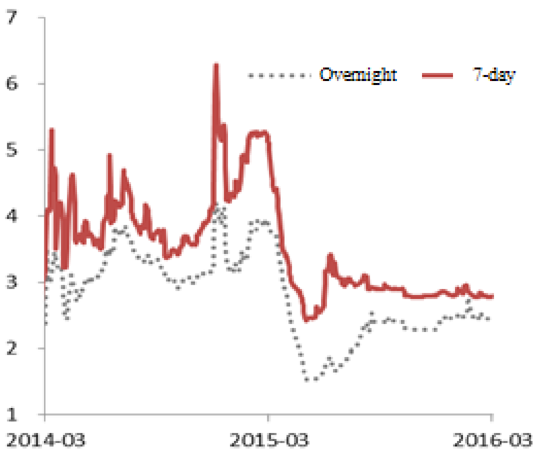
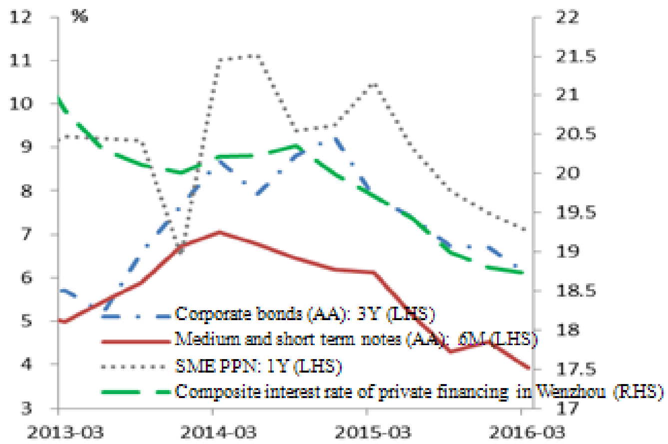


Figure 26: Issuance Rates of Corporate Bonds and Other Bonds



Sources: Wind, BOC Institute of International Finance

II.1.3 The bond market went up despite of certain volatility, with the steep term spread

In Q1, due to the ease of economic downward pressure, accelerated bond supply and increased default events, the bond market exhibited a new pattern with volatile upward trend and steep term spread. Specifically, **the first** was the slowdown of rising speed. On March 25, 2016, ChinaBond Composite Index was recorded at 169.4 points, up 1.67 points from the end of previous year; compared with the fourth quarter of last year (nearly 5 points), the rising speed slowed down significantly (Figure 27). **The second** was the rising bond default risk. Since the beginning of 2016, six bonds have been found default, accounting for about half of the defaulted bonds in last year, with the bond default presenting a spreading trend from "one point to a whole area". **The third** was the steep term spread. On March 25, the 1-year T-bond yield closed at 2.069%, down about 23BPs compared to the end of 2015, while the 10-year T-bond yield rose by 10BPs. The yield spread between the 10-year and 1-year T-bonds widened to 76BPs (Figure 28) from 52BPs at the end of last year. Faster decline in short-term interest rate was mainly caused by the following factors: benefiting from the new round of RRR cut policy, short-term interest rate significantly tumbled, while long-term interest rate was confronted with upward pressure due to the factors such as rising real estate market in the first-tier cities, rebounded bulk commodity prices and nascent inflation.

Figure 27: Movements of China Bond Composite Index

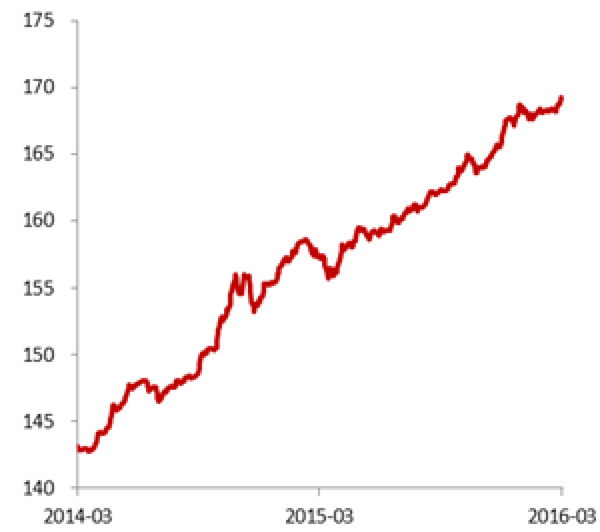
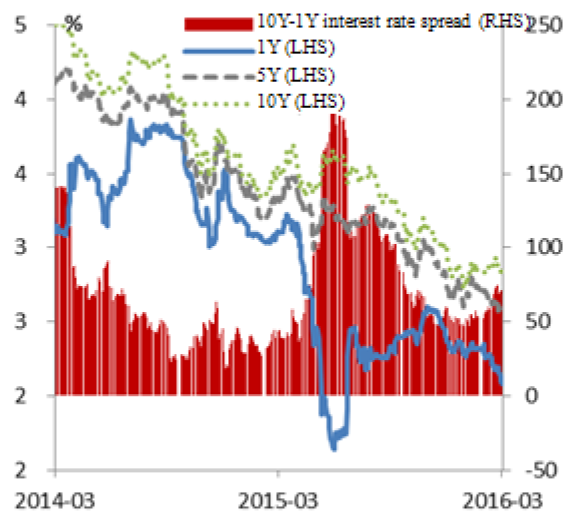


Figure 28: T-bond Yield Curve and Changes in Interest Spread



Sources: Wind, BOC Institute of International Finance

II.1.4 Stock indexes kept falling, mainly due to the previous overvaluation

Since early 2016, stock indexes have presented a falling trend. The SSE Composite Index declined to 2979 points on March 25 from 3539 points at the end of previous year, down 15.8%; meanwhile, the SZSE Component Index fell by 18.3% (Figure 29). The main reasons are described as follows. **Firstly,** China's economic and financial fundamentals were relatively weak, and the stock market required correction internally. Under the backdrop of ongoing weakened fundamentals of the economy, however, the turnover rate of financing transactions in 2015Q4 reached the level at the stock market peak in Q2; in which, only 12% stocks had a P/E ratio of lower than 30x. Such excessively high turnover rate and watered valuation would easily give rise to correction upon any change in the external environment (Figure 30). **Secondly,** global stock market fluctuated wildly. Affected by the less-than-expected global economic recovery, intensified exchange rate fluctuation, and unexpectedly huge deficits faced by European banks including Deutsche Bank, the stock markets of major developed economies have suffered substantial decline since the beginning of the year. From the year beginning to January 11, the indexes including S&P 500, Nikkei 225 and FTSE 100 fell by 5.9%, 9.5% and 6.4% respectively. Consequently, market panic intensified and spread to China's stock market. **Thirdly**, the "circuit breakers" escalated the stock market volatility. Such mechanism, generally adopted by developed countries to prevent excessive volatility, could not be "acclimatized" at the time of trial operation in early 2016 (China's stock market is mainly dominated by retail investors and institutional investors hold less than 40% of tradable stocks, while in developed countries, institutional investors constitute the main force); instead, it turned into a booster of amplifying volatility in the stock market.

Figure 29: Substantial Decline of SSE Composite Index and SZSE Composite Index at Year Beginning

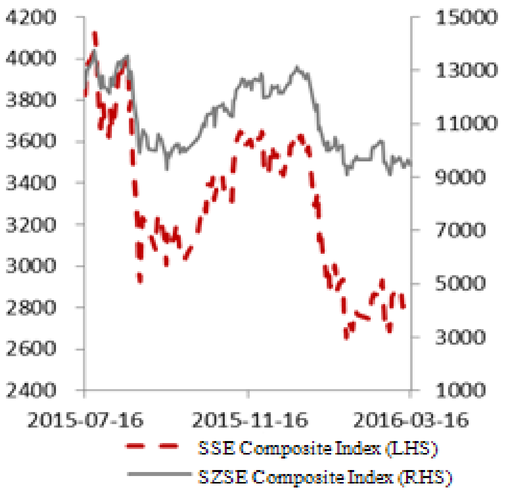
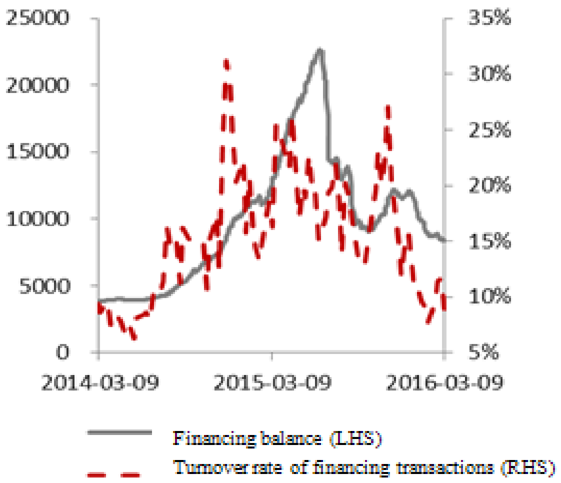


Figure 30: Rising Turnover Rate of Financing Transactions in Early Stage

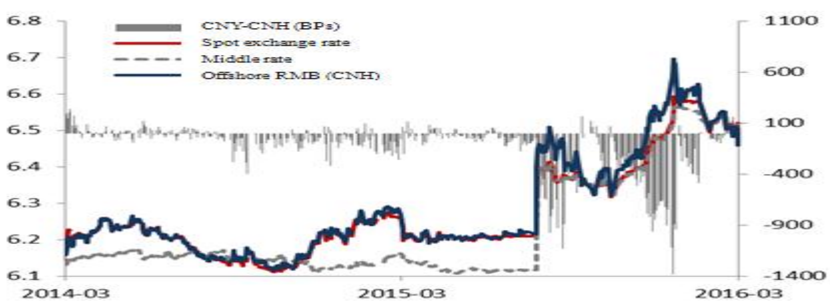


Sources: Wind, BOC Institute of International Finance

II.1.5 RMB exchange rate recently showed a sign of stabilization, despite of a rocky start

Since the beginning of the year, the RMB/USD exchange rate has once undergone the expectation on significant depreciation. The substantial fluctuation of market exchange rate was not only reflected in the spot exchange rate of CNY and CNH against USD, but also manifested by the spread between onshore RMB (i.e. CNY) and offshore RMB (i.e. CNH) which would increase with the intensification of exchange rate volatility (CNH often higher than CNY, see Figure 31). The main reasons are: **firstly,** due to the Fed's interest rate hike and strengthening trend of USD, most countries in the world experienced substantial exchange rate volatility and depreciation. **Secondly,** the pressure on capital outflow increased under the expectation on depreciation, which generated a feedback strengthening effect with the depreciation of RMB exchange rate. **Thirdly,** with the increasing impact of stock market and other financial markets on the RMB exchange rate, market factors have played a more and more important role in the RMB exchange rate formation mechanism. As China's economic fundamentals have shown signs of improvement since March and the Fed has decided to suspend interest rate hike, the RMB exchange rate has started to stabilize, with the offshore and onshore RMB exchange rates tending to be consistent. As of March 25, the spot exchange rate of RMB against USD was announced at 6.5223, basically the same with that at the end of 2015.

Figure 31: Movements of RMB/USD Exchange Rate



Sources: Wind, BOC Institute of International Finance

II.2 Judgments on financial situation in Q2

II.2.1 Room available for monetary credit expansion, and steady growth as the main tone

In Q2, the scale of social financing and credit are expected to maintain stable and rapid growth. **First,** there is a sign of recovery on the demand side; in particular, the growth rate of investment is rebounding fast, suggesting certain room for credit growth. **Second,** insufficient funds still constitute the constraint on investment, thus requiring further credit extension. **Third,** since the release of the "13th Five-Year Plan", major projects have entered the period of implement and accelerated propulsion, hence increasing the supply of credit is the key to "steady growth" in the year. Considering the further execution of macro-prudential assessment system and the governance of "down payment loans" by the Central Bank, financial institutions will make more efforts in the liquidity management. As it is unlikely to promote credit expansion on a large scale, steady growth will be taken as the main tone.

II.2.2 Unchanged liquidity easing pattern, and money market rate to slip steadily

In Q2, the money market is expected to maintain an easing pattern, with the interest rate declining steadily. Main reasons are described as follows. **Firstly,** the Fed's suspension of interest rate hike will alleviate the pressures brought about by capital outflow and excessively fast reduction of funds outstanding for foreign exchange, thus improving the supply of base currency. In February, the Central Bank's funds outstanding for foreign exchange stood at RMB23.98 trillion, declining by RMB227.8 billion from January, with the obviously contracted declining range. **Secondly,** the "interest rate corridor" has gradually become a new tool for the Central Bank's liquidity management, which is conducive to the mitigation of excessive volatility of money market rate. In future, the Central Bank will strengthen the use of liquidity management tools such as SLF, MLF and PSL, to deal with the disturbance resulted from tax payment and other seasonal factors, and maintain the steady decline of central money market rate.

II.2.3 Continued consolidation of bond market, with steeper term spread

In Q2, the factors boosting the bond market include the followings. First, the accelerated bond market reform will help enhance investor confidence and mitigate the risks in connection with the bond market. Since February, PBC has successively issued the *Administrative Measures for OTC Business in the National Interbank Bond Market* and the *Circular on Further Liberalizing the Investment in the Interbank Bond Market by Overseas Institutions*, to initiate the pilot on securitization of non-performing assets and put the discussion about debt-to-equity on agenda. The issue of these policies marks that the bond market has taken a bigger step toward wider opening-up, acceleration of interconnectivity and innovation of bond products. Second, the alleviated pressure of capital outflow will be favourable to the development of bond market. The introduction of new easing policy by the ECB and the postponement of interest rate hike by the Fed have weakened the pressure related to RMB exchange rate and capital outflow. At the FOMC meeting held on March 17, the Fed decided to maintain the federal funds rate target unchanged at 0.25%-0.5%. Third, the bullish bond market will not end thanks to the vast economic potential. A variety of signs show that there is still downward pressure on the macro-economy. The following factors have certain effect on the downward trend of bond market. The first is the intensified shock to bond supply. In 2016, the Central Government's debt-deficit ratio would stand at 3%, which means that about RMB2.6 trillion of T-bonds and RMB4.5 trillion of local bonds might be issued additionally, and the interest rate bonds are likely to increase by nearly RMB1.4 trillion. . The second is the deteriorating profitability of some enterprises, which leads to the rise of default risk for some bond types and further expansion of spread. Overall, the bond rate has dropped to a low level, with limited possibility of further substantial decline; therefore, the consolidation of bond market will continue.

II.2.4 A new stage of slight consolidation for the stock market, with the focus on stability

In Q2, the stock market will be faced with a number of benign factors: firstly, economic fundamentals will see a sign of improvement, thus shoring up the stabilization of stock market. Secondly, the introduction of "13th Five-Year Plan", accelerated reform of state-owned enterprises and the "Shenzhen-Hong Kong Stock Connect" expected to launch in the second half of the year will constitute favourable policy factors. Thirdly, regulators will pay more attention to market stability, which is conducive to the long-term steady development of the stock market. However, a variety of phenomena also show that investors are not so confident in the development of the stock market. Firstly, the sustained low balance of "margin trading" suggests that investors are not enthusiastic about putting additional capital into the market. Secondly, due to the ongoing de-capability, some risks exposed to enterprises in an accelerated manner will spread to the stock market. Thirdly, the recovery of real estate market and stabilization of bulk commodities might have certain crowding-out effect on the stock market. On the whole, the stock market is expected to bottom out in Q2; and it is also likely to present slight rise with the improvement of corporate profitability and accelerated supply-side reform.

II.2.5 Weakened expectation on exchange rate depreciation, with two-way movements as the new normal state

In Q2, the expectation on exchange rate depreciation of RMB against USD will weaken further, and RMB exchange rate is to gradually stabilize. The main reasons include the followings. **The first** is the favourable external environment. Both the expansion of "negative interest rate" by the ECB and the suspension of interest rate hike by the Fed will help alleviate the expectation on depreciation. **The second** is the reduced economic downward pressure, which is also conducive to maintaining the stability of RMB exchange rate. **The third** is the decreased pressure of cross-border capital outflows. Since the beginning of this year, the deficit in exchange settlement/sales and foreign payments/receipts of non-bank sectors including enterprises and individuals has presented a declining trend. In February, the deficit in exchange settlement/sales of non-bank sectors was reported at USD35 billion, a decrease of 50% compared to January. Nevertheless, considering that China still faces the downward pressure on economic fundamentals and market factors play a more important role in the RMB exchange rate pricing mechanism, certain fluctuation of RMB exchange rate in future will be quite normal.

III. Issues of Concern in Current Economic and Financial Operation

III.1 Growth engine is still weak, with unstable foundation for economic stabilization

Despite the steady recovery of investment growth, the sources of funds are not optimistic. In the first two months, the sources of funds for investment in fixed assets increased by 0.9%, 5.8 percentage points lower than that in the same period of last year; in which, foreign capital and self-raised funds dropped by 34.2% and 3.1% respectively. Meanwhile, due to the slowdown of income growth, residents have pessimistic expectation on future employment and income, and new consumer goods have declined from rapid growth, bringing about a variety of challenges to the growth of consumption. On the supply side, the manufacturing PMI has fallen for four consecutive months; in February, PMI further slipped to 49, indicating the relatively sluggish manufacturing industry by and large. As a result of intensified de-capacity, the added value growth rate of overcapacity industries will continue to fall. Notwithstanding the rapid growth of emerging industries, the proportion of such industries is relatively low, with the impact on the economy not as obvious as that of traditional industries. In February, the services PMI was reported at 52.2, still staying in the expansion range of more than 50; as it has dropped for two consecutive months, the growth rate of service sector is expected to slightly decline in Q2.

III.2 The marginal effect of monetary policy is abating, and a new round of housing price rise is found in the first-tier and second-tier cities

Several rounds of interest rate and RRR cuts have gradually lowered social financing costs, but haven’t effectively alleviated the problem of insufficient effective demand.Since the beginning of this year, the investment capital in place has seen a sharp slowdown in growth, indicating the inadequate utilization of monetary credit in the field of investment in fixed assets in spite of rapid growth; instead, a tendency of “capital flow to virtual economy from real economy” has been found, giving rise to a new round of housing price rise in the country. In February this year, the country's new housing price index for 70 large and medium-sized cities rose by 1.9% year on year, up 0.9 and 7.6 percentage points compared with the previous month and the same period of last year respectively. In which, new commercial housing prices of the first-tier and second-tier cities respectively increased by 25.6% and 3.5% year on year in February, up 29.5 and 9.2 percentage points over the same period of last year; that of the third-tier cities slipped by 1.0% year on year, 4.9 percentage points higher than that in the same period of previous year. A month-on-month positive growth could be seen in terms of the new commercial housing prices of the first-tier, second-tier and third-tier cities; of which, changing to positive growth from negative growth in the third-tier cities has become an important symbol for general housing price rise in the country. Overall, housing prices have presented a new feature of “convergence” instead of the “differentiation and overall decline" in last year.

III.3 Various fiscal & financial risks accumulate and spread across different markets

China's economy currently stays is a critical period which could be characterized as “de-capacity, destock and deleverage”, with the reform of banking, fiscal and taxation systems lying in a crucial period and rapid development of new financial patterns, hence all kinds of fiscal & financial risks may further accumulate. First, the bond default risk has increased; especially, with the progress of "de-capacity", such risk is getting bigger in some overcapacity enterprises. In 2016Q1, 10 solvency risk events occurred in the bond market; of which, 6 cases constituted material breach of contract, involving Shandong Shanshui, Baoding Tianwei, Guangxi Nonferrous Metals, Yabang Group, Yunfeng group and Zibo Hongda. Second, the risk of substantial volatility is rising in the foreign exchange market. Affected by a series of factors in early 2016, the exchange rate of RMB against USD once showed a phasic depreciation trend, and domestic and overseas spread once soared to 1800 points above, thus stirring up short selling and panic in the market, and further exacerbating the trend of RMB depreciation. With the increase of economic and financial uncertainties at home and abroad, the risk of phasic substantial volatility has been intensifying in the foreign exchange market. Third, some local governments still have disguised borrowings such as “debts in the disguise of shares” and illegal guarantees. Meanwhile, from January to February this year, the revenue of local governments from land sales gained zero growth, though it actually improved compared to the negative growth of last year. This year, under the positive fiscal policy which encourages increase of spending and decrease of revenue, under the background, the occurrence of local risks is still very likely in some regions.

III.4 Commercial banks face a grim operating situation, implying more difficulties for coordinative implementation of monetary policy

Due to the current severe operating situation, commercial banks are confronted with more difficulties and challenges. First, both NPLs and NPL ratio are rising, and profit growth is slowing down. At the end of 2015, the NPL balance of commercial banks stood at RMB1,274.4 billion, an increase of RMB431.8 billion from the end of last year; the NPL ratio was reported at 1.67%, up 0.42 percentage points from the end of 2014; and net profit had a year-on-year increase of 2.43%, down 7.22 percentage points over the previous year. Although the previous cut of benchmark interest rates for deposits and loans by the Central Bank is considered as symmetrical interest rate cut, the decrease of deposit rate is actually lower than that of lending rate, causing further decline of the deposit-loan spread. In 2016Q1, the impact of successive interest rate cut on net interest margin gradually took effect, bringing about the further drop of net interest income of commercial banks. Second, the four major domestic banks currently are actively implementing the pricing self-discipline management requirements (as of the end of March of 2015, the assets of large banks accounted for more than 25%), while joint-stock banks, local commercial banks and rural credit cooperatives are not subject to the requirements. The latter's irrational quotations for the purpose of seizing market share have resulted in the excessive rise of overall deposit rate in the market, which is inimical to the reduction of social financing cost. Third, in the context of macro-prudential supervision (MPA), the size of bank assets is restricted. In Q1, the open market operations conducted by the Central Bank on each working day stepped onto the normal track, making banks' collateral management more difficult. Currently, the collaterals covered by the Central Bank's open market operations only include T-bonds, central bank bills and policy financial bonds, without the inclusion of local government bonds (at the end of February 2016, local government bonds under custody accounted for 19% of total of these bonds under custody). If the frequency and scale of open market operations continue to expand, banks might be faced with a plight of insufficient collaterals in future.

IV. Macroeconomic Policy Orientations

IV.1 Fiscal policy plays a significant role in growth stabilization and structural reform on supply side

The Government Work Report of 2016 clearly proposes to make more efforts in the implementation of proactive fiscal policy and raise the deficit from RMB560 billion to RMB2.18 trillion, with the deficit ratio increasing to 3% (Table 4). The main task is to moderately expand aggregate demand and stabilize economic growth, with the focus on propping up the structural reform on supply side from the aspects of cost reduction, de-capacity and shoring up weak spots.

Table 3: Forecasts on China's Main Economic and Financial Indicators in 2016Q2 (%)

Indicators	2012 (R)	2013 (R)	2014 (R)	2015 (R)	2016	
					Q1(E)	Q2(F)
GDP	7.7	7.7	7.3	6.9	6.6	6.7
Added value of industries above a designated size	10.0	9.7	8.3	6.1	5.4	5.5
Investment in fixed assets	20.6	19.6	15.7	10.0	10.5	11.0
Total retail sales of consumer goods	14.3	13.1	12.0	10.7	10.2	10.5
Exports	7.9	7.9	6.1	-2.9	-10.0	2.0
Imports	4.3	7.3	0.4	-14.2	-16.0	-12.0
Consumer Price Index (CPI)	2.6	2.6	2.0	1.4	2.1	2.1
Producer Price Index (PPI)	-1.7	-1.9	-1.9	-5.2	-4.5	-3.0
Broad money (M2, period-end)	13.8	13.6	12.2	13.3	13.3	13.5
Social financing scale (existing)	19.1	17.5	14.3	12.4	12.5	13.0

Source: BOC Institute of International Finance

First, intensify tax cut and fee clearance, to reduce the tax burden of enterprises. The first is to push forward the "collection of VAT instead of business tax". From May 1 this year, the pilot on "collection of VAT instead of business tax" will be extended to cover such industries as construction, real estate, finance and life services, and new immovable properties of all enterprises will be incorporated into the scope of VAT deduction, for the purpose of creating a fair taxation environment; the second is to strengthen the clearance of fees and charges. A number of government funds will be stopped or merged, and the scope of exemption from collection of administrative charges will be expanded, so as to alleviate the non-tax burden of enterprises; and the third is to improve the taxation system, for the support of policies regarding "mass innovation and entrepreneurship", technological R&D, industrial upgrading, and "the Belt and Road" initiative.

Table 4: Anticipated Economic Development Targets in 2016

Main indicators (anticipated targets)	2016	2015	Change
GDP	6.5%-7%	7%	↘
CPI	3%	3%	-
New jobs in urban areas	Over 10 million persons	Over 10 million persons	-
Registered unemployment rate in urban areas	4.5% below	4.5% below	-
Decline of energy consumption per unit of GDP	3.4% above	3.1% above	↗
Fiscal deficit	RMB2.18 trillion	RMB1.62 trillion	↗
Fiscal deficit rate	3%	2.3%	↗
M2	13%	12%	↗
Total social financing (TFS)	13%	--	--

Source: Government Work Report

Second, maintain reasonable fiscal expenditure and government investment, and improve the efficiency of public service supply. The first is to play the supportive role of finance in the de-capacity. The Central Government will arrange RMB100 billion of funds to address the problem of staff resettlement arising from overcapacity, hence maintaining social stability; the second is to input more fiscal resources to shore up weak spots. In addition to boosting the investment in the construction of key projects including the major water conservancy projects, railway construction, shantytown transformation in 2016, further efforts will be made to strengthen the construction of modernized agricultural infrastructure and elevate the efficiency and precision of investment; The third is to improve the performance of fiscal expenditure. Local governments at all levels will be promoted to strengthen budget execution management, avoid too much closing balance carried forward to the next year, and continue the efficient use and coordination of existing fiscal funds; the fourth is to bolster PPP projects and government guidance funds, and enhance the efficiency of public service supply.

Third, further regulate the management of local government debts, to guard against financial risks. The first is to further accelerate the debt replacement of local governments and the construction of local government bond market; the second is that the newly issued bonds will be linked to the risk level of different regions, to strictly control the debt limits for the regions with higher debt ratio; the third is to establish and perfect the local government debt disclosure mechanism and strengthen the supervision of the public; the fourth is to properly handle the contingent debts of local governments and strengthen the punishment against the debts of local governments in the disguised form of shares and illegal guarantees provided for enterprises, thus preventing the superposition of fiscal & financial risks .

IV.2 Monetary policy will guide the steady growth of monetary credit through intensified use of structural tools

In Q2, monetary policy will be faced with both favourable situation and some problems to be solved urgently. On one hand, accelerated initiation of major projects and weak recovery of corporate credit demand require monetary policy to further play the role in shoring up the development of real economy and supply side reform. Meanwhile, the Fed's postponement of interest rate hike and weakened expectation on RMB depreciation will provide possibility and time window for the easing of monetary policy. On the other hand, the emergence of inflation and excessive rise of housing prices in the first-tier cities, to a certain degree, restrict the extent of monetary easing. Therefore, monetary policy is anticipated to carry on the keynote of stability and easing, with more flexibility and moderation, thus maintaining appropriate and sufficient liquidity.

First, guide the steady growth of monetary credit, with the attention paid to the strength and timing. Q2 is deemed as a critical period for China's economic stabilization. To maintain reasonable growth of credit and social financing, monetary policy generally should continue the steady and easing orientation and speed up the supplement of base currency, in the context of continuously declining funds outstanding for foreign exchange, insufficient funding, intensified fiscal policy and high reserve requirement ratio for banks. For one thing, the time window generated from the Fed's suspension of interest rate hike can be used to properly lower the reserve requirement ratio by 0.5 percentage points; if the funds outstanding for foreign exchange decline considerably, the expansion of declining range can be taken into consideration. Alternatively, interest rate cut can be suspended. The benchmark interest rates for deposits and loans currently stand at record lows. Further interest rate cut might impose limited marginal effect on the mitigation of problems including difficulty in obtaining loans and high financing costs; instead, it is likely to push up the housing prices in the first-tier and second-tier cities. Consequently, a new round of asset price bubbles may appear, thus bringing about more pressure in connection with cross-border capital outflow and RMB depreciation.

Second, strengthen open market operations, and guide money market rate down steadily. By reinforcing the use of new liquidity management tools including MLF, the 7-day repo rate can be guided to stabilize at 2% or lower, in order to create conditions for further reduction of financing costs in the real economy. Through improvement of interest rate transmission mechanism, financial institutions can be guided to link product pricing with SHIBOR and develop a reasonable and unified capital pricing mechanism in various markets. Besides, the range of collaterals under open market operations can be expanded to raise the proportion of outright repo and stabilize the expectation on liquidity, and the guidance on market interest rate pricing can be cemented to circumvent the negative impact of excessive competition in interest rate pricing on the decrease of corporate financing costs.

Third, tighten up targeted regulation, and boost economic restructuring. The first is to give more credit support to major areas and key processes such as MSEs, "agriculture, rural areas and farmers", affordable housing and high-end equipment manufacturing. The second is to buttress the implementation of new regional strategies including coordinated development of Beijing, Tianjin and Hebei as well as construction of the Yangtze River Economic Belt. The third is to apply the RRR cut policy to targeted financial institutions which can give more support to "the Belt and Road" projects. The fourth is to formulate reasonable window guidelines, to avoid "one-size-fit-all" measures for overcapacity industries. And the fifth is to keep exerting the targeted supporting function of reserves, and apply preferential RRR incentive policy to the financial institutions with certain percentage of loans granted to the encouraged industries.

Fourth, strengthen the coordination with regulators, to prevent the rise of local risks. According to the latest development of real estate market, the policy concerning mortgage ratio can be duly tuned up. For the first-tier cities with “overheating” housing market, housing prices should be contained for the avoidance of excessive rise, and tailor-made credit policies can be performed to properly tighten credit. The micro-regulation mechanism ought to be executed on a rigid and practical basis, with the intensified governance of down payment loans and strict implementation of property-purchasing restrictions. Moreover, in addition to the consolidated guidance for commercial banking services, the risk assessment and risk warning for real estate loans need to be enhanced.

Fifth, keep track of the changes in the financial market, to prevent the cross-market contagion of relevant risks. On one hand, the capabilities in identifying and coping with the risks spreading across different markets should be elevated, including: acceleration of unified regulation over financial infrastructure and comprehensive financial statistics system, establishment of risk identification and market turbulence warning mechanism, formation of coordination mechanism for regulators in turbulent times, and integration of risk disposal tools of various regulatory authorities. On the other hand, regulation should be reinforced. To be aligned with the development of modern financial system, greater importance should be attached to the regulation over functions and conducts based on institutional regulation. The codes of conduct and regulatory standards regarding financial products with the same functions and financial services with identical business attributes can be gradually unified, to abate regulatory arbitrage and avoid regulatory gap.

IV.3 The hard-won investment revival should be carefully maintained from the perspective of policy orientation

With regard to investment policy, two sorts of tendencies should be avoided. One is the “useless investment theory”, which holds that China’s investment rate is too high, while investment efficiency is too low, so future economic growth should depend on consumption. According to such theory, investment revival might make the economy go back to the old way, i.e. driven by investment and exports. The other is the “only investment theory”, which believes, “whatever it is right”, and China's economic growth must rely on investment at current stage. In fact, at the present stage, keeping a certain pace (for example, 10%) of investment is absolutely necessary. Investment should not be demonized; instead, it should be regarded as the most important tool for the supply-side structural reform and strengthened management of demand side. The key is to grasp three points, namely, adjusting investment direction, improving investment system, and enhancing the efficiency of investment.

Based on the “plus-minus method”, credit funds should be channelled into the real economy, with the avoidance of “uncompleted” projects. Albeit lots of new projects have been launched, the huge capital gap (if any) is very likely to result in “uncompleted” projects. With regard to the guidance on capital flow, the “plus-minus method” should also be applied in the macroeconomic policy. For the fields such as promotion of regional coordinated development, "agriculture, countryside and farmers", energy conservation and environmental protection, urban underground pipe network, and the "three major strategies", the “plus method” can be adopted; while for the overcapacity industries (including traditional industries and some emerging industries) and the real estate industry with excess inventory, market should be directed to perform the “minus method”. By making use of the instruments such as industrial guidance fund, investment-credit linkage and equity financing, more support should be given to the emerging industries of strategic importance, start-up and innovative industries; besides, the moves including PPP project financing, bond issue, debt replacement, development financing should be taken, so that additional financial aids can be provided to the key areas including urban infrastructure, water conservancy, and "agriculture, countryside and farmers".

In response to the “sunk” investment in the Northeast China, great importance should be attached and multi-pronged actions should be taken to address the problem. If the investment growth of the northeast is the same with that of the whole country, as estimated, China’s investment growth would rise by 0.5 percentage points, and then national GDP would be driven to move forward by about 0.2 percentage points. For the purpose of coping with the investment downturn in the Northeast China, the Central Government can pump more resources into the areas including regional infrastructure, industrial upgrading and staff resettlement through the introduction of policies on transfer payment, tax breaks and industrial guidance, to ensure the sufficient implementation of national policies for revitalizing the old industrial base in the northeast. At the local level, local governments should cultivate and optimize the soft market environment by further emancipating their mind and spurning the thoughts on “waiting, relying and requesting”. At the same time, the government should learn to "let go", release the direct control over the economy and create a good market environment, thus forcing enterprises to find their own way to solve the problem.

IV.4 Differentiated policies should be applied to different cities, to balance the relationship between the destock of real estate sector and the suppression of asset bubbles

The government should avoid excessive capital flows to the real estate market, curb the new inventories resulted from soaring housing prices, and prevent the adopted solutions from being the cause of exacerbating these problems". For the recent "overheating" housing market in the first-tier cities, local governments should curb the excessive rise of housing prices by adherence to the bottom line of policy, with moderate credit tightening, increase the supply of land and real estate, and prevent excessive real estate speculation by the introduction of price guidelines. For the third-tier and fourth-tier cities, the government should develop supporting destock policy in line with market rules and boost the destock of real estate sector by comprehensive use of fiscal, financial, land and other such means, including but not limited to, financially supporting migrant workers for housing purchase, transferring commercial housing to the leasing market, controlling the supply of new land, innovating homestead transfer and mortgage methods.

V. Special Subject: Multi-Year Budget Balance – Progress, Difficulties and Policy Recommendations

With the ongoing slowdown of economic growth in recent years, China's fiscal policy has been more proactive, albeit the greater pressure on revenue and expenditure. China’s fiscal deficit target has gradually increased to 3% in 2016 from 1.6% in 2012. In the past year, the constraints of management system for annual budget balance were substantially weakened, which is not conducive to the regulation of financial "counter-cyclicity". Furthermore, it has become increasingly difficult to adapt to the needs of China's macroeconomic management. The Third Plenary Session of the 18th CPC Central Committee, for the first time, proposed to improve the budget management system and establish a multi-year budget balance mechanism. The “13th Five-Year Plan” also put forward the betterment of government budget system, implementation of multi-year budget balance mechanism and performance of interim financial planning and management. In respect of budget management, the movement from annual balance to multi-year balance is of great significance to the establishment of a modern financial system and achievement of macroeconomic regulation objectives. In this part, the progress of key links and some issues to be focused are elaborated.

V.1 Progress of key links

In recent years, China has made a lot of beneficial explorations and attempts on the building of through-the-cycle budget balance, in order to meet the requirements of modern finance and economic development, thus laying certain foundation for the reform of budget management system.

First, initiate the interim financial planning, and prepare a three-year rolling budget. In 2008, Hebei Province, Jiaozuo City (Henan) and Wuhu County (Anhui) were selected by the Department of Budget of the Ministry of Finance, to respectively serve as the provincial, municipal and county-level pilot units for interim budgeting, marking the commencement of regional pilot at the local government level. In 2014, the Ministry of Finance required to initiate the preparation of three-year rolling budget for 2015-2017. From then on, enthusiastic explorations have been carried out in different regions. On January 21, 2015, the *Circular of the General Office of the State Council on Further Revitalizing Existing Fiscal Funds* was issued, which definitely provides, "from 2015, during the preparation of national three-year financial planning by the Ministry of Finance and regional three-year financial planning by local fiscal authorities, all the authorities should prepare a three-year rolling budget for the projects with definite objectives at the same time; particularly, the three-year rolling budget pilot should be conducted in the key areas including water conservancy investment and operation, compulsory education, health, social security, employment and environmental protection ". The *Opinions on Carrying out Interim Financial Planning Management,* released by the State Council on January 23, 2015, put forward that "the interim financial planning should be prepared on a three-year rolling basis, in which, the planning for the first year restricts the budget of corresponding year, and the planning for the second and third year plays a guiding role for the budget of corresponding year. Upon the completion of budget for a year, the planning for the following two years should be promptly adjusted, with the supplement of planning for another year, to form the new three-year interim financial planning".

The interim financial planning, as the transitional form of interim budget, focuses on the study and formulation of fiscal policy based on the scientific anticipation for overall fiscal revenue and expenditure, so that the main fiscal policies can be implemented in a relatively stable manner. In the future, the government will make duly research and adjustment according to economic and social development situation, for the gradual transition of interim financial planning to true interim budget.

Second, establish a sound budget stabilization fund mechanism. The budget stabilization fund mechanism, one of the important means to achieve steady operation of budget, acts as the important link between interim budget and annual budget. In 2007, the Central Government set up a budget stabilization fund. Local fiscal authorities can also establish local budget stabilization fund based on local financial resources. In January 2008, Shanghai became the first city which substantively established a budget stabilization fund. As of the end of 2012, the vast majority of cities in the country have issued their own management measures for the budget stabilization fund and explained the measures in the annual budget reports.

The new Budget Law further standardizes and institutionalizes the sources and use of budget stabilization fund. The *Circular of the General Office of the State Council on Further Revitalizing Existing Fiscal Funds* specifies the size of budget stabilization fund; and it also provides that the "size of budget stabilization fund after the inclusion of the budget for the year of preparation generally should not exceed 5% of total expenditure in the general public budget at corresponding level for that year; if exceeding 5%, the local government should increase the deficit to be written down or strengthen the mitigation of governments debts".

Third, propel the reform of government accounting system. Government accounting constitutes the foundation of budget management. In the past, the government usually adopted the accounting method on cash basis, which could only reflect the actual cash flow information including receipt and payment. However, it could neither fully present the government's financial position, nor provide the detailed basic information for the preparation of rolling budget. With the transformation of China's government functions and the establishment and improvement of public finance system, the accounting system on cash basis has been difficult to meet the needs of new situation. To this end, the third Plenary Session of the 18th CPC Central Committee proposed to reform the government accounting system and establish an accrual-basis consolidated government financial reporting system. The new Budget Law clearly put forward that, "the financial departments of the governments at various levels shall prepare a consolidated government financial reports on the accrual basis each year, to report the government's overall financial position, operation as well as medium and long-term financial sustainability".

In recent years, China has been doing a lot of explorations and practices with respect to the establishment of government accounting system on the accrual basis. In 2010, the new system was initially promoted in administrative institutions. At the end of the year, 11 provinces including Zhejiang were selected to experimentally prepare the consolidated government financial reports on the accrual basis. The *Proposal on Reform of Accrual-Basis Consolidated Government Financial Reporting System* released in 2014 proposed to build a government accounting standard system with Chinese characteristics and an accrual-basis consolidated government financial reporting system by 2020, with providing specific implementation steps.

Fourth, ameliorate relevant legislative guarantee. The new Budget Law as adopted in 2014 modifies the previous clause, i.e. "the budgets at various levels shall maintain a balance between receipts and payments", to "the governments at all levels shall establish a multi-year budget balance mechanism". Besides, it defines that the focus of budget review should be shifted to expenditure, including, whether the budget arrangements can accord with the policies on national economy and social development, and whether the budget arrangements for key spending items and major investment projects are appropriate. In addition, it is provided that a budget stabilization fund can be set in the general public budgets at all levels to cover the inadequacy of budgetary funds in subsequent years, and the consolidated government financial reports on the accrual basis should be prepared. All these factors have laid a legal foundation for promoting the establishment of a multi-year budget balance system, provided legal basis for relevant reforms, and turned the past simple departmental guidance documents into legally binding guidance plans.

V.2 Difficulties and problems in building of multi-year budget balance mechanism

Building of multi-year budget balance mechanism involves many technical issues and needs to be constantly practiced and improved in a long time. In the process, it is necessary to properly deal with the following issues.

First, effective links between the medium-term financial planning and the national economic development planning. First of all, coordination between finance and projects within the planning period. According to the medium-term financial planning, significant reform and policies and major projects involving fiscal revenue or expenditure in the next three years should be studied and determined based on the five-year plan on national economic and social development, special plans and regional plans. Major projects will be demonstrated scientifically for a long and medium term, and project reserve should be made properly. Since China's medium-term financial planning is in the early period of implementation, construction of departmental expenditure project library is behind the schedule, with problems of noncompliance or imprudence in preparation and poor ability in development planning. Second, macroeconomic and financial revenue and expenditure forecast. Multi-year budget is intended to analyze various factors affecting financial revenue and expenditure based on reliable data and measurement models, and to predict future fiscal revenue and expenditure, while properly making economic forecast.

Second, coordination between annual budget and multi-year budget. During the implementation of a multi-year balanced budget, it is necessary to draft an annual budget within the framework of a medium-term budget. If the budget is inaccurate or cannot be effectively implemented, or fulfillment of the annual budget falls behind the schedule, it will make the budget of the current year unable to cover the expenditure in key and priority fields, thereby affecting the budget arrangement and implementation in the coming years. Inadequate constraint of annual budget will impair the effect of cross-cycle regulation of medium-term financial plan.

Third, performance assessment on budget expenditure. Performance management is key to standardization of budget management. For the purpose of making budget decisions more scientific, solve the inconsistency between budget drafting and implementation and improving the utilization efficiency of budget fund, China should effectively link budget performance management to budget drafting and implementation and bring the feedback and guidance role of performance information into play. The government published the *Guidelines on Pushing forward Budget Performance Management* in 2011, calling for driving budget performance management as a significant task for promoting budget management reform at present and in the future. However, budget performance management is just getting start. China's performance assessment system is relatively outdated, and relevant implementing rules and performance assessment indicators, standards and methods remain imperfect. There is still a long way to go in building a scientific, fair and reasonable budget performance management system.

Fourth, coordination and cooperation among departments. Multi-year budget balance involves many departments, and needs to be consulted with tax, customs, development, reform and other related departments about tax reform and adjustment to major tax policies. In regard to expenditure policies, it is also necessary to comb expenditure policies and projects within the planning period, and to clarify the policy objectives and tasks. We may determine the total amount of budgetary resources in a top-down manner and departmental expenditure plan and budget items in a bottom-up manner. There are a lot of problems, including "fragmentation of business lines and departments" and "poor management or cooperation of different departments", in China's management system. Besides, some departments don't have proper awareness, and were reluctant to take part. That posed higher requirements on China's administrative management capability.

V.3 Policy recommendations

Building the multi-year budget balance mechanism is a complicated and enormous system engineering that concerns many areas with huge workload and high policy requirements. It requires all parties to work together and strengthen the follow-up of supporting measures.

V.3.1 Enhance top-level design

China may set up an interdepartmental budget management committee with the Ministry of Finance as the core, to reinforce the coordination and cooperation between the finance department and the departments and units at various levels, study major reform and policy measures in related industries and fields, scientifically demonstrate the long and medium-term significant events and determine the priority of budget arrangements.

The finance department should play a leading part in improving medium-term financial plan and the amendment to the three-year rolling budget preparation methods, contents and technique, clarifying budget adjustment procedures, approval authority and responsible parties and intensifying the publicity and application of related policies to governments at various levels and relevant budget units; the finance department will develop and improve information systems, including budget preparation and accounting systems, and reinforce the sharing and unification of information between various departments.

V.3.2 Strengthen the coordination between medium-term budget and medium and long-term plan of the government

Project library construction and management should be improved. China should develop a uniform project management and budget review system, and strengthen the link of medium-term budget expenditure plan to the information on special fiscal fund project library and synchronous update of information. China should also classify and comb projects and prepare for project reserves in advance by selecting, demonstrating, sorting and reviewing expenditure items.

Economic and financial forecast capability should be enhanced. China should create a complete economic and financial database, including information on economy, society, tax and finance, so as to lay a foundation for budget management. China should enhance the data mining ability and analysis technique for modern economic models, and improve the accuracy and reliability of medium and long-term economic forecast and financial revenue and expenditure prediction. China should reinforce the basic study of related fields, widely give play to the social strength, and work closely with colleges, research institutes and experts in related fields.

V.3.3 Reinforce the system building

China should specify the management policies concerning establishment, transfer-in, use and oversight of budget stabilization fund and budget revolving fund. According to the financial strength of each region, China should appropriately adjust the requirements on proportion of budget stability fund and budget revolving fund, and link the setup and transfer-in of these funds to local financial revenue and expenditure structure.

China should gradually improve and implement budget performance management. China should establish the management system covering performance objective, performance monitoring, performance assessment and application of performance results, develop detailed workflow and operating rules, and effectively link them to budget drafting, implementation and supervision. China should improve the building of assessment system, enhance the leading role of financial and budgetary departments in performance assessment, and manage to introduce third party force, including intermediary agencies; system building includes the assessment indicator system and assessment standards relating to comprehensive expenditure and project expenditure; performance assessment results will be linked to budget fund arrangements.