



Global Economic and Financial Outlook

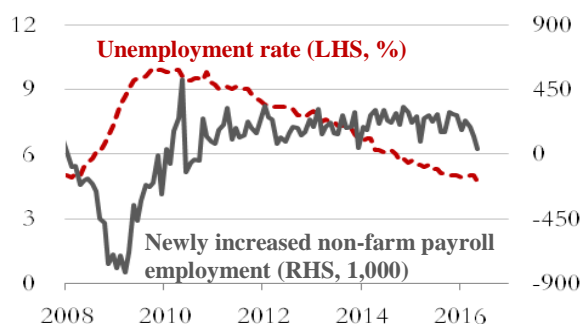
2016Q3 (Issue 27)

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Highlights

- In 2016H1, the global economy was sluggish while CPI remained relatively stable. Developed economies recovered slowly, and the Fed postponed its interest rate hike; the growth of emerging economies slowed down, with such countries as Russia and Brazil still mired in recession.
- Global financial market was picking up. In emerging countries, the exchange rates rallied following a general and in-depth depreciation, the stock markets went through sharp fluctuations, commodity prices bottomed out and the financial stability improved.
- According to our prediction, in 2016Q3 and the rest of the year, the global economy will remain sluggish, the financial markets will be exposed to non-decreasing risks, the factors, including the Fed's rate hike and the UK's exit from the EU ("Brexit"), will further exert influence upon the risk aversion sentiment.
- The present report makes the following specific analyses in particular: the boosting of global economic cooperation under G20, the influence on the world economy by the American presidential election and Brexit, as well as the capital flow of emerging markets.

Falling Employment in the U.S. Postponed the Fed's Interest Rate Hike



Source: BOC Institute of International Finance

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Promote International Cooperation to Stay away from the Growth Trap

--- Global Economic and Financial Outlook (2016Q3)

2016Q2 witnessed the lingering weakness in global economy, trade and investment and the rocky recovery of financial markets; some uncertainties like the Fed’s pause on interest rate hike and the Brexit perplexed investors around the world. In Q3, it is expected that global economy will remain sluggish, and the volatility in financial markets may escalate. International cooperation will play a significant role in reviving the world economy. G20 Summit will be held in China for the first time, expected to make new breakthroughs in relevant issues. This report particularly analyzes the impetus given by G20 to the world economy, the American presidential election and Brexit, and predicts the capital flows in emerging markets.

Part I Global Economic Review and Outlook

I. Enhanced Global Cooperation Plays an Important Part in Boosting Global Economic Recovery

In 2016Q2, with policy communications between major economies becoming clearer, financial risk decreased, market sentiment tended to be stable, real economy recovered, and commodity prices bottomed out. According to preliminary estimation, the annualized growth rate of GDP was about 2.7% in Q2, an increase of 0.5 percentage points over the previous quarter; year-on-year growth rate reached 2.4%, the same as the previous quarter (Figure 2). However, global economic recovery was still weak, and risk aversion sentiment escalated in consideration of the recent referendum on Brexit and timetable for the Fed’s interest rate hike.

Figure 1: Price Indices of Primary Commodities

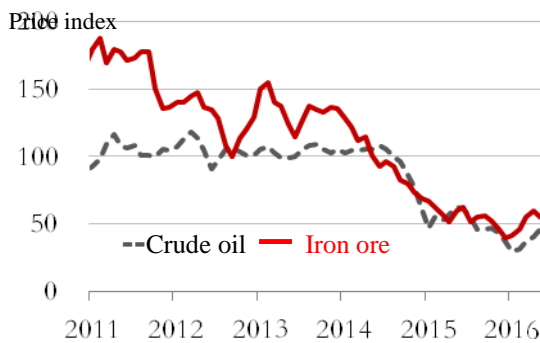
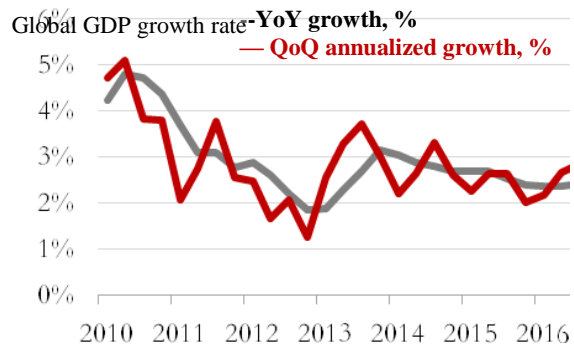


Figure 2: Moving Tendency of Global Economy



Sources: Wind, BOC Institute of International Finance

Looking into Q3, global economy will continue to recover moderately, and the annualized growth rate of GDP will reach about 2.6%, still lower than the potential growth rate of the world economy; given the ripple effect brought by Brexit, we cut our global economic growth rate expectation down to 2.5% for 2016 (Table 1). Among developed economies, the recovery of U.S. economy will be impaired by USD appreciation, sluggish job market and falling labor productivity; European countries will continue to have robust domestic demands thanks to the loose policy, with an increasing number of countries recovering, but the economic growth in UK will decline; though Japan’s economic recovery is improved, its strength and sustainability will be restrained by such factors as yen appreciation, deflation pressure and rise of consumption tax rate. In emerging economies, economic recovery will tend to improve but remain weak, with the intensified

economic stimulus in some countries, bottom-out of commodity prices and political unrest under control in such countries as Brazil.

Table 1: Key Indicators of the World's Major Economies (%)

Region	Yr/Qtr	GDP growth rate			CPI increase			Unemployment rate		
	Country	2014	2015	2016 ^f	2014	2015	2016 ^f	2014	2015	2016 ^f
Americas	U.S.	2.4	2.4	2.0	1.6	0.1	1.0	6.2	5.3	4.9
	Canada	2.4	1.2	2.0	1.9	1.1	2.0	6.9	6.9	6.8
	Mexico	2.1	2.5	2.6	4.0	2.7	3.4	4.8	4.3	4.0
	Brazil	0.0	-3.8	-3.0	6.3	9.0	5.8	4.8	6.6	8.6
	Chile	1.9	2.2	2.0	4.7	4.3	3.9	6.4	6.2	6.6
	Argentina	0.5	-0.5	0.0	21.3	16.0	25.0	7.1	7.3	6.9
Asia-Pacific	Japan	-0.1	0.5	0.5	2.7	0.8	0.7	3.6	3.4	3.5
	Australia	2.7	2.5	2.5	2.5	1.5	2.1	6.1	6.1	6.2
	China	7.3	6.9	6.7	2.0	1.4	2.5	4.1	4.1	4.1
	India	7.3	7.3	7.5	6.4	5.9	4.9	—	—	—
	South Korea	3.3	2.6	2.5	1.3	0.7	1.6	3.5	3.6	3.5
	Indonesia	5.0	4.8	4.8	6.4	6.6	6.3	6.1	5.8	3.6
Europe-Africa	Eurozone	0.9	1.7	1.6	0.4	0.0	0.9	11.6	11.0	10.5
	UK	2.9	2.2	2.0	1.5	0.1	1.5	6.2	5.6	5.5
	Switzerland	1.9	0.9	1.5	0.0	-1.1	-0.5	4.5	4.5	3.6
	Russia	0.6	-3.7	-1.0	7.8	15.5	9.5	5.2	5.7	6.5
	Turkey	2.9	3.6	3.0	8.9	7.7	6.9	9.9	10.2	11.2
	South Africa	1.5	1.3	1.0	6.1	4.5	6.3	25.1	25.8	25.8
Global		2.7	2.6	2.5	3.5	3.3	3.4	—	—	—

Source: BOC Institute of International Finance. Note: f for forecast.

In the future, the global economy will still face the following high risks: (1) the Fed is likely to raise interest rate in the second half of 2016, and there are an increasing number of interference factors; the American presidential election may bring substantial changes to the policy direction of the country. That will affect global investors' confidence and incur volatility of financial markets. (2) Brexit will trigger new international political risks, and, in the medium and long term, result in the activity of populism in Europe and a setback of the integration process; unemployment rate will remain high in the Eurozone, and the refugee crisis will still threaten the unity and stability of Europe and deal a new shock to the European economy. (3) The capital flight from emerging markets will continue, and the debt ratio, especially debts of non-financial sectors, will keep rising, and risks triggering crisis have not been eliminated and may result in a drag on global economic growth.

Global cooperation stands out in order to stay away from the trap of long-term sluggish global economic growth. To do so, the following measures may be considered: first, we should exert to coordinate the orientation of monetary policy of major economies, pay more attention to spillover effect and improvement of transparency and foreseeability, give investors more stable expectations, and in particular, diminish the negative impact on international capital flow by differentiation of monetary policy. Second, we should work together to strengthen international supervision and financial support, push forward structural reform of each country and give play to the role of fiscal policy in stimulating economy, and further reverse the trend of potential slowdown of global economic growth; we should uphold an open global system and multilateral trade system and suppress the escalation of trade protectionism. Third, we should strengthen strategic communication between major countries, and reduce the unstable factors brought by the political

and economic games of great powers to geopolitical situation. Particularly, a few countries intend to expand their economic territory by promoting an alleged “rebalancing” strategy and dominating new global trade rules, posing adverse impact on global investment environment.

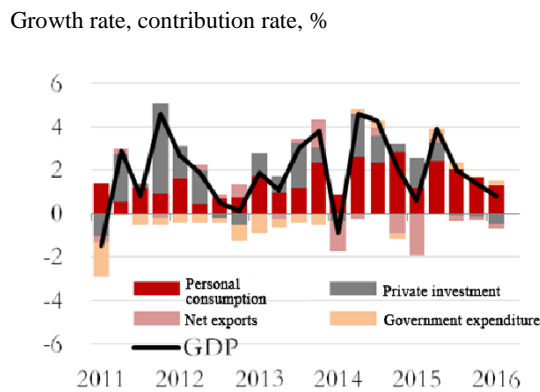
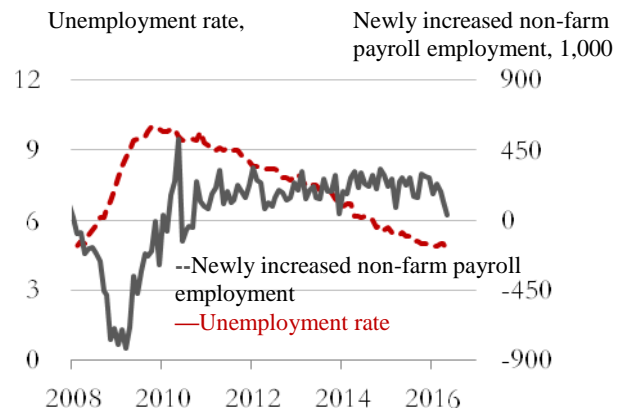
There are numerous global and multilateral cooperation platforms. So far, the most extensive, democratic and efficient international platform is the Group of Twenty (G20). In September 2016, a G20 Summit with the theme of “Towards an Innovative, Invigorated, Interconnected and Inclusive World Economy” will be held in Hangzhou, the first time for China to assume the G20 presidency. We expect that the G20 Hangzhou Summit will play a more important part in improving the effectiveness and pragmatism of global economic policy coordination mechanism, drawing a route map to pull the world economy out of recession, and particularly playing a large role in innovating development approaches, creating an open global economy and perfecting global governance mechanism.

II. The North American Economy Will Continue Moderate Growth and the Fed Is still Likely to Raise Interest Rate in 2016

II.1 The U.S. economy may sustain moderate growth

The U.S. has experienced a deceleration in economic growth since 2015Q2, with the annualized growth of merely 0.8% for real GDP in Q1 (Figure 3). Main negative factors include a negative growth of non-residential fixed investment, industrial output, net exports and inventory investment, as well as part of seasonal factors. Consumer expenditure increased due to growth of personal income, decline in unemployment rate, low oil price and other positive factors. In Q2, economic growth rebounded to around 2.5% moderately. Except for consumer expenditure, mild growth of fixed investment and industrial output was restored. However, owing to the lackluster growth of enterprise profits, investment willingness remained limited, and fixed investment did not increase sharply. Enterprises’ inventories decreased more slowly than before, though their de-stocking has slowed down. Exports did not grow obviously as a result of external markets and USD factors.

Viewing from primary leading indicators, the U.S. economy is unlikely to decline as there is a foundation for continued moderate growth in Q3. Consumer expenditure will keep increasing in the context of increasing personal income, dropping liabilities and rising revolving credits of banks. In consideration of such risks as slowing growth of employment rate (Figure 4) and Brexit, the Fed did not take any action at the FOMC meeting in June, diminishing the anticipation for increase magnitude and frequency of interest rate in 2016-2018 and growth of GDP. It insists that the U.S. economy still has the foundation for continued growth in a short term. The Fed does not rule out the possibility of raising interest rate twice in 2016, which will highly depend on the future economic data of the U.S. Since the British people have voted for leaving the EU and it will affect the Fed’s process of interest rate hike in 2016, we hold that the Fed will raise interest rate at most one time before the end of this year, if the country's economic data are resilient in the future.

Figure 3: U.S. GDP Growth and Contribution Structure

Figure 4: U.S. Employment Growth and Unemployment Rate


Sources: Wind, BOC Institute of International Finance

II.2 Canadian economy grew weakly

Canadian economy is foreign-oriented and energy-dependent. In 2016Q1, the annualized growth of real GDP in Canada reached 2.4% thanks to the export growth, crude oil price rebound, and relatively healthy consumer expenditure. In Q2, wildfires in Alberta were out of control and spread to Fort McMurray, an important oil town. Many companies have decided to suspend or reduce the production activities of oilfields near the disaster-stricken areas, seriously affecting oil production and export. Due to the limited economic size of Canada, this incident might lead to a serious stumble in economic growth or even a negative economic growth in Q2. It is forecast that Canadian economy is likely to rebound to over 2% in Q3. Despite the weak fixed investment, industrial output and export growth will continue to be driven by such factors as the economic growth of the U.S., depreciation of Canada dollar and oil price pickup, thereby invigorating economy in the second half of this year. As the market expects, the central bank of Canada still set the benchmark interest rate at 0.50% at the policy meeting in May, which will possibly remain unchanged in the next quarter.

II.3 Mexico still maintained a relatively strong economic growth

Since Mexico is also foreign-oriented and energy-dependent, it was affected by the slowdown of global economic growth and drop of crude oil price. However, compared with other Latin American countries, Mexico's economic growth is stronger. Its real GDP growth rate approached to the potential level and reached 2.6% year on year in Q1. In the next quarter, with the oil price rise, economic growth of the U.S. and depreciation of the peso, Mexico's exports will possibly continue growing, and drive economic growth in conjunction with domestic consumer demand. The year-on-year growth rate of real GDP is expected to range from 2.1%-2.5%. In order to prevent the escalation of inflation in the context of material depreciation of the peso, the central bank of Mexico will continue to adopt a relatively high interest rate.

III. European Economic Differentiation Continues and the Brexit Referendum Adds to the Uncertainty

III.1 Eurozone economy continues moderate recovery and the European Central Bank still pursues a loose policy

Driven by loose monetary policy, low oil price and other favorable factors, the Eurozone economy continued moderate recovery. In 2016Q1, GDP grew by 0.6%, the highest level in the year. Four major economies in Europe, namely Germany, France, Italy and Spain, grew simultaneously for the first time after 2010, and their economic growth also surpassed the UK and the U.S. for the first

time after 2011. Following the announcement of a package of policy measures in March 2016, financing conditions in the Eurozone were improving, and economy steadily recovered in the first half of the year primarily relying on the stimulus of consumption by the low oil price. After it made a good start, its economic growth will slow down, and investment is expected to rebound and will add momentum to the moderate economic recovery in the second half of this year.

The interwoven internal and external risk factors will be a drag on economic recovery in the Eurozone. Apart from the slowing growth of emerging economies and major developed economies, the complicated refugee crisis and terrorist attacks will also overshadow the region's economic recovery. Though the refugee and security issues will stimulate government expenditure in a short term, it will also affect private consumption and enterprises' investment behavior and confidence and hamper investment growth. In the wake of Brexit, euro is expected to weaken and benefit the Eurozone's exports in a short term. The subsequent Brexit procedures will be time-consuming and will not affect the Eurozone's economic recovery this year. It is expected that monetary policy will gradually become a major driver for economic recovery with the rise of oil price in the future. During the period, member countries of the Eurozone will push forward structural reform to solve the problems of high unemployment and low competitiveness, thereby sustaining Europe's economic recovery in the future. European Central Bank has failed to achieve its inflation rate target of about 2% (Figure 5) for three consecutive years because of low energy price, and the inflation rate in the Eurozone will remain very low or even negative in 2016.

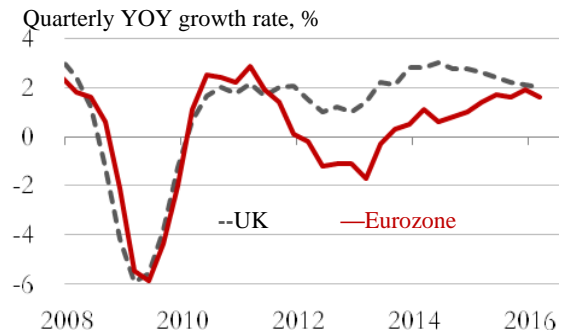
III.2 British economy grew moderately and the negative impact of the Brexit referendum will appear

Driven by the service trade, the UK's economy continued growing in the first half of 2016 (Figure 6), but its construction and manufacturing industries remained depressed. Affected by such factors as low international oil price, price war in domestic retail industry and decline in import costs, consumer price index (CPI) of the UK maintained low growth and was far lower than the growth target of 2% set by the Bank of England, increasing the deflation risk.

Figure 5: CPI Changes in the Eurozone and UK



Figure 6: GDP Growth Rates of the Eurozone and UK



Sources: Wind, BOC Institute of International Finance

The UK's economic growth is less optimistic in 2016Q3 mainly because the results of the Brexit referendum will have a serious adverse impact on its economy. Since the UK announced on February 20 that it would hold a referendum on June 23, it has received a strong response from the market, leading to a drastic fluctuation of housing price, GBP exchange rate and yield of 10-year treasury bond in the country. The uncertainty of Brexit also decelerated the growth of domestic investment and consumption in the UK. Since the British people have voted for leaving the EU, the country's economy will be impacted in the second half of 2016 and afar. As a result, commodity prices will rise and the real economy may sink into a recession. It is forecast that the Bank of England will still implement a low interest rate and postpone interest rate increase again, and continues to boost market liquidity by a quantitative easing policy.

III.3 Economic disparities remained in Emerging markets in East Europe, and Russia's economic recovery will be long and difficult

Driven by low oil price and continuous moderate economic recovery in the Eurozone, most emerging countries in East Europe saw a higher economic growth than the region's average in the first half of 2016. Thanks to domestic fiscal stimulus and robust labor market, Poland and Romania outperformed the other East European countries with a GDP growth rate of around 4%; relying on consumption growth, Bulgaria, Czech Republic and Croatia achieved a better-than-expected economic growth in the first half of this year; Hungary experienced a slowdown in economic growth, which was at the bottom of EU countries in Q2 mainly attributable to the decelerating auto production and the impact on manufacturing industry by the deferred cyclical payment of bailout fund by the EU.

Russia's economy is highly dependent on the oil industry. Facing the adverse environment of sanctions by the western countries and oil price decrease, its economic recovery will be long and difficult, and the outlook for its economy in 2016 is generally pessimistic. In February 2016, towards "import substitution" in domestic market, Russia's government launched a new round of anti-crisis plan to appropriate USD12 billion for the development of non-resource industries, including automobile, light industry, machinery manufacturing and agriculture; in the international market, it has reinforced the cooperation with non-western countries in an effort to get rid of western economic sanctions. If Russia cannot find a proper development route and there is no sign of improvement in external environment, it will possibly encounter a continuous economic stagnation.

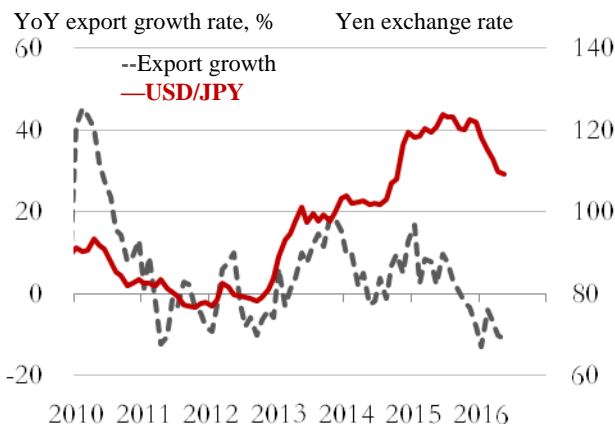
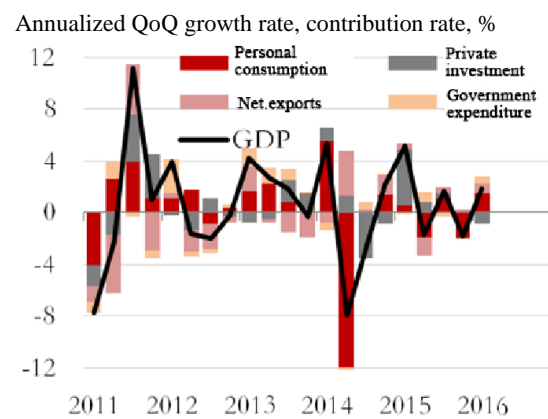
Although tensions in the neighboring countries of Turkey have caused armed terrorist attacks in some regions of Turkey many times, its domestic demand remained strong due to oil price decrease, loose monetary policy and growth of wage income. Its economy is still vigorous after the EU's refugee aid fund was in place and EU economy continued to recover.

IV. Asia-Pacific Economy Tends to be Stable and Monetary Policy Remains Loose

IV.1 Continuous yen appreciation troubled the Japanese economy

In the first half of 2016, yen appreciation became the biggest factor troubling Japan's economy. Influenced by the increasing risk aversion demand and anticipation for delaying interest rate hike by the Fed, the exchange rate of yen rose from one U.S. dollar against 120 yen at the beginning of 2016 to one U.S. dollar against 102 yen as at June 24, a new high over the past 21 months (Figure 7). Yen appreciation exerted a substantial negative impact on Japan's exports and increased deflation pressure. Japan's exports suffered a year-on-year negative growth for eight consecutive months after October 2015, obviously dampening the confidence of enterprises which are highly dependent on automobile and machinery exports. A survey made by the Cabinet Office of Japan shows that the country's export enterprises have an average breakeven point of 99, which means they will suffer a loss if the yen exchange rate drops to one U.S. dollar against 99 yen or below. At present, the exchange rate is approaching to the bottom line to be intervened by the Japanese Government.

Looking into the future, with the escalation of risk aversion sentiment resulted from Brexit and the Fed's pause on interest rate hike, yen appreciation pressure is expected to remain. Japan's economy grew unexpectedly by 0.4% quarter on quarter in 2016Q1 (or 1.7% on an annualized basis) (Figure 8). The Japanese Government's postponement in consumption tax rise will help boost residents' consumption confidence. If the government launches a fiscal stimulus policy in this autumn, it is expected to drive investments. Overall, Japan's economy is likely to get better in the second half of this year, thereby further posing appreciation pressure to yen. The Japanese Government is likely to intervene in yen, which should deserve attention.

Figure 7: Yen Exchange Rate and Japan's Export Growth

Figure 8: Japan's GDP Growth Rate and Contribution Structure


Sources: Wind, BOC Institute of International Finance

IV.2 Upturn of mining industry drove Australia's economic growth

In the first half of 2016, the recovery of commodity market boosted the robust growth of mineral exports in Australia, and drove up its annualized GDP growth to 3.1% in Q1, the highest since the end of 2012, which is higher than the median market expectation of 2.8% and falls within the range of 2.5%-3.5% as predicted by the central bank of Australia for the first half of this year. The country's exports grew by 4.4% in Q1, contributing one percentage point to its economic growth, which trade deficits decreased by 21% in comparison with 2015Q4 mainly because of the rebound of exports of iron ore, coal and liquefied natural gas. Meanwhile, the depreciation of AUD invigorated Australia's tourist market and attracted more overseas students to study here. In the first half of 2016, Australia's unemployment rate dropped from 6% to 5.7%, a new low over the past two years and a half. The upturn of employment market will draw up consumer expenditure. Viewing from domestic demand, owing to the weak income growth, wage growth has dropped to the level 25 years ago when Australia was in an economic recession, inflation decreased and core inflation remained a historic low, driving the central bank of Australia to cut interest rate by 0.25% in May. At an interest rate discussion meeting in June, the central bank announced that the benchmark interest rate would be remained unchanged and at a historical low level of 1.75%. Australia's economic prospect is highly dependent on overseas demands. The commodity market is less optimistic in the second half of 2016, which, coupled with seasonal fluctuation of commodity market and continuous drop in mineral investment, will further hamper economic growth. The central bank of Australia expects that the country's economic growth will range from 2.5% to 3.5% in 2016. The IMF forecasts that Australia's GDP growth will continue to stay at a level of 2.5% in 2016, lower than the world's average growth of 3.2%, and it will slightly rise to 2.9% until 2017.

IV.3 Capital reflux stabilized the situation of emerging economies in the Asia-Pacific region

In the first half of 2016, the outflow of international capital from Asian emerging markets has been reversed, as a result of decreasing urgency for the Fed's interest rate hike and the stabilization of the USD exchange rate. Thanks to a low unemployment rate, growth of disposable income, low commodity price and macro-economic policy support, Asian emerging economies still had relatively robust internal demands, but external demands and foreign trade remained weak. International capital is likely to continue flowing back to Asia in anticipation of slow interest rate hike in the U.S. At the same time, structural reform will wean Asian emerging markets away from over-dependence on a single market, and help them regain economic growth momentum. Asian Development Bank forecasts that Asian developing economies will still realize an annual GDP growth of 5.7% in 2016-2017, and it has raised their predicted inflation rates to 2.5-2.7% for the

two years. According to IMF, the inflation rates of Asia's emerging and developing economies will edge up to 3.0% and 3.2% respectively in the two years.

V. African Economy Is Worrisome and South American Recession Continues

In general, as the international commodity price continued to remain low, expectation for the Fed's interest rate hike escalated again, casting a shadow over the economic situations in Sub-Saharan Africa, the Middle East and the North Africa which are highly reliant on commodity exports; Latin America encountered political turbulence, decline in demands, deterioration of trade, serious inflation and continuous economic recession.

V.1 Economic growth in Southern Africa slowed down

In the first half of 2016, economic growth in Southern Africa continued to decelerate, with a GDP growth rate dropping to around 3%, lower than 3.4% in the previous year and the lowest level since 1999. The drastic drop of oil and mineral prices resulted in the economic fragility of nearly half of countries in the region, of which such oil or mineral product exporters as Nigeria, Angola and South Africa (Figure 9) took the severest hit. Moreover, these countries including Ethiopia, Malawi and Zimbabwe were stricken by a drought, plunging millions of people into a food shortage crisis; such countries as Liberia and Guinea were seriously affected by the Ebola epidemic; Chad and Cameroon continued to be influenced by terrorist attacks. Certainly, there are a few bright spots in the region. For example, economic growth of such oil importers as Ivory Coast, Kenya and Senegal is expected to reach 6% or higher this year. These countries' economic growth is supported by continuous infrastructure investment and strong private consumption, and benefits from oil price decrease.

In Q3, British people's vote for exit from the EU will trigger domestic political turbulence; USD, as a safe haven currency, will move higher against other currencies, while the prices of commodities, excluding gold, will possibly fall in a short term. The economic situation of Southern Africa is not promising in the near future, and the countries seriously reliant on oil and mineral product exports are likely to be further impacted.

V.2 The Middle East and Northern Africa are challenged by low oil price

In the first half of 2016, the Middle East and the Northern Africa continued to be challenged by the low oil price, and many international agencies have cut their forecast for these regions' economic growth. The new normal of long-term low oil price has dampened the growth prospect of oil exporting countries in the Middle East, and the economic growth mode centering on oil industry has become unsustainable and such a situation cannot be eradicated in a short term. Oil exporting countries in the Middle East lost oil income of USD390 billion in 2015 and the figure may exceed USD500 billion in 2016. Despite a zero economic growth in 2015, Iran expects its GDP to grow by 3% and 3.7% respectively in 2016 and 2017, with its resumption of oil export and the lifting of sanctions by western countries.

In Q3, the Middle East and Northern Africa are unlikely to see an economic recovery. With the international political turbulence, USD will appreciate again, and a sharp rebound of oil price is impossible in a short time, further overshadowing the economic prospect of these regions. The sharp decrease in oil income will lead to an expansion of budgetary deficit and a slowdown of economic growth, particularly in the countries highly reliant on oil income, such as Saudi Arabia. The good news is that all governments have taken various measures to improve the industrial structure, and attach great importance to economic diversification. Non-oil industries will become an important growth engine.

V.3 Latin American economy continues to be in a recession

In the first half of 2016, Latin America's economic situation was still bleak. Primary commodity

prices in the international market remained low, uncertainties in the international financial market increased, the political situations of major Latin American countries were not stable, and the structural problems of economy have not been completely solved. Consequently, financial risks in each Latin American country were gathering. The global economic downturn, worsening trade conditions and outstanding fiscal problems have plunged such commodity exporting countries as Brazil and Venezuela into an economic recession, particularly Venezuela.

In Q3, the Latin American economy is unlikely to recover. First, global economic growth will remain weak in a short term; second, addressing overcapacity requires a long period due to sluggish demand, and commodity prices will remain low; finally, Latin America is in the cycle of interest rate hike in response to capital flight and high inflation (Figure 10), prejudicing the investment enthusiasm of domestic enterprises and limiting the room of monetary policy.

Figure 9: Economic Growth of Some African and Latin American Countries

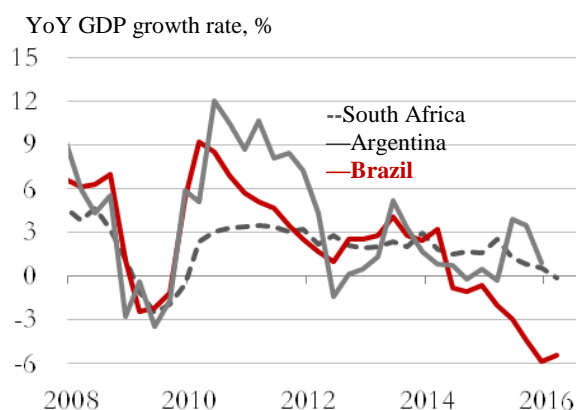
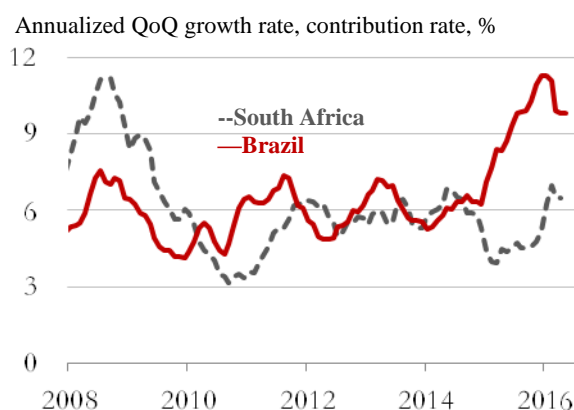


Figure 10: Inflation Rates of Some African and Latin American Countries



Sources: Wind, BOC Institute of International Finance

Part II Global Financial Review and Outlook

I. Global Financial Market Has Big Potential Risk although with Lower Volatility and Higher Stability

I.1 Financial market risks linger

At the end of 2016Q1, global financial market gradually stabilized following a drastic fluctuation in early this year, and such a tendency remained in Q2. The market expectation for slowing pace of monetary policy normalization in the U.S. and the trend of economic stabilization of emerging markets, particularly economic and RMB stabilization in China, raised investors' risk appetite and channeled assets back to emerging markets. Crude oil price rally drove up the prices of other assets, especially stocks, currencies and commodities in emerging markets. MSCI World Index has been on the rise since the middle of Q1, while VIX, an index reflecting the volatility of stock market, plunged. However, the potential risks that affect the stability of financial markets still exist, posing big uncertainties in Q3.

First, the market anticipation for the likelihood of the Fed's interest rate hike at any time of the second half of 2016 is still an important factor affecting the global investors' confidence, the destination of financial assets and USD value. However, the Fed's ambiguous judgment about the U.S. economy and its monetary policy will also affect investors' judgment on the market trend and investment willingness.

Second, the possibility of Brexit and uncertainty of its impact are increasing and have become one

of the important factors leading to market volatility in Q2. The Fed and the central banks of the UK and Japan consider it as a global risk. The result of Brexit referendum on June 24 directly caused a huge volatility in the UK, the EU and the global market at large. GBP, euro, currencies of emerging markets, global stock markets and most commodities, other than gold, saw the biggest drop. However, such safe haven assets as USD, yen and major government bonds rose remarkably. Subsequently, major central banks stabilized the markets by currency swap and liquidity injection. Though these measures help restore market confidence, the uncertainty of such event and its impact will remain in the next quarter, in which global market, consequently, is unlikely to restore stability.

Third, with the gradual stabilization of the oil price, its support for assets in emerging markets is decreasing; however, the above factor will continue weakening the energy price hike's support for assets, particularly stock markets in emerging markets.

Fourth, low-rated enterprises in developed markets and enterprises in emerging markets issued a large amount of bonds in the past several years, raising their leverage ratios. Among them, the debt/GDP ratio of emerging markets approached to 105%, far higher than that of developed markets. However, the income growth of these enterprises remained weak. With the gradual maturity of bonds, the debt service pressure of the holders of high-yield bonds and bonds of some emerging markets is mounting. According to estimates of IIF, about USD655 billion of bonds and syndicated loans in emerging markets will become due in the second half of 2016. Meanwhile, asset quality of banks in emerging markets is worsening, and all these factors may result in an increase in credit risk.

Fifth, the rise of debts and decrease of foreign exchange reserves in emerging markets further increased debt risk. Except for a few countries, the debts of most emerging countries are denominated in local currencies, and such foreign currencies as USD only accounted for around 30% of their total debts. Therefore, debt service risk mainly comes from solvency instead of currency mismatch.

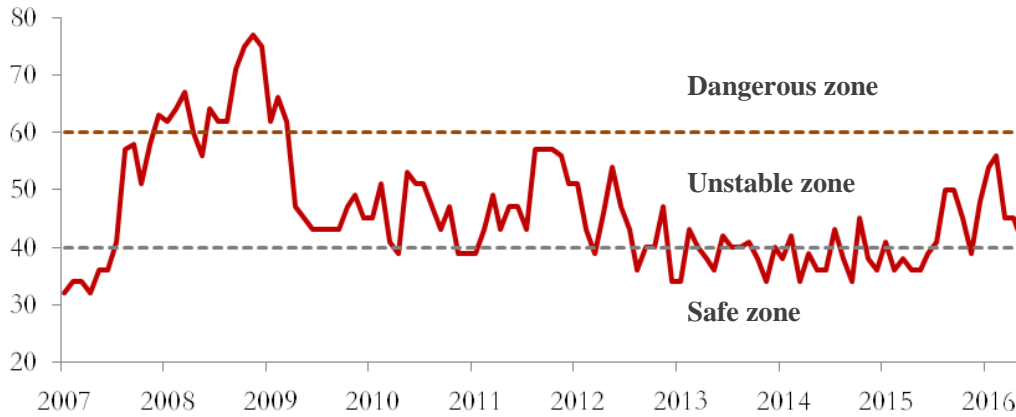
Sixth, enterprises' profits fell recently in contrast with the rally of global stock markets, resulting in a rapid rise of P/E ratios of stocks in developed and emerging markets. That may impact on the rally of the stock market in the future. In 2016Q3, the stability of global financial market will be difficult to obviously improve. Though the probability of serious deterioration is small, it should require close attention.

I.2 ROFCI improved following a sharp decline

In 2016Q2, the monthly average of the U.S.' Risk of Financial Crisis Index (ROFCI) decreased to 43.66 from 51.66 in the preceding quarter, still within the unstable territory but having a substantial improvement (Figure 11). Stability improved mainly in the fields of stock market, corporate credit market, bank stock market and macro economy. ROFCI shows that credit risk and market risk fell but liquidity risk and foreign exchange risk rose.

Viewing from the change trend, ROFCI dropped after hitting a high in Q1, but rallied at the end of Q2. Given the numerous uncertainties in global financial market in Q3, particularly the impact of Brexit, the stability of financial market is unlikely to improve significantly, and ROFCI will possibly fluctuate within the unstable zone.

Figure 11: Movement of the ROFCI

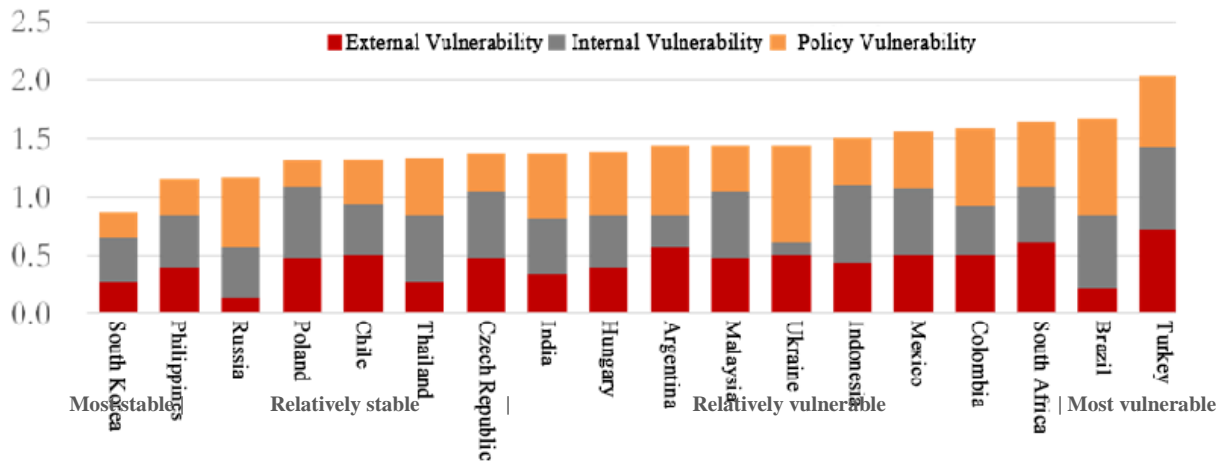


Sources: New York Branch of BOC, BOC Institute of International Finance

I.3 Overall financial vulnerability of emerging economies edged up

We have analyzed and ranked the financial vulnerability of 18 emerging economies according to the Emerging Economy Vulnerability Index issued by the Institute of International Finance (IIF) (Figure 12). One country's financial vulnerability index consists of three parts: external financial vulnerability, which is based on the degree of its dependence on foreign capital; domestic financial vulnerability, which is based on the status of its financial sector and real economy; economic policy vulnerability, which is based on the policy credibility and political stability. The total scores of the country's financial vulnerability are derived from a comprehensive analysis of the above three parts, and then it will be ranked by four levels: most stable, relatively stable, relatively vulnerable and most vulnerable.

Figure 12: Financial Vulnerability Index of Major Emerging Economies (June 2016)



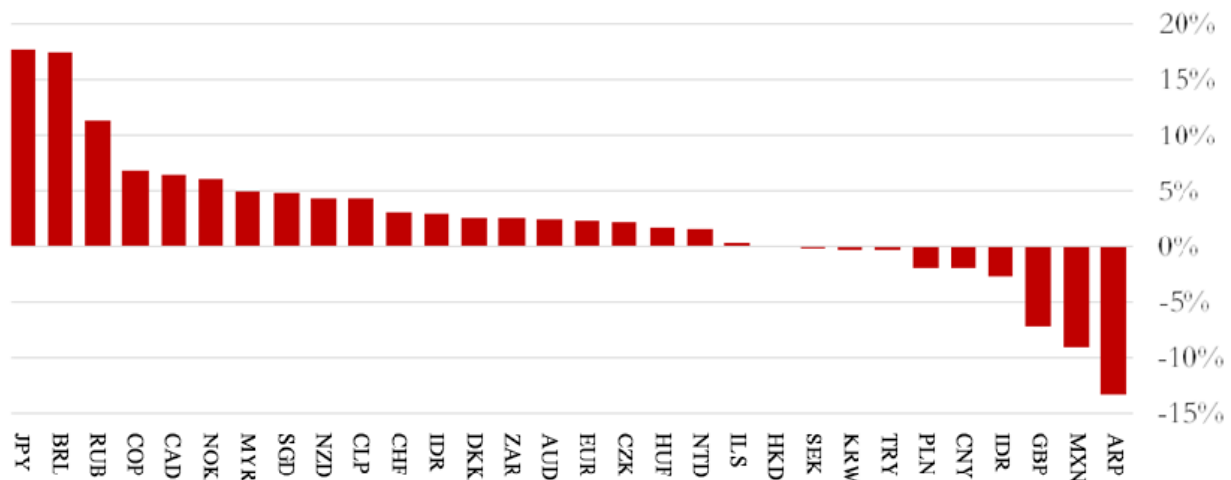
Sources: IIF, BOC Institute of International Finance

In 2016Q2, Turkey and South Africa were the most externally vulnerable; Indonesia and Turkey were the most internally vulnerable; Brazil and Ukraine were the most vulnerable in the policy sphere. Overall, Turkey remained the most vulnerable; relatively vulnerable countries mainly include Brazil, South Korea, Colombia, Mexico, Indonesia, Ukraine, Malaysia and Argentina; Russia and Philippines were relatively stable; South Korea was still the most stable. Compared with Q1, the number of vulnerable countries increased in Q2, while that of relatively non-vulnerable countries decreased; overall financial vulnerability rose slightly.

II. Foreign Exchange Market: the Fed's Interest Rate Hike and Brexit Triggered Exchange Rate Fluctuations

In 2016Q2, the process of the Fed's interest rate hike and the Brexit referendum successively drew close attention in the foreign exchange market. Major currencies became more volatile, GBP and euro were seriously hurt, and safe haven currencies rose. USD rallied at the end of the quarter, and consequently the currencies of emerging markets were passively under pressure (Figure 13). In the future, political and economic risk rise in Europe will intensify foreign exchange market fluctuation and raise risk aversion sentiment in the market. Meanwhile, the Fed's monetary policy developments should not be ignored.

Figure 13: Changes in the Exchange Rate of Major Currencies against the U.S. Dollar as Compared with the Year Beginning (as at June 24, 2016)



Sources: Bloomberg, BOC Institute of International Finance

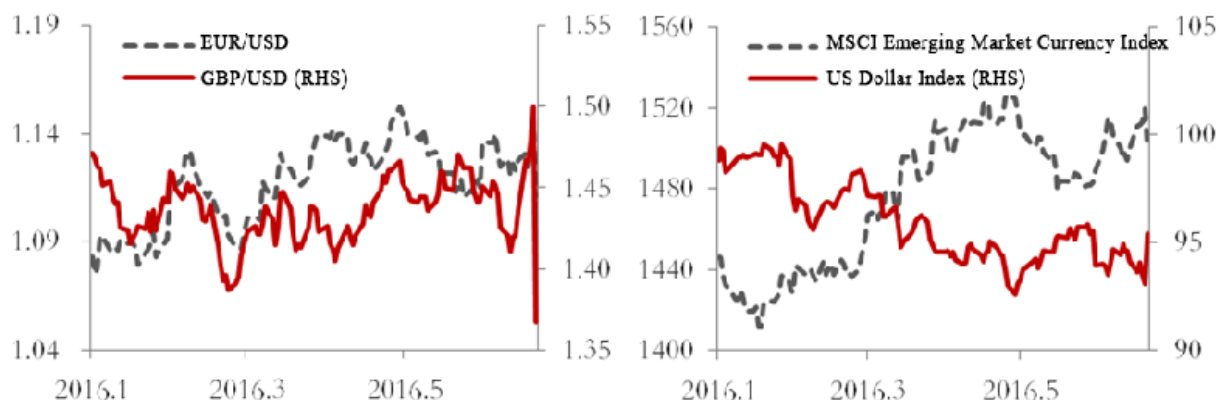
US Dollar Index showed a trend of two-way fluctuation. In 2016Q2, U.S. economic data were mixed. The Brexit risk intensified international financial market fluctuation, and the Fed was cautious towards monetary policy. Anticipation for interest rate hike was strong after May, but the Fed Funds Rate remained unchanged at the FOMC meeting in June. Consequently, USD exchange rate fluctuated at around 94.5 on a two-way basis. The result of the UK's referendum on June 24 is exit from the EU, driving up US Dollar Index to 95.4392.

Euro and GBP tumbled, while such safe haven currencies as yen were on the rise. In 2016Q2, despite smooth economic expansion of the Eurozone and weak USD rose, the Brexit risk, the challenges that European banking industry was facing and the refugee issue added to the uncertainties of Europe's economic prospect, intensified the fragility of euro market expectation and led to a rapid rise of the implied volatility of GBP options. After the Brexit referendum on June 24, the exchange rate of GBP against USD plummeted by more than 10% to a bottom of 1.3227, and that of euro against USD dropped by 2.68% (Figure 14). The risk aversion sentiment worldwide drove up the exchange rate of yen against major currencies to a high, and the rise of intra-day exchange rates of such safe haven currencies as NOK and CHF hit a record high after the Brexit referendum.

Currencies of emerging markets and commodity exporting countries rose slightly. In 2016Q2, emerging markets got better by and large, and such economies as India, Thailand and Indonesia maintained a strong growth momentum due to expansion of investment and consumption. The pause on the Fed's interest rate hike and the slowdown of USD rally drew up the currencies of

emerging markets (Figure 15). Meanwhile, prices of commodities including crude oil, precious metals and agricultural products went up, vigorously supporting the exchange rates of the currencies of commodity exporting countries, including RUB, CAD, CLP and AUD. After the Brexit referendum on June 24, US Dollar Index rose passively, placing pressure on the currencies of emerging markets.

Figure 14: Movement of Euro and GBP **Figure 15: USD and Emerging Market Currency Index**



Sources: Bloomberg, BOC Institute of International Finance

In 2016Q3, global risk aversion sentiment will soar, and political and economic risk rise in Europe will intensify foreign exchange market fluctuation. Meanwhile, the Fed's monetary policy developments should not be ignored. Albeit the decreasing expectation on U.S. economic growth, its development momentum remains, and USD will fluctuate at a relatively high level while EUR and GBP stumble. The Fed downgraded the expectation on the number of interest rate hikes in the future, but it does not rule out the possibility of raising interest rate this year, and a USD rally is expected in the second half of this year. After the UK decided to leave the EU, the UK, the Eurozone and the EU will face a series of adjustments and reforms, and suffer a serious negative impact in the economic fields such as trade, investment and employment. At the same time, the trend of domestic and regional political divisions will be evident, vulnerability of European market will escalate and GBP and EUR will continue to fluctuate drastically at a low level. Given the volatility of the global financial market and rising risk aversion sentiment, yen will remain relatively high for a certain period. However, if yen continues to move higher against USD, it does not rule out the possibility that the Japan's authority may step in. Currencies of emerging markets and commodity exporting countries will fluctuate with USD, and face a certain depreciation pressure in the second half of this year, as a result of global trade depression and short-term USD rally, especially when The geopolitical issues in East Europe still exist, when some Southern American economies will be in a recession, and when the exchange rate volatility risks remain in such countries as Russia and Brazil.

III. Global Stock Markets Remain Range-bound

Global stock markets stumbled in 2016Q2. Benefiting from loose monetary conditions worldwide and the Fed's pause on interest rate hike, the market panic has been eased. Compared with Q1, the fluctuation range of global stock markets narrowed and it has entered a stage of two-way fluctuation (Figure 16). In Q2, the fluctuation range of global stock markets reached 4.8%(as at June 25), obviously lower than 14.3% in Q1. It is consistent with the changes in global risk aversion sentiment reflected by VIX (Volatility Index), which averaged at 15.3 in Q2, compared with 20.5 in Q1, indicating a risk decrease in global stock markets. However, when British people voted for exit from the EU on June 24, global stock markets slumped. The stock

indices of major economies moved similarly and generally fluctuated within a narrow range. As at June 25, Dow Jones Industrial Average, S&P 500 Index and NASDAQ Index dropped by 2.2%, 0.9% and 4.2% respectively in Q2; European FTSE-100 Index, French CAC40 and German DAX fell by 0.3%, 5% and 2.4% respectively, far lower than the growth rate of over 10% from mid-February to the end of March; in Asia-Pacific region, Nikkei 225 and Korea Composite Index stumbled by 7.5% and 2.4% as a result of market panics before the FOMC meeting in June and after the Brexit.

Figure 16: MSCI World Index and VIX



Sources: Wind, BOC Institute of International Finance

In the second half of 2016, global stock markets will remain range-bound but volatility will intensify. During the period, the volatility of global stock markets will intensify due to the effect of buyers and sellers. There are favorable factors as follows: first, the central banks of Japan and major European economies will continue pursuing a quantitative easing monetary policy and will provide emergency liquidity to the market when unexpected events take place. The adequate global liquidity will bolster the stock prices. Second, the number of countries implementing negative interest rates increased, and the yield of treasury bonds was further lowered even below zero. To pursue a relatively high yield, funds will flow from bond markets to stock markets. Third, stock prices will be boosted by gradual stabilization of global economy, upturn of profitability of listed companies and improvement of corporate fundamentals and cash flows. Unfavorable factors are set out below: first, the UK's political situation is uncertain. After the British people voted for exit from the EU, Prime Minister Cameron announced his resignation, and Northern Ireland and Scotland may hold another referendum to exit from the UK and to stay in the EU, intensifying the political turbulence in the country. The developments and uncertainties of such event in the future may worry global stock markets. Second, when the Fed will raise interest rate again is uncertain. The anticipation for the Fed's interest rate hike in the second half of this year will lead funds to flow from high-risk stock markets to fixed-income markets with a relatively low risk. Third, global banking industry may continue to suffer a loss. In Q1, the slump of global stock markets was attributed to the huge financial losses of European banking industry. In the context of negative interest rate and loose monetary conditions in the world, the banking industry is unlikely to effectively improve its operating status. With the joint effect of buyers and sellers, global stock markets will remain range-bound and volatility will further intensify.

Global stock markets may become more volatile in the second half of this year. The Brexit referendum will give rise to a new round of asset allocation worldwide. Global risk aversion

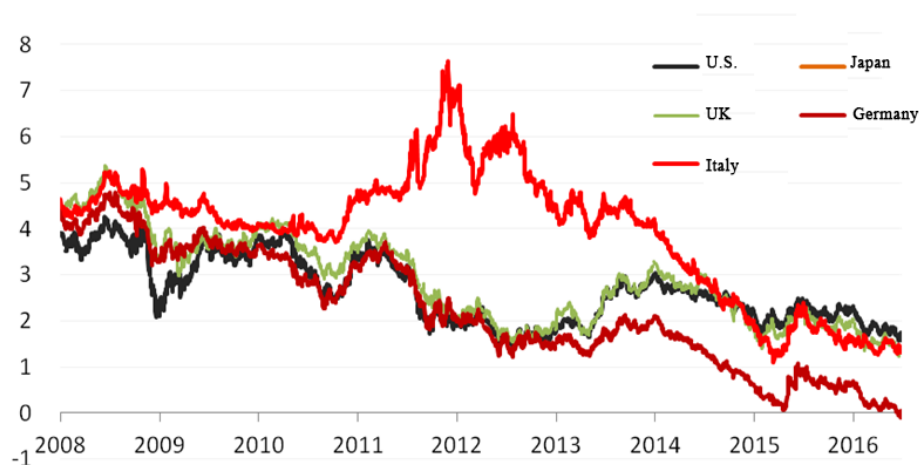
sentiment escalates, such safe haven assets as gold, USD, yen and treasury bonds of each country will be popular among investors, while stocks and other high-risk assets will be sold off. Considering the possible referendum on exit from the UK to be held in Northern Ireland and Scotland in the near future, it may further exacerbate financial risk and chaos in Europe and the world, and the stock markets in the UK and the Eurozone will possibly slump in a short term. Besides, the rally of USD, which is a safe haven currency, will intensify capital flight from emerging economies, and lead to domestic liquidity squeeze and short-end interest rate hike and outflow of funds from stock markets; USD appreciation will also drive down commodity prices again, Brazil, Argentina and other emerging countries which have a large amount of foreign debts or are highly dependent on commodity exports will remain in an economic recession, and stock markets will stumble.

IV. Global Bond Yields Remain Low

The long-term treasury bonds of major bond markets in the world had a low yield. After 2016Q1, the yields of 10-year treasury bonds of major bond markets in the world trended down (Figure 17), and investors tended to be risk-averse. With the decline in the U.S. treasury bond yield, the market expectation on the possibility of the Fed's interest rate hike has weakened; the yield of German treasury bonds extended losses, indicating that the European Central Bank will continue pursuing a loose policy to boost market confidence; the yield of British treasury bonds was still lower than that at the beginning of this year, but rose 10% one month after the announcement of the Brexit referendum date. After the said date, the yield of Japanese treasury bonds remained negative, but investors regarding Japan as a safe haven purchased a huge amount of Japanese treasury bonds. After the result of the Brexit referendum was announced on June 24, the yields of treasury bonds of Germany, Japan and the UK dipped to a historical low.

It is expected that the yields of sovereign bonds of major countries will remain low in the second half of 2016. After the Fed postponed the interest rate hike, long-term treasury bonds will continue to maintain low yields. Europe will continue to boost market liquidity with a loose policy, the European Central Bank will still implement a negative interest rate in the future, and the yields of treasury bonds in the Eurozone are unlikely to rise in a short term. After Japanese treasury bonds had a negative yield in March 2016, to invigorate domestic economy, the central bank of Japan is expected to further loosen policy and cut negative interest rate. Consequently, the yield of Japanese treasury bonds will remain negative.

Figure 17: Yields of 10-year Treasury Bonds of Selected Countries (%)



Source: Wind

The Fed's interest rate hike and Brexit will have an impact on the market in the coming months. In consideration of rising domestic unemployment rate and the influence of Brexit, the Fed announced a pause on interest rate hike in June, raising demands for U.S. treasury bonds and drawing down the yield of such bonds. The delay in raising interest rate in the U.S. made USD funds reluctant to flow back to the U.S., thus lifting the liquidity in European capital market, and the yield of European bonds continued its downward tendency. At the same time, the European Central Bank still pursued a low interest rate policy, and invested heavily in treasury bonds, thereby substantially drawing down the yields of treasury bonds of EU countries. For example, the yield of German treasury bonds became negative on June 15, a new low after more than 90 years. The risk aversion sentiment of investors around the world soared. Since Japan is regarded as an ideal safe haven, investors purchased a huge amount of Japanese treasury bonds, drawing down the yield of such bonds.

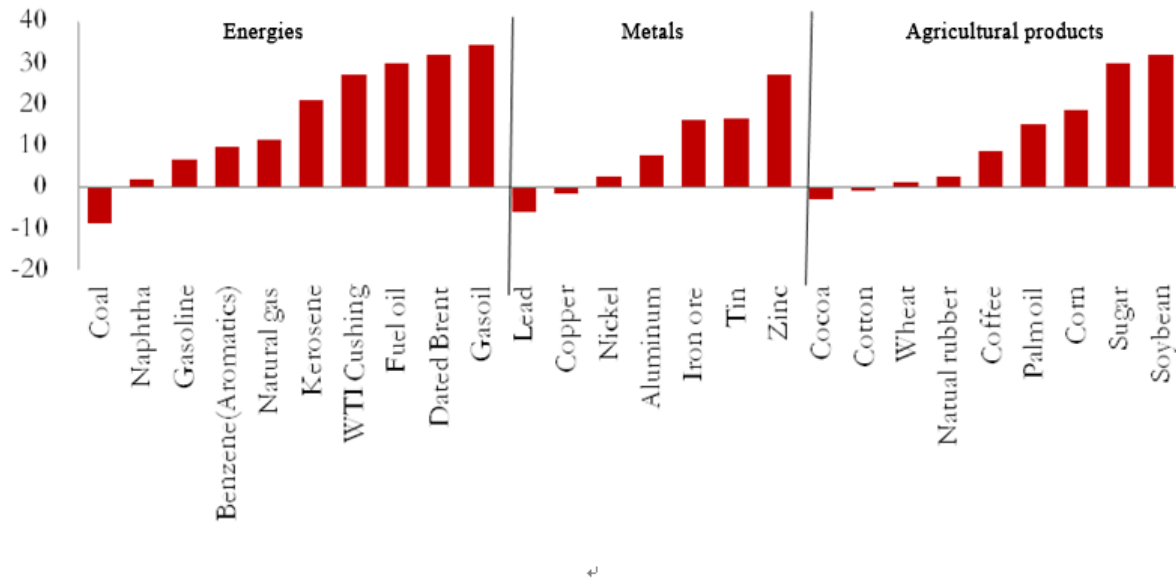
As the UK has voted to leave the EU, the Bank of England is expected to cut interest rate in the future to guarantee economic stability. The benchmark interest rate will be further reduced from the current level of 0.5%, already a historic low, thereby benefiting the short-term UK treasury bonds. In the long term, first, the negative impact of non-typical monetary policy upon the bond market will surface; second, the Brexit will increase the uncertainties in the relationship between the UK and the EU, and consequently, more EU countries may request for exit from the EU; besides, the EU itself also has big uncertainties, and risk aversion funds will leave Europe and flow into such markets as the U.S. and Japan, thereby further reducing the yields of treasury bonds of these countries.

V. Commodity Markets Remain Volatile

V.1 Commodity markets rebounded in 2016Q2

Following a stumble early this year, global commodity prices rebounded in 2016Q2, since the world economy has shown a sign of recovery, the anticipation for unbalanced supply and demand has eased somewhat and USD is weakening. As at May 31, S&P Commodity Index rose by 14.70% compared with March 31. S&P Energy Commodity Index rocketed by 24.18%, and non-energy commodity prices only rose by 3.18%.

In the **energy industry**, though the OPEC meeting failed to reach an agreement on freezing output, and such oil producers as Russia and Iran maintained a high output, the decrease of oil output in Canada, Nigeria and Zambia caused by natural, political and other emergencies, to a certain degree, eased the anticipation for oil oversupply. Besides, the decline in the U.S. crude oil inventory for the first time, the Fed's slowdown of interest rate hike and China's strong demands have jointly contributed to a sharp rise of major international oil prices. The **metal industry** continued to bottom out in Q2, and the quantitative easing policy and demand rise in the Eurozone and the U.S. were behind the rebound of nonferrous metal prices. Iron ore price surged mainly because of China's economic stabilization, consumption recovery and seasonal factors. In the **agricultural industry**, global agricultural products were in abundant supply in Q2 due to the weather factor and the recovery of downstream consumption, and the prices of major agricultural products continued increasing (Figure 18).

Figure 18: Growth Rate of Commodity Prices on May 31 vs. the Year Beginning (%)


Sources: Bloomberg, Singapore Branch of BOC

V.2 Volatility of commodity markets will continue in the second half of 2016

In the second half of 2016, commodity prices will fluctuate frequently due to the joint effect of buyers and sellers. In the energy industry, though the anticipation for a high crude oil inventory in the world and the U.S. is not obviously improved, the expectation for a gradual balance between supply and demand is widely arising in the market, and may major sellers in the market have announced an adjustment to their forecast for low oil price in 2016. In the metal industry, China is playing an important role in the global market, accounting for more than 40% of global demands for copper, aluminum, lead, nickel and zinc. It has become the largest iron ore importer in the world. Hence, China's macroeconomic development will exert a great influence on the movement of metal prices. If Chinese economy cannot substantially improve, the oversupply of metal industry will remain unchanged this year, except for tin, zinc and other metals that have been increasingly undersupplied in the market. Overall, global agricultural product industry has a weak demand and abundant output and inventory. The movement of such market in the future will be divided due to weather, transportation and production cost (e.g. energy price), among others, and the price movement of different products will also vary.

V.3 Commodity markets are exposed to potential risks

With regard to the development of commodity market in the future, on the one hand, we should continue to pay attention to the economic development trend and supply and demand conditions of the U.S., the Eurozone and China; on the other hand, we should keep an eye on the impact of natural, political factors and other emergencies and monetary policy of each country on the market: (1) the process of the Fed's interest rate hike. Though the Fed's interest rate hike was consecutively delayed due to the factors of production of U.S. manufacturing industry and its employment, it is still possible in the year, and US Dollar Index will change accordingly, thereby affecting the international prices of commodities dominated in USD. (2) Changes in the oil supply and demand landscape. Year to date, influenced by such factors as natural disasters and political events, the pressure of oversupply of international crude oil has been eased somewhat, and the market expects an earlier balance between crude oil supply and demand. But we still pay close attention to the market factors that may affect oil supply and demand and avoid optimistic anticipation. (3) The market effects of Brexit. The final result of Brexit will impact on commodity markets by affecting

the USD movement and European demands, but we should wait and see the degree of such impact. (4) Development of El Nino phenomenon. According to the National Aeronautics and Space Administration, El Nino will continue to affect global weather this year, and the rise of carbon dioxide content brought by the EL Nino will exert continued influence on the output and prices of global agricultural products.

Part III Analysis of Hot Topics

I. Enhanced Role of G20 in Global Economic Governance

I.1 G20 plays a pivotal role in global economic governance

Since the financial crisis in 2008, G20 has gradually become an important platform for cooperation between developed and emerging economies and played a pivotal role in coordinating international economic and financial policies and in boosting global governance reform. **First, it introduced the mechanism of global cooperation to cope with the crisis.** For example, at the G20 London Summit in 2009, the leaders of all countries decided to launch a USD1.1 trillion global economic recovery and growth plan, a strong signal to the international community of tackling the international financial crisis. It cemented the market confidence and symbolized the unity, consultation and collaboration between developed and emerging countries. **Second, global financial regulatory system was improved.** The financial crisis drove all governments and financial regulators to rethink about an in-depth reform of global financial regulatory system. In 2009, G20 decided to authorize the Financial Stability Board (FSB) to lead and coordinate the development and implementation of international financial policies and supervisory rules, and manage to build a countercyclical macro-prudential regulatory framework. It released Basel III to regulate systemically important financial institutions, reformed the international accounting standards, and strengthened supervision over shadow banking and OTC derivatives market. Domestic reform of each country went ahead quickly. The U.S. passed the *Dodd-Frank Act*, Europe established a pan-European financial regulation framework, and the UK developed a twin peaks regulation model. Driven by the G20 Summit, financial regulation has achieved the most fruitful reform results to date. **Third, progress was made in the reform of international financial institutions.** IMF, as the international lender of last resort, plays an important role in tackling the international financial crisis. But IMF's own strength is limited, and its assistance to the affected countries is often accompanied with tough conditions. G20 convened many summits to push forward IMF reform, including increasing the scale of Special Drawing Right of IMF; injecting capital into IMF by member countries to enhance its assistance strength; granting of more voting rights to developing countries; reforming IMF governance structure.

I.2 G20 has its limitations and policy effect is not obvious

Though G20 has become the most important multilateral strategic and economic dialog platform in the world, various proclamations published by G20 meetings are difficult to be implemented and policy effect is not obvious due to its mechanism defects. **First, discussion on related issues is not in-depth.** G20 dialog almost covers all economic spheres, including macroeconomic policy coordination, governance of international financial system, combat against corruption, and promotion of employment and growth, causing discussion of each issue to be less in-depth and unable to achieve substantial progress. **Second, G20 does not have a binding force,** and the commitments made by member countries at the meeting cannot be translated into their domestic policies. For example, all G20 summits called for opposing trade protectionism, but with very little effect. According to WTO, WTO member countries carried out more than 1,900 trade restriction measures in 2015, and 75% of the trade restriction measures promulgated after 2008 are still being implemented. **Third, without an implementing agency, G20 can only rely on its existing mechanism.** For example, such international organizations as IMF still need to play a direct role in stabilizing the financial market. **Fourth, developed and emerging countries have big policy**

divergences. Developed countries emphasize more on crisis response, while emerging countries on prevention of the spillover effect of economic policy of developed countries and lifting of their own position in the international economic and financial governance.

I.3 Outlook for G20 Hangzhou Summit

The 11th G20 Summit will be held in Hangzhou on September 4-5, 2016. With the theme “Towards an Innovative, Invigorated, Interconnected and Inclusive World Economy”, the Hangzhou Summit has identified four topics, namely, "breaking a new path for growth", "more effective and efficient global economic and financial governance", "robust international trade and investment" and "inclusive and interconnected development". In our opinion, the G20 Hangzhou Summit should highlight the following functions:

First, changing from crisis response to the concern about growth. Though the world economy has weathered the most dangerous stage of the crisis, its recovery is not robust and downturn pressure still remains. We should give prominence to the promotion of growth in the global macro policy framework. G20 must develop relevant guiding principles regarding how to take effective measures to boost sustainable economic development (including a package of fiscal, monetary and structural reform plans), how to establish a complete reform progress and achievement indicator system, and how to coordinate each country’s macroeconomic policy, so as to give an impetus to global economic growth in a medium and long term.

Second, paying attention to the interests of emerging markets. G20 provides an important platform for emerging countries to participate in global economic governance. Therefore, maintaining its position and authoritativeness is of vital importance to let emerging countries have a greater say in global economic governance. In recent two years, the growth of emerging markets slowed, and some emerging countries got into trouble. China should develop practicable plans that give consideration to the interests of emerging countries. With respect to Latin America and Russia, their financing difficulties and big pressure of economic transition should be addressed. As to African countries and least developed countries, G20 members may strengthen cooperation with those countries and help them accelerate industrialization, reduce poverty and achieve sustainable development objectives through taking such measures as capacity building, investment increase and improvement of infrastructure. When making the international economic and trade rules, dominance by developed countries should be prevented so as to safeguard the legitimate and due rights and interests of emerging countries.

Third, embodying China’s characteristics. As the host country, China may take full advantage of the opportunity to bring up constructive and cooperative initiatives from a broad vision of the second largest economy in the world, and build a cooperative platform for its economic development in the future. For example, in response to the tendency of slowing trade investment, China may push forward the establishment of global trade growth strategy and investment guiding principles, and coordinate international trade investment policy to create conditions for its opening-up of trade and investment. The “interconnectivity” initiative raised by China has been accepted by all parties, and the importance of infrastructure to growth has been widely recognized. China may table a subject "how to promote the interconnectivity of hard and soft infrastructure of global markets" in the summit. Overall, when drafting G20 topics, being problem-oriented, China may encourage all parties to enhance the common ground, strengthen outcomes and make due contributions to improvement of international economic and financial governance order.

II. Global Spillover Effect of the Brexit

In the Brexit referendum on June 23, 51.9% of the British voted to leave the EU, higher than the wide expectation around the world, posing a huge impact on the international financial market.

Foreign exchange market experienced drastic volatility. A huge amount of speculators quickly

sold off other currencies while buying yen and USD as safe haven currencies. On June 24, US Dollar Index rose by 2.54%, and the exchange rate of yen against USD went up 4.13%; correspondingly, the exchange rate of GBP against USD slumped by 8.87%, while that of euro against USD fell by 2.70%. In contrast, the exchange rates of onshore and offshore RMB against USD withstood the market test and only dropped by 0.7% and 0.9% respectively.

Global capital markets synchronously stumbled. On June 24, Nikkei 225 Index nosedived by 7.9%, leading the downside in Asia-Pacific region; Hang Seng Index and the FTSE Singapore Index decreased by 2.9% and 2.2% respectively; the stock indices of South Korea, Thailand, Vietnam, among other emerging markets in Asia all fell by more than 1.6%; China's SSE Composite Index was relatively stable and declined by 1.3%. In Europe, FTSE-100, CAC40 and DAX indices declined by 2.8%, 8.0% and 6.8% respectively; in the US, Dow Jones Industrial Average, NASDAQ and S&P 500 indices dropped by 3.4%, 4.1% and 3.6% respectively.

Gold prices rose while commodity prices fell. The safe haven functions of gold were underscored in the market volatility. On June 24, the spot gold price rose by 4.9% to USD1,317 per ounce, NYMEX crude price dropped by 5.1% to USD47.6 per barrel, and the S&P Goldman Sachs Commodity Index declined by 3.02%.

In the future, the Brexit will substantially affect the global economic and financial development and political and economic situations.

First, the Brexit will heavily hit the UK's economic and financial development.

Though the UK will benefit from the exit from the EU in loosening of regulation, restriction of inflow of low-skilled labor and reduction of expenditure on EU treasury, the exit will exert a negative impact on the country's economic growth, fiscal revenue, employment and financial system by such channels as trade and investment.

In terms of economic growth, IMF forecasts that the UK's real GDP will decrease by an average of 4.2% in the coming six years under the worst scenario compared with the period when it stays in the EU. The harsh trade conditions after the Brexit will heavily hit the UK's service industry. According to the HM Treasury, the UK's trade amount under the WTO mode in 2030 will drop 17%-24% in comparison with the period when it remains in the EU. Its trade position among non-EU countries will decline, and the process of TTIP negotiation will be affected. Meanwhile, the Brexit will lead to a substantial decrease in direct investment, exacerbate capital flight, and drive up employment rate and consumer prices.

In respect of financial system, GDP will depreciate sharply, financial market volatility will intensify and London's international financial competitiveness will be impaired. The Brexit will increase economic uncertainties and affect financial asset prices. The exchange rate of GBP has dropped to a relatively historic low, and Standard & Poor's and some other rating agencies disclosed that they would downgrade the UK's credit rating after its exit from the EU. Furthermore, the Brexit will prejudice the position of international financial center of London, which is an important bridge between Europe and the rest of the world and the largest foreign exchange trading center.

Second, the Brexit will generate a spillover effect on global economy and financial markets.

It is expected that the risk aversion sentiment will last a period of time in the future. The Brexit will dampen the EU's economic fundamental and prospect, increase the downside pressure on euro and cause European bond and stock markets to stumble. The escalation of global risk aversion sentiment will benefit USD and yen-denominated assets. Exchange rate volatility will intensify and remain high, and be more sensitive to market events. Commodity, stock and emerging markets will be pressured. Major central banks will pursue or strengthen a loose policy and maintain sufficient

market liquidity so as to guard against additional risk events.

The Brexit will disturb the established global trade system, prejudice the TTIP negotiation between the U.S. and Europe and adversely impact on the EU's and even the world's economic growth. According to the IMF, the Brexit will affect 0.2%-0.5% of EU output and lower than 0.2% of output of other economies in 2018. Given the global economic depression, each country may further reinforce fiscal stimulus, and the Fed will delay its interest rate hike.

Third, the Brexit has a long-term profound influence on the pattern of the world.

Scotland may take the opportunity to hold another independence referendum. The Brexit is likely to make the problem of Scotland's independence resurface and increase the domestic political uncertainties of the UK. Most Scottish people hope to stay in the EU. The Scottish National Party has announced that, if the majority of Scottish residents wish to remain in the EU, it will call on Scotland to hold another independence referendum to join the EU again as an independent country.

Other EU countries may copy the Brexit and try to leave the EU. The exit of the UK, as an important member of the EU, will seriously weaken the economic strength and political influence of the EU and may trigger a chain reaction of exit from the EU. A public opinion poll shows that, apart from the UK, Greece, Italy, France and Portugal also have more than 40% of residents in favor of exiting from the EU. After the Brexit, the ratio in some countries may exceed 50%. Spain will hold a presidential election in 2016; the Netherlands, France and Germany will hold presidential elections in 2017; Belgium, Italy and Sweden will hold a presidential election in 2018. These countries will take the opportunity to cater to the people and unfold political jockeying, resulting in a material setback in European integration.

The pattern of world multi-polarization will be adjusted. The populism is escalating in each country, and international situation is becoming increasingly complicated. The Brexit will impair the strength of the EU, as an important polar in the multi-polar world, and weaken the ability of Europe to deal with international. It is in-conducive to the solving of such global hot issues as the issue of Syria, the nuclear problems of Iran and North Korea and combat against terrorism in Islamic countries. Russia, under the leadership of Putin and neighboring the European continent, has been opposing to the eastern enlargement of the EU and the NATO's absorption of the former Soviet republics, and may take the opportunity to strategically benefit from the impairment of European force.

Fourth, the Brexit brings both challenges and opportunities to China.

The exit of the UK, as "China's Best Partner in the West", will exert a negative influence on the economic and trade ties between China and Europe. On the one hand, China and the UK have a close tie. After the exit from the EU, the UK will face the risk of recession, the exchange rate of GBP will depreciate sharply, weakening its external demands and jeopardizing its trade relationship with China. On the other hand, the UK plays an important role in Sino-Europe relationship, and lead EU countries in the opening-up to China. The Brexit will impact on China's access to Europe, trade and investment negotiation process between China and Europe, and exert a negative influence on Sino-Europe economic and trade ties in a short term. Moreover, the turmoil of global financial markets will increase China's financial risk.

The "Belt and Road" initiative and RMB internationalization may face certain development opportunities. After the Brexit, the investment and trade of the UK and the EU will be weakened, and each country needs to seek new markets. That provides opportunities for China to push forward the "Belt and Road" initiative and strengthen infrastructure construction and monetary and financial cooperation with Europe. In the context of depreciation of GBP and euro, relatively stable RMB will attract global investors to channel more funds to RMB-denominated assets, and the development of cross-border RMB settlement and offshore RMB financial business will pick up

speed.

III. New Situation and Influence of American Presidential Election

The presidential election in 2016 will be the first election of a new president after the financial crisis in 2008, and a review of the political and economic policies of the U.S. and their consequences. Democrat Hillary is the most likely to win the Democratic Party's presidential nomination. But she will still confront some constraint factors, such as continuity of Obama policy, Hillary email scandal and its strong opponent Sanders. Trump, the most likely winner of the Republican Party's presidential nomination, holds plural standpoints towards the policy, and has extreme opinions on immigration and combat against terrorism, causing tremendous discontent of some electors of the Republican Party. In respect of diplomatic policy, Hillary is likely to continue implementing Obama's current diplomatic strategy, with appropriate adjustments to the foreign policy orientation towards the Middle East affairs, U.S.-Israel relationship and U.S.-Russia relationship. The Republican Party will change Obama's Middle East policy and safeguard the rights and interests of Israel. Viewing from the general developments of election, the presidential election of 2016 was obviously affected by such factors as internal and external conditions of the U.S. in the post-financial crisis period, and Obama's political legacy confined to the political cycle of president.

Since the domestic economic policy is of great importance in previous presidential elections, we simply compare the economic policies of the two candidates.

Hillary explained her economic policy from three aspects: robust growth, fair growth and long-term growth. First, she expects for a **robust growth** by taking the following measures: investment in infrastructure construction, clean energy and scientific and medical research; decrease of tax burden for small enterprises and working families; increasing the labor participation especially for the female, and raising job opportunities and salaries. Second, in terms of **fair growth**, she encourages enterprises to share profits with employees, increase their salaries, welfare and productivity, and enjoy a 15% tax credit; she recommends to raise the Fed's minimum salary to USD12 per hour, and encourages all states to lift their minimum salaries according to their respective conditions; remedy the deficiencies in tax law system and ensure the rich will pay a sufficient proportion of taxes. Finally, in respect of **long-term growth**, she hopes to end the short-term behavior by the following program: encouraging enterprises to consider the long-term development of employees in terms of salary and training and their own sustainable development, instead of eyeing short-term interests only; improving capital gain tax to incentivize enterprises' sustainable development.

With respect to financial reform, Hillary hopes to ward off economic crisis by avoiding risks in advance, for example, paying a risk expense based on scale and risk degree; improving the Volcker Rule to curb banks' huge investment in hedging funds; directly linking the operating income or loss of financial institutions to the personal rewards of senior management; vesting regulators with more powers to prevent the events of "too big to fail"; increasing a tax for the high-frequency transactions that jeopardize the market, and changing rules to make the trading markets more fair, open and transparent.

In regard to the Wall Street accountability system, she opines that the Department of Justice and the Securities and Exchange Commission should be principally responsible for directly instituting lawsuits against financial institutions which conduct fraud, and withholding corresponding amount from the salaries of direct liable persons when the financial institutions breach regulations and need to pay fines. Moreover, such enterprises will also be heavily fined to avoid such contraventions from taking place again.

Trump does not have a complete and systematic economic policy, and his statements regarding

certain topics and economic issues mainly focus on three aspects: tax reform, Sino-U.S. trade war and U.S.-Mexico trade war:

First, in respect of tax reform, he calls for cutting taxes for the middle class (those with an annual income of less than USD25,000 per person or USD50,000 per couple are exempt from tax); simplifying tax procedures; reducing taxes for various sizes and types of enterprise by 15% at most, so as to retain these enterprises in the U.S. and increase job opportunities for American; avoiding continuing to increase treasury bonds.

Second, in respect of Sino-U.S. trade war, he said publicly that China is a trade manipulator; he calls for protecting U.S. intellectual property and preventing China from obtaining market access by sharing core content of technology; preventing China from providing illegal subsidy to export trade, so as to create more job opportunities to the U.S.; reducing the income tax for local enterprises to prevent them from outsourcing plants and jobs to China.

Third, in respect of U.S.-Mexico trade war, Trump considers that the illegal immigrants from Mexico, on the one hand, grab the jobs from American; on the other hand, they transfer the U.S. dollars earned in the U.S. to Mexico, amounting to USD24 billion on average every year. Therefore, he put forward several solutions: requiring remittance institutions (e.g. Western Union) to check the remitters' legal identity; requiring Mexican Government to pay the expenditure on the boundary wall between the U.S. and Mexico; the U.S. may impose trade sanctions against Mexico if the Mexican Government does not agree; canceling immigration visa or increasing the visa fee.

According to the public opinion poll, Hillary from the Democratic Party has a slight advantage over Trump from the Republican Party (Table 2).

Table 2: Public Opinion Poll on American Presidential Election of 2016

(As at the week when the Orlando event occurred)

	Trump	Hillary
Bloomberg	37%	49%
Fox News	42%	39%
NBC & Wall Street Journal	43%	46%

Sources: Strategy and Research Department of New York Branch of BOC

The final result of the election is pending. The interwoven hot political and economic topics in the U.S. will produce a potential influence on the economy of the U.S. and even the whole. From the political perspective, the final presidential election result will have a far-reaching influence on the domestic situation of the U.S. and the international situation. Since Obama from the Democratic Party took office, the deep-rooted contradictions in the U.S. have not been effectively solved. The strife between the two parties intensified, and the "veto politics" of the Congress rose. Economic recovery in the U.S. is slow, with a period of more than seven years, and there are increasing arguments on recession. Such social topics as immigration, gun control, abortion and legalization of same-sex marriage continuously gave rise to controversy, and the racial contradictions and terrorism tended to rise.

Compared with domestic political and economic pressure, the U.S. government still tried to sustain its alleged "global leadership" in the international arena, continuously reinforcing its Asia-Pacific strategy, resuming diplomatic relations with Cuba, and pushing forward the conclusion of Iran Nuclear Agreement. In the face of the issue of Syria and such terrorist threats as "Islamic State", however, Obama administration selected to a cheap balance policy of "Don't do stupid stuff", which is unable to convince the international community.

According to the Pew survey, at least 60% of Americans interviewed are not optimistic about the country's development direction, considering that it needs to prioritize the primary topics as

economy and employment, anti-terrorism, medical reform, immigration and diplomatic policy. That means the electors have strong expectations on reform of the election, and the primary topics that they are concerned about require the presidential candidates of the two parties to deal with in earnest and put forward key optics on election in the change plan. The arguments of the two candidates-Hillary and Trump with respect to the above topics cannot convince the majority of electors. In our opinion, regardless of whoever wins the presidential election, the deep-seated contradictions in the U.S. will remain in a long term, unless in-depth structural reform is carried out.

In the economic sphere, after the U.S. economy experienced seven years of recovery, the Fed raised interest rate at the end of last year for the first time after its interest rate normalization. Due to the moderate growth of domestic economy in the U.S. and the advent of foreign market volatility, the Fed delayed the process of its interest rate policy normalization for six months. During the period, though the Fed once planned to quicken the pace of interest rate hike, it was paused due to the recent weak data in the non-farm labor market. The Fed's interest rate policy swinging between the hawks and doves repeatedly has exerted and will continue to exert a substantial influence on the exchange rate of USD, resulting in the drastic volatility of USD against other major currencies, particularly offshore RMB. In the future, global financial markets will continue fluctuating in line with the Fed's interest rate policy and the movement tendency of USD.

IV. Capital Flow Changes in Emerging Markets

IV.1 Current risk characteristics of emerging markets

In 2016Q1, emerging markets had four risk characteristics. First, the financial sector became more vulnerable. The increased number of countries in high-risk zones indicates that some emerging countries are facing liquidity shortfalls or debt service risks. Second, the vulnerability of asset market tends to be bipolar. The number of countries in extreme zones (safe and high-risk) increased, suggesting that asset market risks are likely to erupt in certain countries, while other countries are relatively safe. Third, the vulnerability of the public sector generally remains low. Ukraine has huge public debts; both India and Brazil have serious fiscal deficits and rising public debts. Fourth, the number of countries with external vulnerability in low-risk and high-risk zones is more than that of countries with external fragility in the zones of weak safety and safety. Argentina has exchange rate risk, and such countries as Ukraine are confronted with high foreign debts and capital flight risk.

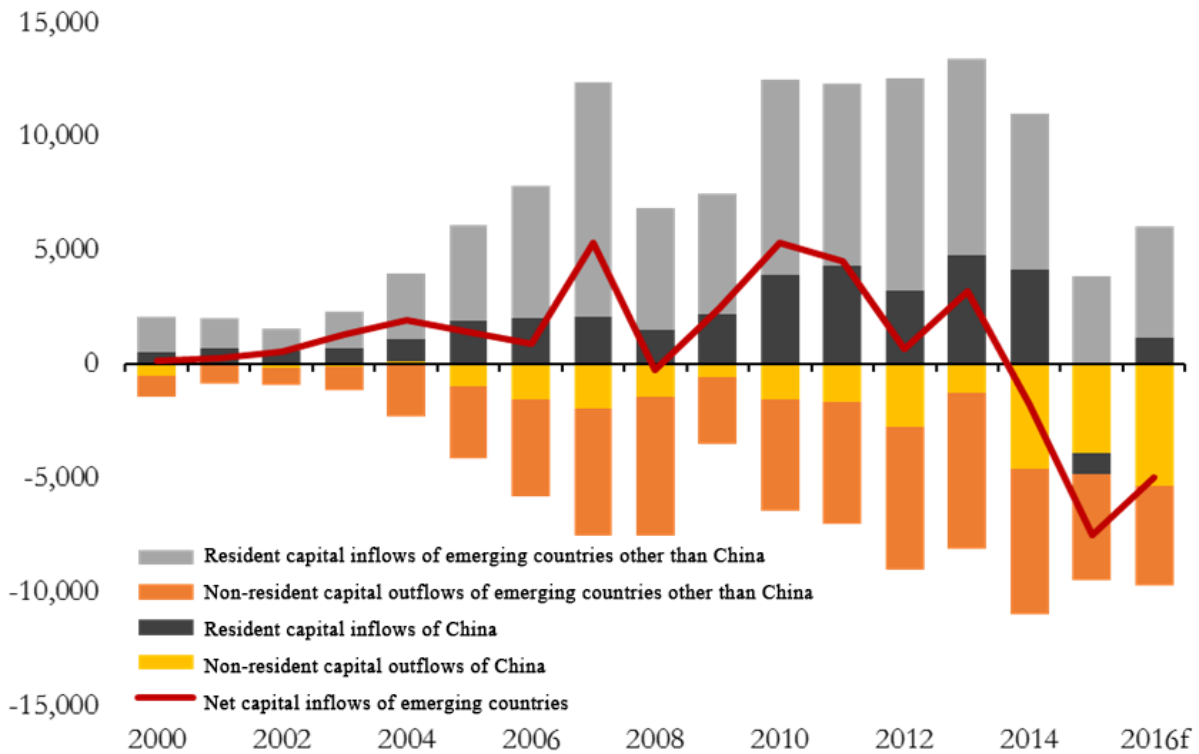
Overall, the joint effect of financial sector risk and external risk require further attention. Compared with 2015Q4, external risk profile remains stable, but the majority of countries are still in the low-risk and high-risk zones. The distribution of external vulnerability tends to be bipolarized. Besides, external risk may exert effect on financial sector risk, and the withdrawal of foreign capital and capital flight will cause wide debt service risks to financial institutions.

IV.2 New changes in capital flows of emerging markets

After emerging countries experienced more than a half year's capital flight, in early 2016, major developed countries continued to pursue a loose monetary policy, the exchange rate of RMB tended to stabilize, risk aversion sentiment in the market was gradually eased, and capital flowed to the undervalued emerging markets again. Emerging markets saw an asset price rebound and entered a critical stage of capital flow. However, the fundamental of emerging economies did not improve continuously. Some countries are taking policy measures in response to the global economic environment, while others are still endeavoring to accommodate to the difficult conditions, including falling commodity prices, long-term inclination from manufacturing to service trade, over-debt, slowing productivity growth, population aging and public opinion constraints on policy. In the long term, the net capital outflows from emerging markets will remain

enormous, but slightly slow down compared with the previous year. According to the IIF, the net capital outflows from emerging markets in 2016 will still reach USD500 billion, lower than USD750 billion in 2015 (Figure 19). The deceleration of net capital outflows is mainly attributed to the gradual increase in non-resident capital inflows, which are expected to rocket from USD240 billion in 2015 to USD560 billion in 2016.

Figure 19: Capital Flows of Emerging Countries (Unit: USD100 million)



Sources: IIF, BOC Institute of International Finance

Specifically, in terms of the structure of non-resident capital inflows of emerging countries, such an indicator dropped to USD1.2 billion in May 2016 following two months of robust performance, far lower than USD26.4 billion in March and USD17.3 billion in April. Investment security inflows in the form of both debts and equities remained weak. Regionally speaking, investment security inflows in Asian and Latin American emerging markets reached USD7.7 billion and USD1.1 billion respectively; to the contrary, investment security outflows in European and African emerging markets totaled USD7.6 billion. The anticipation for USD interest rate hike is the main reason for the decline in capital inflows of emerging markets. Moreover, the weak capital inflows of emerging markets exerted a negative influence on domestic economic growth and impaired the investment attractiveness of assets of emerging markets.

IV.3 Role of China in capital flows of emerging markets

Though it is impossible to realize an ideal capital flow in emerging markets, non-resident capital inflows will steadily increase while resident capital outflows will gradually slow down, so long as the global economic activities remain robust and reasonably ward off market risks. China’s performance will be vital to the smooth transition of capital flows of emerging countries.

Judging from the amount of capital flows, China's net capital flows account for half of the total net capital flows of emerging countries. Therefore, its capital flow performance is of great importance

to the overall movement of the capital flows of emerging markets. Since February 2016, China's net capital outflows have been remained reasonable. In May, its net capital outflows were relatively moderate at about USD27 billion, slightly lower than USD28.5 billion in April. From February to April, China's net capital outflows remained stable mainly due to the weakening of USD. The decline in net capital outflows from China in May mainly because RMB is valued with reference to the exchange rate of a basket of currencies published by CFETS while RMB depreciated against USD, and domestic economy and businesses boosted investors' confidence in RMB. In the future, China will continue to maintain a stable exchange rate of RMB and achieve its economic growth target for 2016. Meanwhile, due to the delay in repayment of foreign debts and gradual resumption of investment security inflows, China's non-resident capital inflows will revert to positive. Driven by policy, domestic economic activities that are carried out in order will gradually push forward the normalization of net capital outflows, thereby positively influencing the capital flows of the entire emerging markets.

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