

China's Economic and Financial Outlook

2016Q3 (Issue 27)

June 30, 2016

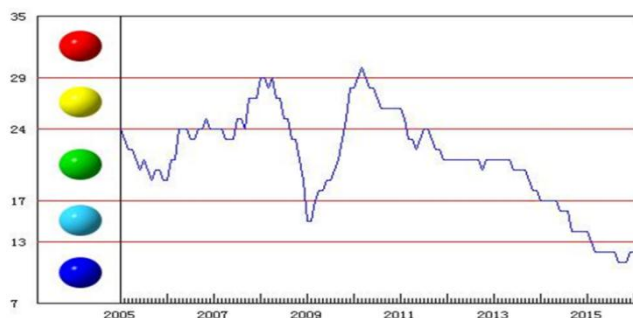
Highlights

● Under the effects of multiple factors such as the economic stabilization policy, a booming real estate market, and the government's efforts to streamline administration and devolve powers to units at lower levels, 2016H1 saw stable development of China's economy, improvement of enterprise performance and progress in China's reform efforts to address overcapacity, destock and deleverage. However, due to falling private investment and transitional challenges in the Northeast and other areas, China's economy still faced relatively large downward pressure. GDP was expected to grow by around 6.7% in Q2, basically the same as in the previous quarter.

● In 2016H2, due to many global economic uncertainties caused by the gloomy U.S. economic outlook and sluggish growth of world trade, the external environment for China's economy was not looking optimistic. With its weak domestic demand and growing financial risks, China's economy will have a difficult time rebounding in the short term. All factors considered, China's GDP growth in Q3 as well as the full-year growth are expected to be around 6.7%.

● Since China's economy is still facing relatively large downward pressure, stabilization policies cannot be eased in the short term. China needs to implement more effective policy measures to expand aggregate demand, raise real growth towards the potential, ease downward pressure and create opportunities for structural reforms and development of new growth engines. In the short term, the basic direction will continue to be fiscal easing and monetary stabilization and the reform efforts to address overcapacity, destock and deleverage need to be coordinated. In the mid to long term, China should speed up restructuring, conduct supply-side reforms and foster new growth engines to lay a solid foundation for sustained economic growth.

China's Macroeconomic Early Warning Index



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Steady Growth is a Prerequisite for Promoting Structural Reforms

----China's Economic and Financial Outlook (2016Q3)

Under the effects of multiple factors such as the economic stabilization policy, a booming real estate market, and the government's efforts to streamline administration and devolve powers to units at lower levels, 2016H1 saw stable development of China's economy, improvement of enterprise performance and new progress in China's reform efforts to address overcapacity, destock and deleverage. However, due to falling private investment and transitional challenges in the Northeast and other areas, China's economy still faced relatively large downward pressure. GDP in Q2 was expected to grow by around 6.7%, the same as in the previous quarter. But after entering 2016Q2, because of many global economic uncertainties caused by gloomy U.S. economic outlook and sluggish growth of world trade, the external environment for China's economy was not looking optimistic. With weak domestic demand and growing financial risks, it will be difficult for China's economy to rebound in the short term. All factors considered, China's GDP growth in Q3 as well as the full-year growth are expected to be around 6.7%. Since China's economy is still facing relatively large downward pressure, stabilization policies cannot be eased in the short term. China needs to implement more effective policy measures to expand aggregate demand, raise the real growth towards the potential, ease downward pressure and create opportunities for structural reforms and development of new growth engines. In the short term, the overall direction will continue to be fiscal easing and monetary stabilization, and the reform efforts to address overcapacity, destock and deleverage need to be coordinated. In the mid to long term, China should speed up restructuring, conduct supply-side reforms and foster new growth engines to lay a reinforced foundation for sustained economic growth.

I. Economic Review and Outlook

I.1 Operational characteristics of economy in 2016H1

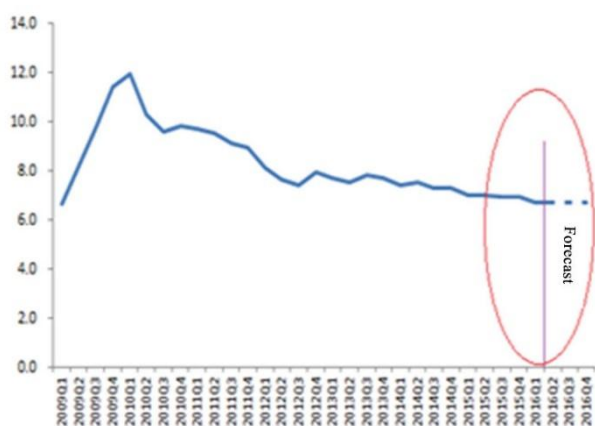
In 2016H1, thanks to steady growth promoting policies, China's economy was a stable growth path. Some economic indicators outperformed expectation, but endogenous drivers were still weak and the foundation for economic stabilization remained fragile. Special attention should be paid to the slump in private investment, reform challenges in Northeast China and elsewhere, the rocketing house prices and other issues.

I.1.1 Steady growth thanks to supporting policies

In 2016Q1, China's GDP grew by 6.7%, largely thanks to the government's supporting policies (Figure 1). Last year, especially during the first half, we witnessed a bullish stock market, which caused the financial industry to be the most important economic driver. However, in 2016H1, the rebound in the real estate market contributed the most to economic growth^①, which was partly thanks to relevant policies. According to our calculations, if the investment in infrastructure and real estate maintains the annual growth rate of last year, the GDP growth rate may decline by 0.6 percentage points in the first quarter. If the impact of infrastructure and real estate on the upstream and downstream industries is taken in to account, the drop in the growth rate might be bigger. Without the policies promoting steady growth or high investment growth in infrastructure and real estate, it would have been difficult for China to achieve a GDP growth rate of 6.7% in 2016Q1 and the economic indicators would have been as impressive in April and May. In this sense, without the

^① China's economy grew by 6.7% in 2016Q1, with 8.6% contribution from the real estate industry, which was the highest since 2008. As compared to 2015Q4, China's GDP grew by 1.1% in 2016Q1, with the real estate and financial industries, the largest two contributors, contributing 9.1% and 8.1%, respectively.

help of the policies in driving the economy, the 6.7% growth would have been difficult to achieve. Since Q2, investment, consumption and exports have been declining, causing downward pressure to be exerted onto the economy, but steadily increasing industrial production and improved corporate performances have curbed the downward pressure. Based on the macroeconomic early warning index of the Institute (Figure 2), we believe that GDP might continue to grow by 6.7% as with in the first quarter while the number of quarterly fluctuations will significantly decrease, indicating increased economic stability.

Figure 1: Quarterly Growth in China's GDP

Figure 2: China's Macroeconomic Early Warning Index


Sources: Wind, BOC Institute of International Finance

I.1.2 New progress in economic restructuring, with consumption further driving economic growth

Consumption growth held steady while new types of business and new products maintained high growth. The total retail sales of consumer goods grew by 10.2% in the first five months, merely 0.2 percentage points lower than in the same period last year. Looking at the monthly numbers, we see that the growth rates in April and May were 0.2 and 0.3 percentage points respectively, lower than the first quarter's (Figure 3). If we take the price factor out of the picture, the consumption in Q2 basically grew at the same pace as in Q1. Some highlights related to consumption in 2016H1 included: **(1) There was a divergence in the consumption growth in the housing market.** With strengthened regulation of real estate in some cities, the real estate market cooled off which had an impact on the housing consumption market. Sales growth in household appliances & audiovisual equipment (15.1% year on year), and furniture (0.7% year on year) slowed down in May, with 7 and 1.4 percentage points lower than in the previous four months respectively, while the growth of sales in construction and decoration materials (16.8% year on year) sped up and was 1.1 percentage points higher than the previous four months (Figure 4). **(2) Growth in automotive oil consumption declined.** Affected by the introduction of the new standard, known as "China 5," which sets the sulfur content for gasoline at no more than 10 parts per million in 11 eastern provinces in April and other factors, the growth in car sales slowed down. In the first five months of 2016, the retail sales of automotive consumer goods with units above designated size grew by 7.3% year on year, 0.4 percentage points lower than the first quarter. While, automotive oil consumption growth, affected by lower gasoline prices and other factors, turned from positive to negative, with accelerated drop in growth. In the first five months, the retail sales of petroleum and petroleum products fell by 4.5% year on year with a growth rate 4.8 percentage points lower than in the first quarter. **(3) New types of business and new products**

maintained high growth. New types of consumption, including online shopping, continued their rapid growth and the proportion of online retail sales to total consumption increased further. In the first five months of 2016, the online retail sales of physical goods accounted for 11% of the total retail sales of consumer goods, and the online retail sales of goods and services grew by 27.7% over the same period last year, 0.1 percentage point lower than in the first quarter. Thanks to advancements in battery and charging technology, the introduction of new models and improvement of charging facilities, 126,000 new energy vehicles were sold in the first five months, increasing by 134.1% over the same period last year.

Figure 3: Growth in the Retail Sales of Consumer Goods

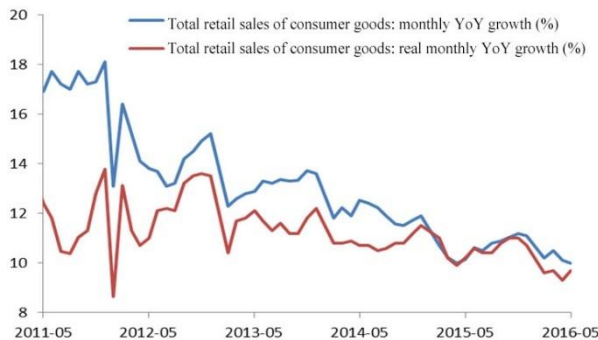
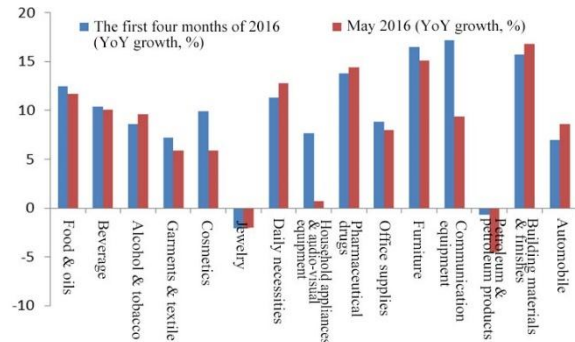


Figure 4: Growth in the Retail Sales of Units above Designated Size by Type



Sources: Wind, BOC Institute of International Finance

Investment growth slowed down and private investment almost flat-lined. In the first five months of 2016, fixed asset investment grew by 9.6% over the same period last year, 0.4 percentage points lower than in the first quarter. The growth in private investment slowed even more obviously in recent months, directly adding to the downward pressure on the economy. To be more specific, the investment slowdown was reflected in the following aspects: **(1) Investment growth in primary, secondary and tertiary industries all decelerated.** The slowdown in investment growth in the secondary industry resulted in a 0.6 percentage point drop in the overall investment growth rate, while the drop rate of tertiary industries led to a nearly 0.3 percentage point drop in the overall investment growth (Figure 5). As traditional industries and industries with overcapacity are at a crucial point in their efforts to reduce capacity, the opportunities and driving forces for investment have significantly declined, leading to a continual drop in investment growth in the manufacturing industry. In the first five months of 2016, investment in manufacturing merely increased by 4.6%, 1.8 percentage points lower than in the first quarter (Figure 5). Based on past experiences, as the problem of overcapacity is being resolved, investment growth in manufacturing is likely to decline further. **(2) Investment in some areas dropped significantly.** As economic transitions and restructuring were accelerated, investment growth in Eastern China sped up slightly. In the first five months of 2016, investment growth in Eastern China increased by 10.9%, 0.1 percentage points higher than in the previous four months. Investment growth in Central China and Western China slowed down but was still quite high, at 13% and 12.6% in the first five months respectively. Both rates were higher than the investment growth in Eastern China. However, in Northeast China which faced difficult economic restructuring challenges (as reflected in the substantial reduction of investment), which caused investment to drop by 30% in the first five months of 2016. The drop was 11.7 percentage points higher than in the first quarter (Figure 6). **(3) Private investment growth eased markedly.** Affected by the lack of effective demand, the reduction of excess capacity, poor profit prospects and other factors, private investment growth further slumped. The growth rate of private investment was significantly lower than the total

investment and the proportion of private investment to total investment further dropped. In the first five months of 2016, private investment increased by only 3.9%, 6.2 and 1.8 percentage points lower than the previous year and 2016Q1 respectively, while the total investment was only 0.4 and 1.1 percentage points lower than last year and 2016Q1 respectively (see Part V).

Figure 5: Investment Growth in Primary, Secondary and Tertiary Industries

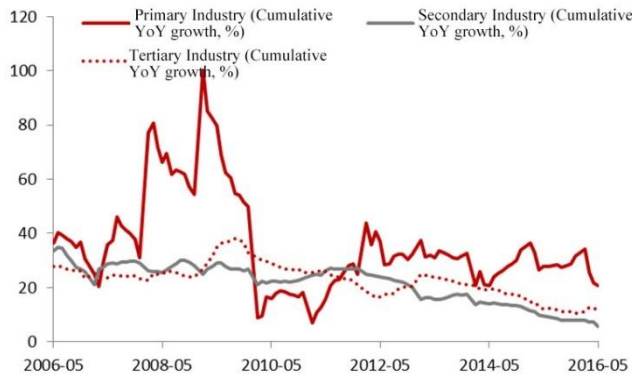
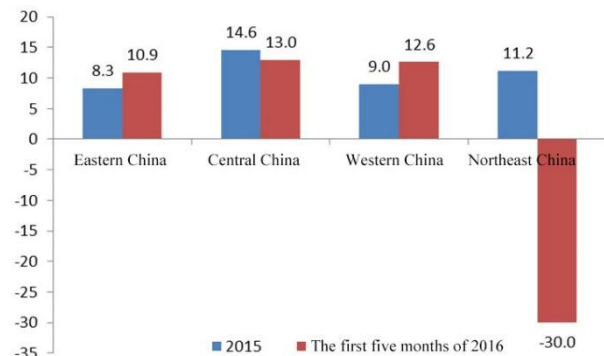


Figure 6: Investment Growth by Region



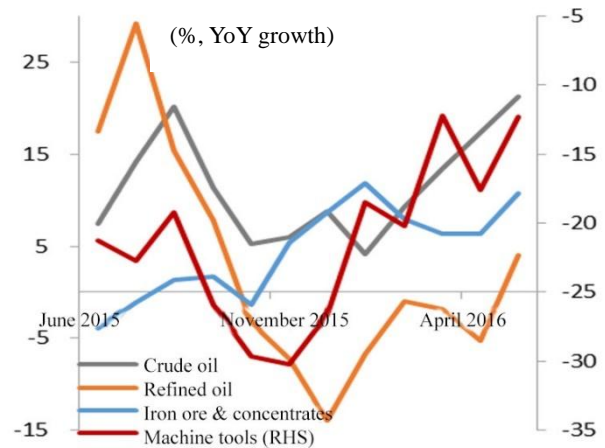
Sources: Wind, BOC Institute of International Finance

Exports were dragged down by sluggish external demand while imports were boosted by an increase in domestic demand. In the first five months of 2016, total exports fell by 7.3% cumulatively and the decline was 2.3 and 4.4 percentage points smaller than in the first quarter and last year respectively. Imports fell by 10.3% and the drop was 3.1 and 4 percentage points smaller than the first quarter and last year respectively. Influenced by a downturn in external demand, export growth although higher than the first quarter was still lower than in the same period last year. Global manufacturing PMI edged down from expansion (50.1) in April to contraction (50) in May. Manufacturing PMI in the U.S., Eurozone, Japan and emerging markets dropped by 0.1, 0.2, 0.5 and 0.6, respectively, from the previous month, reflecting weak external demand. An increase in imports was reflected markedly in the increase in import volume of some commodities with the price factor excluded, partly thanks to recent robust industrial production and infrastructure investment. Recently, stable industrial production and accelerated infrastructure investment have given a strong impetus to the imports of relevant goods. In the first five months of 2016, crude oil, refined oil and iron ore imports grew by 16.5%, 4.6% and 9% respectively. Their growth rates were 3.1, 6.5 and 2.6 percentage points higher than the first quarter respectively and are significantly higher than the full-year growth rate in 2015 (8.8%, -0.1% and 2.2% respectively).

Figure 7: Divergence between Imports and Exports



Figure 8: Continual Rise in the Imports of Main Goods

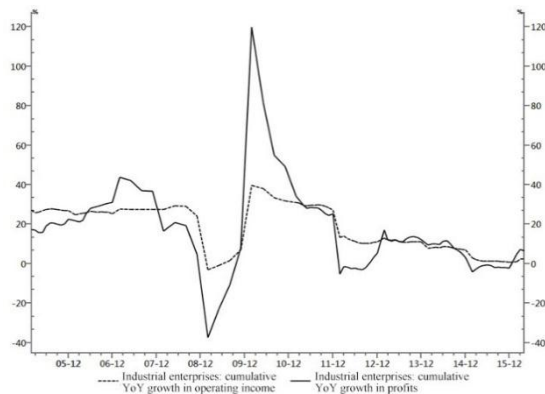
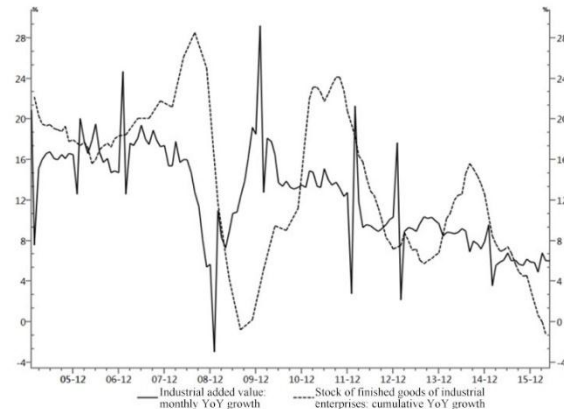


Sources: Wind, BOC Institute of International Finance

I.1.3 Accelerated efforts to tackle overcapacity in some industries, leading to significantly improved corporate performance

Influenced by stimulus policies, a rapid growth in infrastructure and in real estate investment, a narrowed decline in PPI and other factors, industrial production has been relatively stable so far this year. In the first five months of 2016, the total value added of the industrial enterprises above designated size increased by 5.9%, 0.3 and 0.2 percentage points lower than the growth rate in the same period last year and the full-year growth rate of last year respectively, but 0.1 percentage points higher than in the first quarter. The value added of secondary industry in the second quarter is expected to grow by around 6%. **With the increased speed at which the overcapacity is being tackled and the rebound in prices of energy and raw materials, capacity utilization in some industries went up.** By June 17, the capacity utilization rate of the float glass industry was 73.1%, 2.7 percentage points higher than in the beginning of the year. The operating rates of blast furnace, float glass and coke enterprises were 75%, 67% and 77% respectively on June 17, up 1, 3.2 and 8 percentage points from the beginning of the year's.

In connection with this was **the improvement in the performance of industrial enterprises.** Firstly, corporate profits continued to demonstrate strong growth momentum since the beginning of the year. Corporate profits in January-April increased by 6.5% over the same period last year (Figure 9) and the growth rate reached 11.1% in March. However, with the slowdown in demand and non-prime operating revenue, the growth rate in corporate profits dropped slightly in April. Secondly, the destocking process picked up the pace. In April, the stock of finished goods was RMB3.66 trillion cumulatively, RMB210 billion lower than the end of last year and representing a 1.2% decrease from the same period last year (Figure 10). It was the first negative growth since August 2009, and the growth rate dropped by 8.3 percentage points from the same period last year.

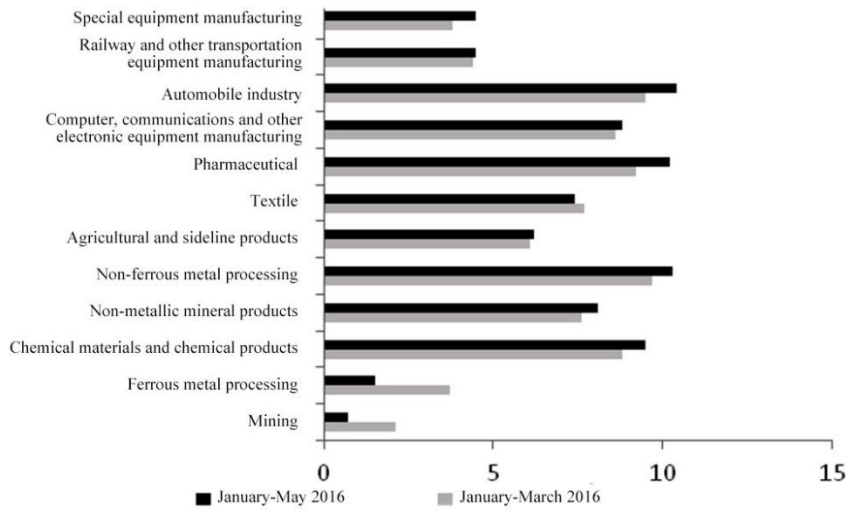
Figure 9: Growth in Prime Operating Revenue and Profits**Figure 10: Growth in Industrial Value Added and Stock of Finished Goods**

Sources: Wind, BOC Institute of International Finance

There was a clear divergence between different industries. The growth in value added of mining and ferrous metals industries was slowing down. The growth rates of the two industries from January to May were 0.7% and 1.5% respectively, lower than in the previous quarter and in the same period last year. Heavy industries such as chemical materials and chemical products, non-metallic mineral products and non-ferrous metal processing industries quickly rebounded. The growth rates of the aforementioned from January to May were 9.5%, 8.1% and 10.3% respectively, higher than in the first quarter. The growth rates of some heavy industries from January to May even outpaced last year's rates. Among the light industries, the growth of the agricultural and sideline products processing industry picked up the pace and was 6.2% from January to May, higher than in the previous quarter or in the same period last year. The growth rate of the textile industry (7.4% from January to May), although slightly lower than in the first quarter, was higher than in the same period last year. The growth of the pharmaceutical, computer & communications, instrumentation, other high-tech manufacturing industries, automotive, transportation equipment, and special equipment manufacturing industries was also higher than in the first quarter (Figure 11).

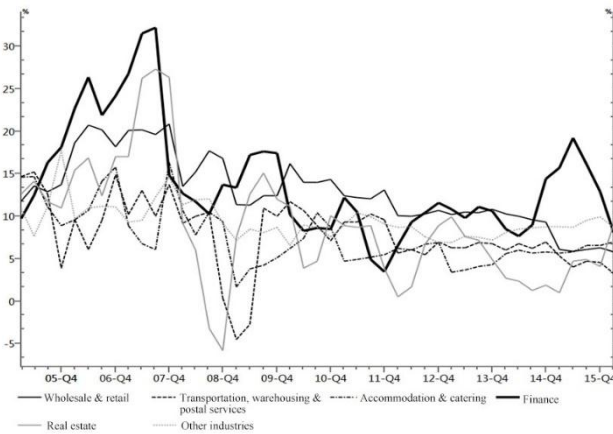
The growth in value added of service industries slowed down. In Q1, service industries grew by 7.6%, 0.4 percentage points lower than in the same period last year. The key service industries, affected by the stock market downturn, had their growth rate drop to 8.1% in the first quarter, 7.6 percentage points lower than in the same period last year. Due to the high average daily turnover rate in the stock market in 2015Q2, which was up to 1.5 trillion per day on average, the growth in the financial industry in 2016Q2 was expected to be lower than in the same period last year. From January to May, the growth in sales of food and beverages, and the retail sales of commodities edged downward when compared with last year's numbers. The growth of the wholesale, retail, accommodation, and catering industries in the second quarter have dropped slightly. Due to the rebound of the real estate market, the growth of the real estate industry increased to 9.1% in Q1, 8.1 percentage points higher than in the same period last year. In Q2, the sales and sales area of real estate still maintained a rapid growth, at 33.2% and 50.7% respectively in January-May. The growth in value added of the real estate industry is expected to continue to rise in Q2. All factors considered, the growth of service industries in Q2 is expected to be at around 7.5%, slightly, slower than Q1.

Figure 11: Growth in Value Added of Main Secondary Industries in Q1 and January-May (%)



Sources: Wind, BOC Institute of International Finance

Figure 12: Growth in Value Added of Service Industries (%)



Sources: Wind, BOC Institute of International Finance

I.1.4 Relatively stable consumer prices with the PPI drop narrowing on a month-on-month basis

From January to May 2016, China's consumer price index (CPI) rose by 2.1% cumulatively. The increase was 0.8 percentage points higher than the same period last year. To be more specific, between 2-3%, except for in January. In May, China's CPI was 2% higher than when compared to the same period of last year's numbers. The increase was 0.3 percentage points lower than the previous month, mainly due to the marked drop in food prices. In relation to prices, there are three themes: **First, the prices of fresh vegetables fell sharply.** As days got warmer, the supply of fresh vegetables increased, leading to a 16.3% drop in the growth of prices (6.4%) from April (22.7%). The decrease contributed to an approximate 0.14% drop in the CPI growth, in contrast to the 0.56% drop in April. **Second, pork prices remained high while beef and mutton prices were basically stable.** In May, the prices of pork rose by 33.6%, little change from the previous month. The rise in pork prices contributed to a 0.77% growth in the CPI. Beef prices rose by 0.5%. The growth was 0.1 percentage points higher than in the previous month. Mutton prices fell 5.1%, 1.7 percentage points lower than in the previous month. **Third, service prices rose steadily.** The CPI of family services rose by 2.1% in May, and the rise was 0.1 percentage points higher than in April.

The price of family services, educational services, health care and other services, except for communication services, rose by 4.2%, 2.3%, 3.2% and 2.2% respectively, over the same period last year and the rise increased by 0.3, 0.2, 0.2 and 0.5 percentage points, respectively over the previous month. In contrast to the slowdown of the CPI growth, the growth in service prices was increasing, showing the reality that China's economy was entering into a new phase, including the decrease in migration from rural areas, and the population aging problem leads to diminishing demographic dividends and rising labor costs.

Figure 13: CPI Growth Driven Down by Food Prices

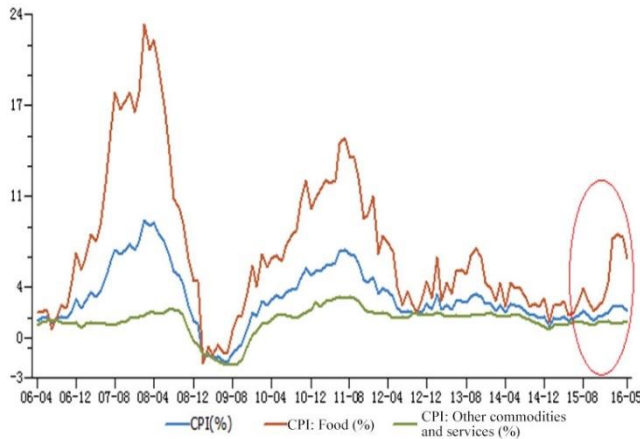
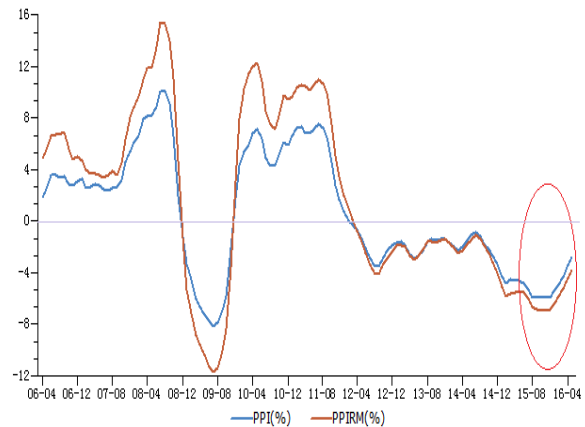


Figure 14: Decrease in the Monthly Decline of the PPI



The price decline in the mining industry is significantly slowing and a positive PPI could be expected. In May, the Producer Price Index (PPI) fell by 2.8% year on year and the decline was down 0.6 percentage points from last month's, mostly because of the sharp drop in the price decline of production factors (0.8 percentage points) caused by the recent rise marked prices in the mining industry. In May, the prices of the mining industry fell by 9.6% over the same period last year and the year-on-year decline narrowed by 3.4 percentage points from April. Compared to April, the prices rose by 3.8% in May and the rise was 0.9 percentage points higher than in April. The monthly price increase in the mining industry has been positive for 3 consecutive months. With a modest rebound in the prices of crude oil, steel, coal and other commodities and the monthly increase from the carryover effect from last year, the PPI decline is expected to slow in the coming months and some months it might even register as a positive growth, thereby ending the long-lasting downward spiral of more than 50 months. A positive PPI growth will help improve corporate performance, improve market confidence, reduce overcapacity and thus have a positive impact on the steady growth.

In short, influenced by the increase in infrastructure investment, the rebound in the real estate market, the government's efforts to streamline administration and devolve powers to units to lower levels and other factors, 2016H1 saw a steady economic growth, improvement of enterprise performance and new progress in China's reform efforts to address overcapacity, destock and deleverage. However, due to falling private investment and transitional challenges in the Northeast and other areas, China's economy still faced relatively large downward pressure. According to our preliminary estimates, China's GDP in Q2 is expected to grow by around 6.7% and this growth was approximately 0.3 percentage points lower than in the same period last year, with little change from Q1.

I.2 Forecast for 2016H2

Heading into the second half of the year, influenced by the gloomy U.S. economic outlook, sluggish growth of world trade, turmoil in global financial markets and other factors, China's economy is facing many uncertainties from external environment. With its weak domestic demand, while attempting to attack overcapacity and the deleveraging process at a faster rate, while having difficulty driving up its main economic indicators and bearing great financial risks, China's economy will have a difficult time rebounding in the short run. Meanwhile, we also see a large increase in the number of new projects, a rapid growth in infrastructure investment, acceleration of the destocking process, rapid growth of the real estate stock market, emerging industries, new types of consumption, and faster economic restructuring process. All factors considered, China's GDP growth in Q3 as well as its full-year growth are expected to be around 6.7%.

I.2.1 Growing difficulty for hiking up consumption growth

First, income growth is expected to slow significantly in the near term. In Q1, China's per capita disposable income grew by 6.5% and the growth rate was down 0.9 percentage points from last year's, higher than the GDP growth rate over the same period. Second, according to the survey of urban bank depositors, conducted by the central bank, residents are not optimistic about future employment opportunities and their personal income. The lack of confidence is not conducive to increases in consumption. In Q1, indices of urban residents' confidence in employment and income were 44.8% and 48.4%, down 0.5 and 0.7 percentage points respectively from 2015Q4. Third, consumer confidence and willingness to spend fell. The consumer confidence index in April was 101, one of the lowest points since 2014. On top of that, the central bank survey also reflected a decline in residents' willingness to spend, especially on expensive items such as houses and cars. Given all of the above factors, consumption growth is expected to remain stable. It will be difficult for China to accelerate any growths in consumption.

I.2.2 Great challenges in ramping up investment

First, overcapacity may cause the growth in investment in manufacturing to continue to plunge and the rapid growth in real estate investment to be difficult to maintain. Second, a near-term rebound of private investment will be unlikely. Influenced by high costs, poor profit outlook and other factors, the enthusiasm to invest in the private sector is not high. It is also very difficult to boost private investment in the short term. It takes time for stimulus policies to produce desirable results. Third, rapid investment growth depends on the schedule of projects and availability of funds. Planned investment in new projects climbed by 32.2% year on year in the first five months of 2016 and the growth rate was down 7.3 percentage points from the first quarter's. In terms of financing, financing in place in the first five months rose by 7.9% year on year and the growth rate was 1.5 percentage points higher than the first quarter's. The growth in financing eased financial tensions. Overall, we forecast a small drop in investment growth in Q3.

I.2.3 Possible near-term obstacles in foreign trade

On one hand, the number of mid & long-term positive factors in relation to structural optimization, external environment and internal policies is increasing. In the first five months of 2016, the growth in general exports was 10.3 percentage points higher than processing exports, and the proportion of general exports in total exports rose to 56%, reaching the highest level ever recorded in the first five months of a year. It reflected a continual increase in endogenous drivers and value added of China's exports. In terms of the international environment, analysis of the Fed's June meeting revealed a slowdown in its rate spikes and decreased uncertainty. Exchange rates and international trade demand may provide favorable conditions for the stabilization of China's foreign trade. In terms of domestic policies, *the 14 Opinions to Promote Stabilization and Recovery*

of Foreign Trade issued by the State Council in May this year and several other policies introduced earlier will play an important role in boosting foreign trade. On the other hand, exports will still face great pressures from external demand in the near term. Global manufacturing PMI (new export orders) plunged to 48.9 in May. It was one of the steepest plunges during the past three years. The leading indicators for China's exports failed to maintain their upward trend lasting over the past two months and fell in May. Overall, the third quarter will be rocky for China's foreign trade.

I.2.4 Weak foundation for secondary industries to rebound, continual fast growth in tertiary industries

We see a weak foundation for the secondary industries to rebound because its ability is mainly restricted by the following three factors: First, domestic and external demand will remain weak. The gloomy outlook for manufacturing and private investment is unlikely to turn around in the near term. External demand remains relatively subdued as indicated by the negative PPI growth (-4.1% in January-May). Second, the real estate market will cool off. First-tier cities and some second-tier cities with rapidly growing real estate markets will further tighten market regulations. With the high base in the second half of last year, we forecast a decline in the growth of sales and sales area of real estate in Q3. Whether real estate investment can maintain its upward trend is also uncertain. Third, as overcapacity is further reduced, the growth in value added of mining, ferrous metal processing and other industries will further plummet. Of course, we should also look at the bright side: First, infrastructure investment will maintain its rapid growth, which will provide strong support for industrial production, and the rebound of the real estate market will also continue to drive industrial production. Second, enterprises will speed up the destocking process, which can help enterprises create capacity and increase production in the future. Third, the decline in prices of industrial products is expected to further slow down, and tax cuts and cost reduction measures will gradually produce their desired results of helping enterprises maintain stable profits. Heavy industries (including non-metallic mineral products) and the equipment manufacturing industry rebounded in Q2 and the momentum is likely to continue in Q3. In the meantime, the growth of emerging industries will continue to speed up. High-tech industries and high-end equipment manufacturing industries will maintain a rapid growth under the support of relevant policies. Overall, the transition and upgrading of traditional industries and development of emerging industries will take time, while policies promoting steady growth will have to continue to play its key role in stabilizing industrial production. The growth in value added of secondary industries is expected to be around 6% in Q3, at par with Q2.

Among key consumer service industries, as consumption remains generally stable, traditional service industries such as wholesale, retail, accommodation and catering will maintain a steady growth. According to some leading indicators, real estate investment grew by a high rate of 7% in May. Construction area of new housing projects increased by 18.3% year on year and the decline in land acquisition area edged down to 5.9%, indicating rapid growth in the real estate industry. However, taking into account the high base last year and the cooling down of the real estate market, the growth in the real estate industry is expected to decline slightly in Q3 compared to Q2.

The producer service industries that are influenced by the weak real economy and industrial growth are the transportation, warehousing and the postal industries, have growth rates that are edging downwards. In Q1, the growth in transportation, warehousing and postal services was 3.3%, down 2 percentage points from the same period last year. It is unlikely for secondary industries to rebound markedly in Q3. We forecast a further drop in the growth rate of transportation, warehousing and postal industries. Affected by the low trading volume in the stock market, rising financial risks and other factors, also taking into account the smaller base of last year, the growth in the financial industry is likely to be flat in Q3 from Q2.

Culture, tourism, information, rental and business services, logistics and other key industries supported by the government will maintain rapid growth. Based on the above analysis, the growth in the tertiary industries is expected to be around 7.5% in Q3, flat from Q2. Its growth rate will be still higher than the secondary industry's.

II.1 Financial Review of 2016H1

II.1.1 Growth in money supply and social financing slowed down

The growth rate of broad money (M2) declined and M1 and M2 growth diverged. At the end of May 2016, the growth rate of M1 reached 23.7%, the highest level since June 2010. The growth rate of M2 slowed to 11.8%, down 1.6 percentage points from the end of March, also lower than the 13% growth target set at the beginning of the year. The growth rate of M1 was higher than that of M2. This situation had only occurred twice previously, once between September 1999 and March 2001 and once between August 2006 and February 2008 (Figure 15). At the first time that this occurred (September 1999 - March 2001), the divergence of M1 and M2 growth was related to overcapacity and price deflation. At the second time that this happened, it was largely related to price overheating and serious inflation. In 2007 and 2008, the growth rate of China's CPI was 4.8% and 5.9%, respectively.

Currently, the main reasons for the divergence of M1 and M2 growth and the decline in the growth rate of M2 are as follows: First, the overall monetary policy stance was changed from “prudent with a slight easing bias” in Q1 to “prudent with a slight tightening bias”. The central bank eased liquidity strains mainly by using tools such as medium-term lending facility (MLF) and pledged supplementary lending (PSL) without RRR cut. Second, the acceleration of the local government debt swap program led to a drop in the growth of loans, which in turn affected the ability to create money. Between April 1 and June 17, local governments issued a total of approximately RMB2.23 trillion bonds, up RMB1.28 trillion from Q1. Third, a lot of money was wasted on overcapacity, as reflected in the drop in M2 despite the increase in the monetary base (especially M1), similar to the situation in 1999.

Figure 15: Divergence between M1 and M2 Growth

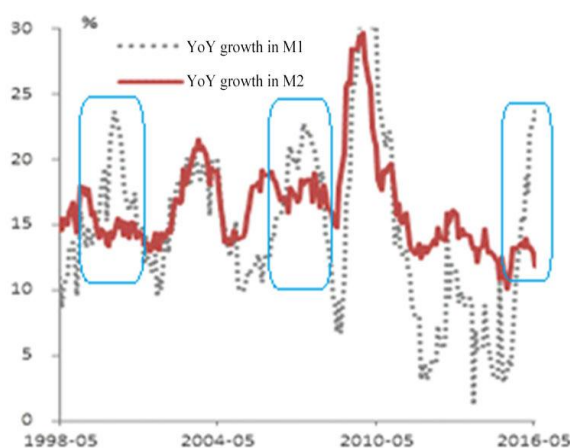
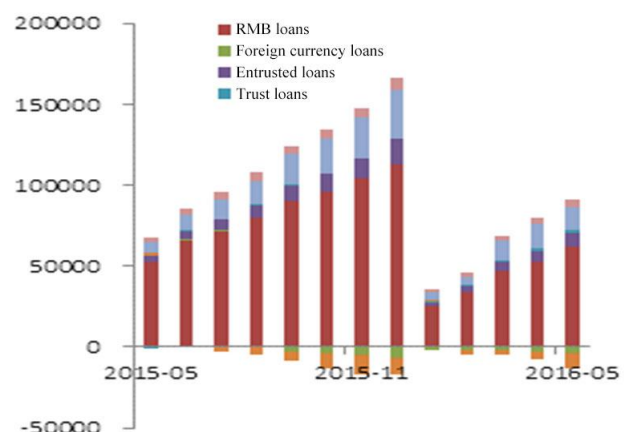


Figure 16: Stable Growth in Social Financing



Sources: Wind, BOC Institute of International Finance

The growth in social financing as well as its growth rate dropped. In the first five months of 2016, social financing grew by RMB8.1 trillion, up RMB1.16 trillion from the same period last year (Figure 16). In Q1, social financing increased rapidly by RMB2.2 trillion monthly on average,

significantly higher than the average monthly increase of RMB1.1 trillion in 2015Q4. Heading into Q2, social financing grew by RMB705.5 billion per month on average (in April and May), substantially slower than Q1, mainly due to the following reasons: First, the financing demand of the real economy was in the doldrums. At the end of May, the growth rate of investment, consumption and export showed a downward trend compared to Q1. Second, with the increase in default risk and the tightening of regulations on bill business, corporate bonds and bill financing decreased rapidly. In May, the monthly growth in corporate bond financing was RMB249.3 billion lower than April, which was the second net monthly decrease since 1998. Undiscounted bankers' acceptances decreased by RMB506.6 billion, down RMB228.8 billion from April. Third, the issuance of municipal bonds accelerated, offsetting the increase in social financing. The plunge in the increase of social financing led to a decline in social financing. At the end of May, social financing rose by 12.6 percent year on year, marking the second time that both the growth rate of social financing and the growth rate of M2 declined since March 2015.

An important reason behind the steady growth in RMB loans was the rapid growth in housing loans. Despite the slowdown in the growth of broad money supply and social financing, RMB loan maintain rapid growth. In the first five months, RMB loans grew by RMB6.17 trillion, up RMB904.7 billion from the same period last year, accounting for 76.1% of the social financing. The themes related to the growth in RMB loans were as follows: **First**, medium and long-term loans grew steadily. In the first five months of 2016, the balance of medium and long-term loans was RMB56.77 trillion, accounting for 56.7% of the balance of RMB loans, up 0.2 percentage points compared to the end of March. **Second**, residential mortgage was an important reason behind the rapid growth in medium and long-term loans. In May, medium and long-term loans (mainly mortgages) in the household sector contributed to 53.6% of loan growth in the month, up 21.5 percentage points compared to March. This ratio was close to the record level, making medium and long-term loans one of the largest contributors to the rapid growth in RMB loans. **Third**, growth in loans to non-financial corporations was weak. In May, loans to non-financial corporations contributed to 36.5% of loan growth in the month, down 12.4 percentage points from March, hitting a historic low. **Fourth**, under the pressure of RMB depreciation expectation, foreign currency loans continued to plunge. At the end of May, the balance of foreign currency loans fell by 15.2% year on year and the fall was 3.6 percentage points larger than the end of March.

II.1.2 Interest rates in the money market remained low and its volatility further decreased

Heading into April, as the influence of MPA (Macro-Prudential Assessment) at the end of the first quarter and other factors diminished, inter-bank interest rates were stable at low levels since Q1. The overnight SHIBOR remained stable at around 2% and the loan prime rate (LPR) was stable at 4.3%. In the meanwhile, interest rate fluctuations further decreased. From the beginning of April to June 15, the standard deviation of overnight SHIBOR and 7-day SHIBOR was 0.014 and 0.019 respectively, down 0.032 and 0.028 respectively from the first quarter. Specifically, the money market showed the following characteristics: **First**, the market was yet to respond to relevant policies and liquidity remained vulnerable to the effects of external shocks. In late April, the final settlement and payment of corporate income tax, the deadline for satisfaction of reserve requirements, the promotion of MPA and other factors resulted in tight liquidity in the short term. **Second**, beforehand liquidity injections improved market expectations. After Q2, the central bank cleverly used tools such as open market operations and MLF to inject liquidity beforehand and effectively reduce fluctuations of money. **Third**, the central bank adjusted the reserve requirement to decrease the volatility in the money market. On June 3, the central bank decided to change reserve requirement rules, and that is, the amount of deposits that banks must set aside as reserves will be regulated on an average basis, as opposed to an amount on a specified point of time. The change was effective from June 15 and will help commercial banks reduce the risk of an abrupt

tightening in liquidity at the end of each quarter and each year.

Figure 17: Trends of Overnight and 7-Day SHIBOR

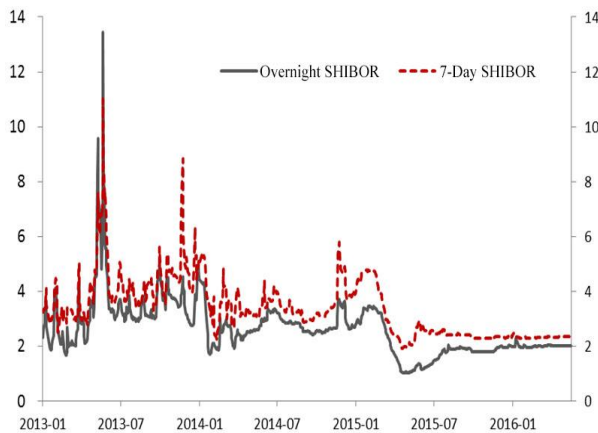
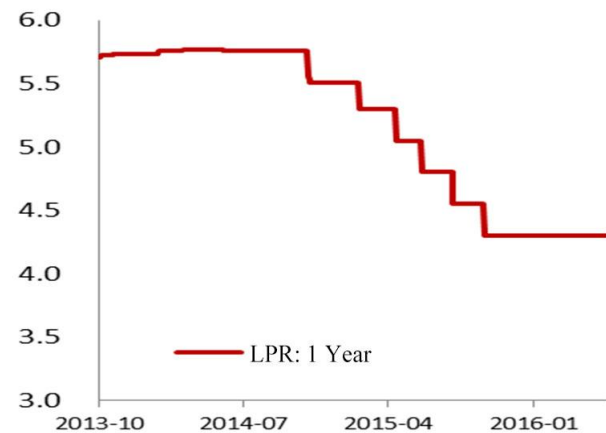


Figure 18: Trend of LPR



Sources: Wind, BOC Institute of International Finance

II.1.3 Turmoil in the bond market intensified with a slight increase in interest rates

In the context of accelerated opening of the bond market and the local government debt swap program, 2016H1 saw continual growth in bond issuance and the restarting of the non-performing asset (NPA) securitization program. However, influenced by companies' poor ability to generate profit, rising risk aversion and other factors, the bond market also underwent increased volatility, rising defaults and rising rate of return, among others. **First**, bond supply went up and the non-performing asset (NPA) securitization program was restarted. The total amount of bonds issued in January-May was RMB7.9 trillion, up 95% year on year. The growth in local government bonds was the most significant. And municipal bonds issued in April and May reached RMB1.59 trillion, up 66.6% compared to Q1. On May 26, Bank of China and China Merchants Bank have issued RMB300 million and RMB230 million, respectively, of bonds backed by NPAs, indicating the restarting of the NPA securitization program after it was halted for one decade. **Second**, the bond market was volatile with high prices. Heading into April, the volatility in the bond market significantly increased. The fluctuating upward trend of China Bond Index turned to a fluctuating downward trend. As of June 16, the value of China Bond Index was 169.34 points, down 0.25 points compared with the end of March, ending the upward trend starting from 2014. **Third**, bond rates demonstrated a stable rise, with rates of bonds with maturities of less than one year were moving up rapidly. Influenced by factors such as the neutral stance with a slight tightening bias in monetary policy, the yields of government bonds with different maturities went up in Q2 and rates of bonds with maturities of less than one year moved upward at a much faster speed. On June 16, 2016, 1-year bond yields closed at 2.4006%, up about 31 basis points compared to the end of March, while 10-year bond yields rose by 10 basis points. **Fourth**, bond defaults continued to rise. As of June 16, 2016, 19 issuers have defaulted. The total amount of bonds (39 bonds) in default was RMB23.7 billion, up 99% compared to the amount of bonds in default in 2015. Issuers which have defaulted include not only private enterprises but also state-owned enterprises. Defaults occurred not only in industries with overcapacity but also some emerging industries.

Figure 19: Changes in China Bond Index

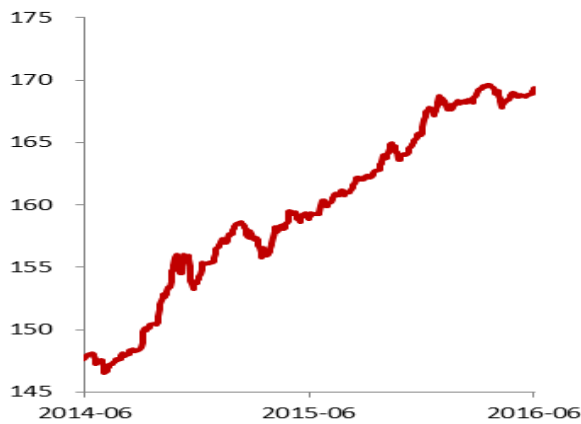
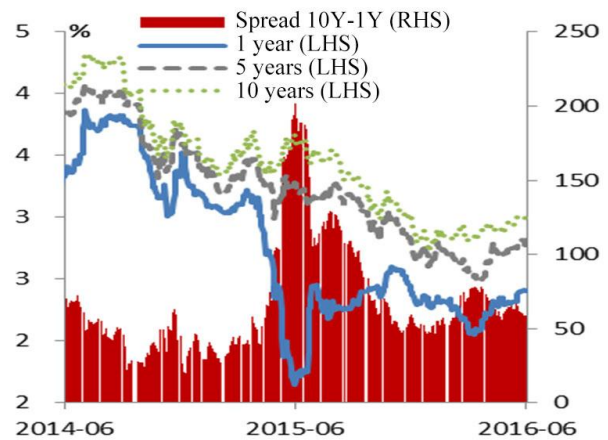


Figure 20: Treasury Yield Curve and Changes in Spread



Sources: Wind, BOC Institute of International Finance

II.1.4 2016H1 saw small fluctuations in stock indices and relatively weak trading figures in the stock market

In 2016H1, after undergoing volatility at the beginning of the year, China's A-share market demonstrated a pattern of price fluctuations within a narrow range. On June 16, the Shanghai Stock Exchange Composite Index closed at 2,870 points, down 4.4% compared with the end of March, while the Shenzhen Stock Exchange Component Index closed at 10,094 points, down 2.7% compared with the end of March. Generally speaking, the stock market in 2016H1 had the following three characteristics: **First**, stock indices fluctuated in a narrow range. Since March, the Shanghai Stock Exchange Composite Index has been fluctuating between 2,800 points and 3,000 points, and the Shenzhen Stock Exchange Component Index has also demonstrated a similar pattern. **Second**, market volatility gradually dropped. During the four months from March to June, the monthly rise in the Shanghai Stock Exchange Composite Index was 11.5%, - 2.2%, - 0.74% and 0.36%, respectively, reflecting a downward trend, which is in stark contrast to the ups and downs in the same period last year (13.2%, 18.5%, 3.8%, and - 7.3%). **Third**, trading figures were relatively weak. During the four months from March to June, the average daily trading value in the Shanghai Stock Exchange was RMB223.2 billion, RMB210.7 billion, RMB150.2 billion and RMB184.8 billion, respectively, far less than the average daily trading value of RMB776.9 billion in the same period last year. The narrow-range fluctuations in the stock market were mainly because the stock market received little new inflow of money and most activities in the stock market were related to movement of money within the existing stock of money under game theory which could only create some hot spots, rather than pushing up the overall market trend.

Figure 21: Small Fluctuations in Stock Indices of Shanghai and Shenzhen Stock Exchanges

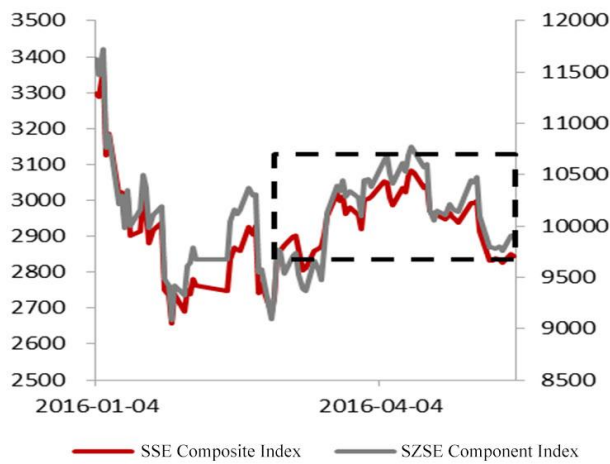
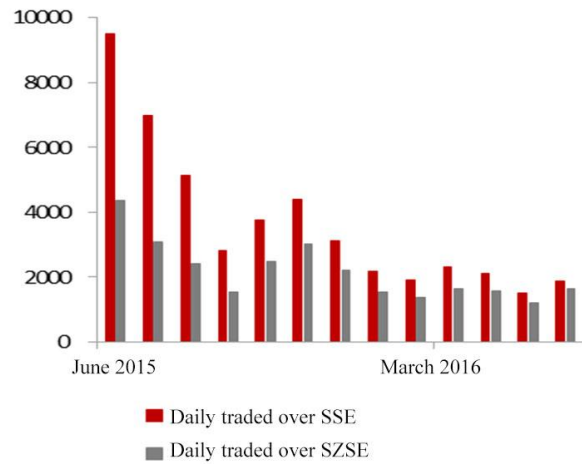


Figure 22: Relatively Weak Trading Figures in Shanghai and Shenzhen Stock Exchanges



Sources: Wind, BOC Institute of International Finance

II.1.5 RMB depreciated against USD periodically, with large two-way fluctuations

Heading into Q2, there was a periodic devaluation of RMB against the US dollar. On June 17, 2016, the central parity rate of the RMB against the USD was 6.5795, down 1.80% and 1.16%, respectively, compared with the end of Q1 and the beginning of 2016. To be more specific, RMB movements were as follows: **First**, influenced by the market's expectation for rate hikes by the Fed and other factors, the exchange rate of the RMB against the USD remained relatively stable in April and then was on a periodic downward trend. In May, the Fed revived expectations of a rate hike and the USD index broke its downward trend and moved upward. On May 30, the central parity rate of the RMB against the USD was 6.5784, hitting the lowest level since February 2011, and depreciated by 1.85% within a month. Thereafter, the U.S. reported markedly weakened nonfarm payroll data in May. In mid-June, the Fed announced it will keep the federal funds target rate range unchanged at 0.25% -0.5%, lifting the devaluation pressure on the RMB. **Second**, the central parity system of the RMB was more rule-based and transparent. Under the new system, the central parity rate of the RMB is determined based on the closing rate with a reference to a basket of currencies. In the meanwhile, China's central bank further stepped up efforts to track the market. The expectation of RMB exchange rate was relatively stable. No panicked devaluation was triggered. The difference in the exchange rate of the onshore RMB (CNY) and that of the offshore RMB (CNH) remained low. **Third**, the CFETS RMB index slipped by 1.04% in April compared to March and nudged up 0.03% in May compared to April. The exchange rate of the RMB became more market-based with large two-way fluctuations.

Figure 23: Trend of RMB/USD

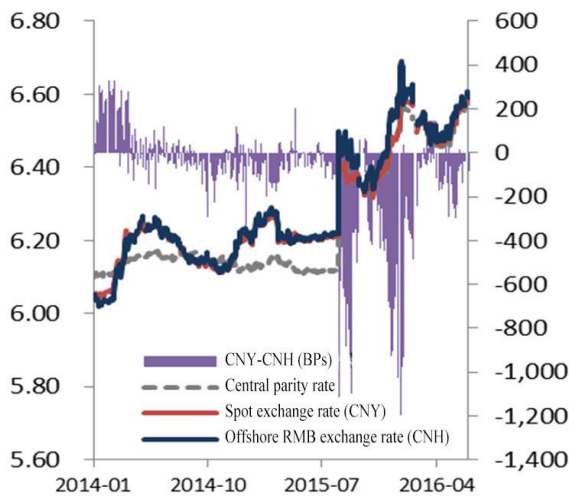
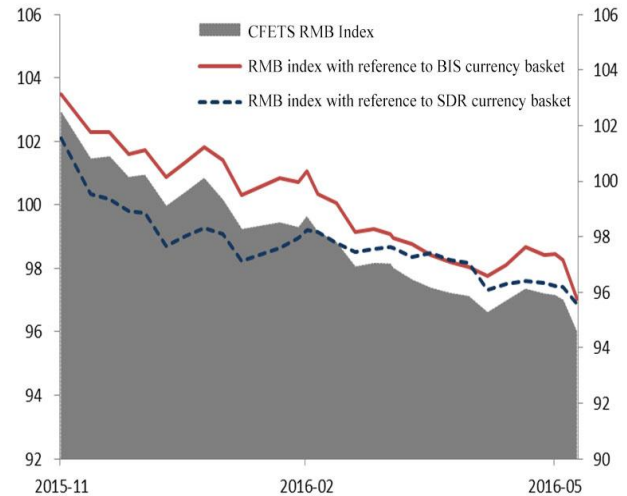


Figure 24: Trend of RMB Indices



Sources: Wind, BOC Institute of International Finance

II.2 Financial Outlook for 2016H2

II.2.1 Monetary loans will grow stably and there will be obstacles for a further increase

Heading into the second half year, as the decline in funds outstanding for foreign exchange slows down, infrastructure investment remains stable and real estate prices stay high, monetary loans will continue to grow rapidly. First, the decline in funds outstanding for foreign exchange is expected to slow down. By the end of May, China's funds outstanding for foreign exchange stood at RMB23.72 trillion, down RMB53.7 billion compared to the end of April. The decline has been slowing down for five consecutive months and this trend will continue in the future, reducing pressure from monetary tightening. Second, demand for monetary loans will remain relatively high. Stable infrastructure investment and high real estate prices will drive up the demand for credit. However, influenced by the slowdown of the growth in real estate sales, the restrictions placed on the financing sources of local governments and other factors, it is expected that real estate and infrastructure investment will contribute less to financing demand growth compared to Q2. Special attention should be paid to the plunge in the financing demand of non-financial sectors, which will restrict the growth in monetary loans. Overall, we foresee weak endogenous drivers to fuel the rebound of financial figures. By the end of Q3, the year-on-year M2 growth is expected at 12% and the social financing is expected to grow by 13%, rebounding slightly from Q2.

II.2.2 Interest rates in the money market will fluctuate within a narrow range and the overall liquidity will remain stable

Heading into 2016Q2, the liquidity in the inter-bank market is projected to remain steady with an easing bias and interest rates for main categories of term loans will fluctuate in a narrow range. Main reasons behind the above forecast are as follows: **First**, the expectations for a near-term rate hike by the Fed cool off. Recently, there is a divergence in the economic figures of the United States. In mid-June, the Fed announced that it will maintain the target range for the federal funds rate unchanged. The announcement alleviates pressure on the depreciation of the RMB against the USD as well as outflow pressure in the short term. The funds outstanding for foreign exchange declined by RMB53.7 billion in May. The slowdown of the decline, which has lasted for five consecutive months, can help close the gap in the money supply to the monetary base and reduce liquidity pressures. **Second**, the flexibility and effectiveness of monetary policy instruments has

been increasing. The combination of open market operations and MLF can effectively stabilize fluctuations in the money market, while SLF, PSL and other instruments have further enhanced the policy mix. Normalization of open market operations, reintroduction of 1-year MLF and initiatives indicate the central bank is ramping up its efforts to stabilize long-term funding. New reserve requirement rules will also help reduce the risk of an abrupt tightening in liquidity. Overall, liquidity is expected to remain stable with fluctuations from time to time. Large fluctuations are unlikely.

II.2.3 Bond prices will remain high with a small range of fluctuations or edge down slightly

In 2016Q2, the key drivers for the growth of the bond market are as follows: **First**, China is speeding up its efforts to open up the bond market. On May 27, the People's Bank of China decided to allow the more qualified foreign institutional investors to invest in China's bond market and cancelled restrictions on the amount of investment. This will drive the growth of the bond market in both depth and breadth. In the next five years, the proportion of domestic bonds held by foreign investors is expected to increase from the current 1.6% to 5% -6%. **Second**, a low interest rate environment has made China's local bond market attractive to global investors. Currently, the world's biggest economies continue to keep interest rates low, especially Japan and Germany whose central banks have adopted negative interest rates on 10-year bonds. Recently, China's 5-year government bond yields fell to around 2.7%, looking very attractive for global investors. Factors that have adverse impact on the bond market include: **First**, as enterprises continue to cut overcapacity and corporate debts remain high, we believe default risks will continue to rise. The number of bond defaults in the second quarter this year was higher than the first quarter, reflecting a rising trend. **Second**, some financial products have payment problems. Currently, principal-guaranteed wealth management products offered by banks and money market fund mainly invest in bond markets. With the increase in the number of defaults, products that overuse leverage may have payment problems and may even need to be redeemed. Overall, bond prices are projected to remain high with a small range of price fluctuations or edge down slightly.

II.2.4 Fluctuations in the stock market will continue

In 2016Q2, the stock market is expected to continue to fluctuate within a larger range. Factors preventing the stock market from soaring include: **First**, risk appetite remains weak. Margin balance is dropping steadily and has reached a level that is less than half the highest level recorded for last year. The turnover rate of margin trading also remains low and may plummet further in the future. **Second**, a substantial increase in macro liquidity is unlikely. China is unlikely to use monetary policy in an extensive manner. The central bank's interest rate corridor and open market operations have become more and more mature. Macro liquidity is currently neither too loose nor too tight and its only role is to stabilize the stock market. **Third**, the rebound of the real estate market may have crowding out effect on the stock market. On the other hand, the stock market is also expected to react positively to the following factors: **First**, the long-planned program to connect Shenzhen and Hong Kong stock exchanges is likely to be launched in the second half of this year. The entry of global investors will gradually change the capital structure and value orientation in China's stock market. **Second**, China's economy will gradually bottom out and stabilize market expectations. New growth points brought by structural optimization will create many highlights in the market. **Third**, the outlook for international financial environment is favorable. The FOMC meeting in June confirmed the dovish bias of the Fed on interest rates. The delay in interest rate hike by the Fed will have positive impact on A-share and other emerging markets.

II.2.5 Two-way fluctuations of RMB exchange rate will persist

Heading into 2016Q2, the downward pressures on the RMB against the USD will continue to exist.

However, they will not lead to a downward trend. Two-way fluctuations may become the main feature of the RMB exchange rate, mostly because of the following reasons: **First**, lower-than-expected domestic investment, consumer, industrial and other economic numbers in May are putting great downward pressure on China's economy. **Second**, the Fed may still raise interest rates. The USD is most likely to continue to consolidate in the short term. In the case of improved U.S. economic activities, a rise in inflation or heating up of expectation of a rate rise, there will be room for the USD to rise periodically, thereby increasing the devaluation pressure on the RMB. However, there are also factors that can help keep the RMB exchange rate stable. **First**, China's long-term economic fundamentals remain sound. Current account surplus and other fundamentals are expected to continue to help the RMB maintain a strong currency status. **Second**, the decline in funds outstanding for foreign exchange has been slowing down for five consecutive months and the RMB exchange rate is expected to be relatively stable. **Third**, the inclusion of the RMB in the SDR basket of currencies in October 2016 was another step by China towards internationalizing the RMB and is likely to fuel demand for RMB-denominated assets. **Fourth**, China is ramping up efforts to further open up its bond and stock markets, which will help attract capital inflows and improve the foreign exchange market.

III. Highlighted Issues with China's Current Economic and Financial Sectors

III.1 Growth engines are weak in general, with the pressure of economic downturn not eased

First, traditional engines are continuing to decline. The demand for real estate has developed past its peak. The per capita housing floor area in China has reached 32.9 square meters per person, higher than the Asian developed economies with similar population density and approaching the level of European developed countries such as the UK and France. As the elderly dependency rate rises, the population growth slows down and the course of urbanization eases down, the housing demand in the future might decelerate. The demand for infrastructure investment enjoys the development space, but faces the dilemma of insufficient financing sources, e.g. lack of will and impetus for private capital participation, absence of a long-term credit system and modes of government borrowing remaining to be standardized.

Second, new engines are emerging, but still cannot serve as the backbone. At present, Chinese economy has shown the momentum of structural optimization and innovation-driven accelerated development. However, as new industries remain small in both volume and size and new business formats such as "Internet plus" and green economy have not come to their prime, new engines of economic growth still cannot serve as the backbone in the economic development. For instance, the output value of manufacturing goods such as pharmaceuticals, communication and instrumentation only accounts for around 10.7%, far lower than the share of mining and the six major energy-consuming industries (about 38%), thus unlikely to offset the downward effect of traditional industries in the short term. Meanwhile, as it still takes time for innovation to pay off, the misaligned supply structure featuring surplus of mid/low-end products and shortage of high-end products will sustain.

Third, international demand is declining as well. Changing conditions of economic growth and weakened international demand both make China's export-oriented economy unsustainable. On the one hand, the re-industrialization in developed countries such as Europe and the United States speeds up the reconstruction of global value chain and therefore the foreign demand will remain weak for a long period of time. On the other hand, China's competitive advantage in low-cost manufacturing is challenged and its export share faces a bottleneck. In 2015, the share of China's export globally already reached 13.4%, ranking first in the world, leaving only limited space for further expanding the market share.

III.2 Overcapacity remains extrusive, making overcapacity reduction an arduous task

According to the prevailing international standard, it is categorized as overcapacity when capacity utilization rate is lower than 79% and severe overcapacity when the rate is lower than 75%. In 2014, China's overall industrial capacity utilization rate was 78.7%, a four-year low. Seven industries suffered a utilization rate of lower than 70%, thus categorized as severe overcapacity. The problem existed not only with traditional industries such as steel and coal, but also emerging ones such as PV and polysilicon. Overcapacity consumed a large amount of social resources, curbed the formation of new supply and reduced the profitability and investment ability of enterprises, thus intensifying the pressure of economic downturn. In 2015, main business revenue of industrial enterprises grew only by 0.8% and their profit dropped by 2.3%; the number of unprofitable enterprises climbed by 31.3%, up 19.1 percentage points over the same period of the year before. More than 50% of the enterprises in steel and coal suffered loss.

III.3 Debt of enterprises and local governments rapidly climbs and it is unlikely to drop in the short term

After the international financial crisis, China's leverage ratio (ratio between debt and GDP) is moderate in general and the debt risk is controllable, but the leverage ratio of local government sector and non-financial enterprise sector rapidly increased. At the end of 2015, the credit/GDP ratio of China's non-financial companies already reached around 160%, standing at a high level globally. High-leverage enterprises were mainly distributed in overcapacity industries (such as raw materials, heavy chemical and energy), real estate, traditional manufacturing such as foreign trade and consumption and some state-owned enterprises and enterprises based in old industrial areas such as northeast China, North China and southwest China generally shouldered greater debt pressure than those in other areas. For instance, regarding listed companies, in 2014, the debt/asset ratio of China's raw material sector was 74.3%, around 1.36 percentage points higher than the world's average level. The ratio of the northeast and southwest regions was approximated at 90%, even higher than the level of 76%-82% in the northwest, North China, East China and central south regions. The high leverage in the enterprise sector is both related to the counter-cyclical regulation policies adopted to respond to the impact of the financial crisis since 2008 and to the predominance of China's financial system by banks (the banking sector can only provide funds for the real economy in the form of loans, which easily drives up the leverage in the enterprise sector, but makes it difficult to decrease). High leverage will inevitably bring high risks, which will trigger systematic financial crises if not controlled properly.

III.4 Financial risks accumulate and spread more frequently across borders and markets

China's economy is currently staying at a critical period which could be characterized as "de-capacity, de-stock and de-leverage" and new types of financial businesses are rapidly developing, hence all kinds of financial risks may further accumulate. First, the possibility of debt chain being broken is enlarged. As affected by de-capacity and de-stock by real economy, occurrences of debt default have considerably increased. Second, financial risks spread more frequently and rapidly across different markets, regions and countries. In recent years, multiple cross-market risk spreading events already occurred. Since 2015, several plunges of exchange rates were all related to the discrepancy between offshore and onshore markets in the RMB exchange rate expectation and pricing and the impact of offshore exchange rate on onshore exchange rate. Third, cross-border capital flows and RMB exchange rate fluctuation are mutually consolidated. Since 2015, China's cross-border capital flows have displayed the momentum of net outflow in general. In the past few months, the pressure of capital outflow was weakened. Given the possibility of the Federal Reserve further raising the interest rate and stronger will of residents for global wealth allocation, exchange fund might continue with net outflow and take an enhancement effect together with RMB exchange depreciation.

Table 1 Forecasts on China's Main Economic and Financial Indicators in 2016H2 (%)

Indicators	2013 2013 (R)	2014 2014 (R)	2015 2015 (R)	2016			
				Q1 (R)	Q2 (E)	Q3 (F)	Whole year (F)
GDP	7.7	7.3	6.9	6.7	6.7	6.7	6.7
Added value of industries above a designated size	9.7	8.3	6.1	5.8	6.0	6.0	6.0
Investment in fixed assets	19.6	15.7	10.0	10.7	9.0	8.5	9.0
Total retail sales of consumer goods	13.1	12.0	10.7	10.3	10.0	10.0	10.1
Exports	7.9	6.1	-2.9	-9.6	-3.0	1.0	-2.0
Imports	7.3	0.4	-14.2	-13.4	-7.0	-5.0	-7.0
Consumer Price Index (CPI)	2.6	2.0	1.4	2.1	2.0	1.9	2.0
Producer Price Index (PPI)	-1.9	-1.9	-5.2	-4.8	-2.7	-0.9	-2.1
Broad money (M2, period-end)	13.6	12.2	13.3	13.4	11.6	12.0	12.2
Social financing scale (existing)	17.5	14.3	12.4	13.4	12.8	13.0	13.0

Source: BOC Institute of International Finance

IV. Macroeconomic Policy Orientations

As the pressure of economic downturn is intense, equal attention needs be paid to both short-term demand management and mid/long-term structural reform. In the short term, the policy of stabilizing economic growth cannot be loosened and more forceful policy measures need be taken to expand aggregate demand, bring actual growth closer to potential growth, ease the pressure of economy further declining and make time for structural reforms and cultivation of new growth engines. In the mid and long-term, it is imperative to accelerate restructuring and the reform on the supply side and foster new growth engines, so as to lay a solid foundation for sustained economic growth.

First, “loose fiscal policy and prudent monetary policy” should become the basic orientation of short-term macro policies.

This year, Chinese government will continue to make greater efforts in the implementation of proactive fiscal policy and will raise the deficit from RMB1.62 trillion to RMB2.18 trillion and increase the deficit ratio from 2.3% to 3%. There are concerns about whether a higher deficit ratio will result in fiscal risks. In fact, slight fiscal deficit does not matter, but the key lies in the cross-cyclical dynamic fiscal balance, with expenditure and input enlarged during economic downturn and reserve being made in years of sound economy. Under the current circumstances, the fiscal policy needs to continue to play a key role in stabilizing economic growth. On one hand, budget execution management should be strengthened and fiscal funds allocated in time to promote major projects in the 13th “Five-year” Plan such as railway, road, key water conservancy projects, hydro and nuclear power, ultra high voltage transmission, smart power grid, oil and gas pipelines and urban rail transit as a priority. On the other hand, infrastructure investment and financing systems need be optimized and market-based approaches need be used to raise dedicated construction funds, explore infrastructure asset-backed securitization, play the role of government guidance funds and promote PPP project landing, so as to mobilize the initiative of private capital for participation. Meanwhile, support need be offered to the structural reform on supply side. First,

the role of fiscal funds should be substantially put into play to solve issues such as employee settlement arising from the process of de-capacity. Second, while the reform of business tax replacement by VAT is comprehensively promoted, efforts should be continuously made to perfect the VAT deduction chain to considerably reduce the burden of enterprises. Some government funds will be stopped or merged and local government at various levels will be urged and supervised for fee clearance. Preferential tax policies will be perfected in an expedited manner for new high-tech businesses and high-tech business incubators. The fiscal and taxation system reform will be deepened, with resource tax to be reformed in an all-round way and excise tax reform to be promoted rapidly, and main local taxes will be cultivated to enhance the engine of independent local development.

It's not true that the looser monetary policy the better and it's not wise to blindly tighten the policy as long as leverage is high. The key lies in a moderate degree, which is neither excessively tight nor excessively loose. At present, the pressure of China's economic downturn remains intense and both broad money and social financing scale stock have showed the sign of tightening, increasing the possibility of Chinese economy being stuck into the "debt - credit contraction" cycle. Monetary policy needs to turn greater in its force and support the economy above its lower limit together with fiscal policy. First, "progress" shall be made while ensuring stability. Given the current pressure of economic downturn, the low price level and the interest rate remaining stable amid an upward trend in the mid and long term, RRR cuts can be considered in the short term. Second, it's not wise to cut interest rates in the short term. Currently, the real interest rate of one-year deposit is already negative (one-year deposit interest rate is 1.5%, while CPI in the first five months was 2.1%). Given the fact that if the Federal Reserve further raises the interest rate, the asset pricing bubble and cross-border capital outflow might be boosted, it is not wise to continue to cut interest rates in the short term. Third, it is necessary to promote the transformation from "loose monetary policy" to "loose credit policy". The supportive role of the bond market for real economy should be put into greater play. Under the current background of frequent occurrences of bond default, the core is to perfect the protection mechanism for bond investors, reinforce disclosure of bond default events and establish the bond trustee system.

Second, the relationship among "de-capacity, de-stock and de-leverage" shall be properly handled.

There are two approaches to solve overcapacity. One is "shutdown, suspension, combination and transfer", i.e. using the method of reducing capacity to eliminate capacity. By phasing out zombie companies and reducing output, the approach is likely to increase PPI and improve the market efficiency of enterprises. The other approach is to adopt expansionary fiscal and monetary policies with the aim of stimulating effective demand to eliminate overcapacity. The former enjoys the advantage of being able to improve enterprise competitiveness and facilitate de-leverage (decreasing numerator), but suffers the disadvantage that if no new growth engine emerges, it may cause economic growth stagnation and affect economic and social stability. The latter can resume economic growth in the short term, gain some time for the structural reform and help with de-stock and de-leverage (increasing denominator), but cannot automatically promote the enterprise productivity to improve and may further drive up leverage (Yu Yongding, 2016). In the future, de-capacity will, with no doubt, be a major task, which takes a process to fulfill and requires the market to determine and answer "whether to proceed with de-capacity or not", "to what degree" and "how to realize" on its own within the established policy framework. Attention must be paid to avoid excessive use of administrative methods to intervene with normal production and operation of enterprises. De-leverage is by no means simply and blindly decreasing the numerator, but about taking multiple measures to promote economy to make a rebound for the better, which is the foundation (expanding the denominator), and optimize the financing structure, which is

fundamental (reducing the numerator). This also takes time. Too hastily, either excessive stimulation will make a greater bubble out of the economy, or excessively expediting the debt compression will cause economy to plunge into recession. Therefore, it's not wise to reduce leverage by each and every sector simply because the leverage of the entire society needs to be lowered.

Third, violent fluctuations in financial market need to be prevented to avoid risk communication across different markets.

It is imperative to improve the ability in identifying and disposing cross-market risk spreading, accelerate to unify financial infrastructure regulation and financial integrated statistical systems, establish the mechanisms of risk identification and early warning against market fluctuations and form a coordination mechanism for various regulators in times of fluctuation. Meanwhile, macro prudential needs to be perfected. On the basis of strengthening regulation over institutions, more attention needs to be paid to regulation over functions and behaviors and the regulation criteria for financial products with same functions and financial services with same business attributes need be gradually unified, so as to reduce regulation arbitrage, vacuum, and provide a period of adaptation and some space of cushion for financial institutions to adapt to regulation transformation. It is also necessary to study the spillover effect and spill back of monetary policies under open conditions in China, a big economic power, and highlight coordination of monetary policies of major economies to promote internal and external balance.

In the mid and long term, China's economy enjoys potential, reserved strength and also conditions for continuing to maintain rapid growth. However, potentially high growth does not mean actual high growth and in order to translate the potential growth into actual growth, great efforts need be made in the following aspects.

First, sustained economic growth shall be maintained to avoid “major ups and downs”.

International experience shows that in order to transform the economy of a country from the underdeveloped stage to a developed one, the key lies in maintaining sustained economic growth. After more than thirty years of high growth, though China's potential economic growth has slightly dropped, the growth remains at a mid/high level. According to our research, it is believed that in the next ten years, China's potential growth is approximated at around 6%-7%. Proactive efforts must be made to create conditions to promote the translation of potential growth to real growth and maintain sustained economic growth. The first is to promote the structural reform on the supply side to improve the efficiency of resource allocation across the entire society and cultivate new growth engines. The second is to promote development of the industrial structure to the mid/high level through scientific and technological innovation, identify China's position in the global value chain according to dynamic comparative advantages and so that sound policy decisions can be made about industry, investment and foreign trade. The third is to expand the space of regional development from coastal areas to inland, build up new growth poles and promote coordinated and interactive development among different regions.

Second, manufacturing shall be promoted to extend from the low-end of global value chain to the mid and high-end.

Manufacturing is the pillar of a national economy and the main battlefield of scientific and technological innovation, having a bearing on whether industries can smoothly evolve to the mid/high end. After the outbreak of the international financial crisis this time, countries started to reflect upon their previous development modes and back to manufacturing became a global trend again. This was attested by the re-industrialization of the United States and Industry 4.0 of Germany and China also launched the “Made in China 2025” strategy. In recent years,

restructuring of the global value chain brought revolutionary changes to global economy. In the face of the new round of reform of the global value chain pattern, China should actively transform its development mode, integrate into the global labor division system in a larger scope and at a higher level, evolve from regular manufacturing to mid and high-end manufacturing and seek to improve its position in the global value chain, to drive Chinese economy towards the mid and high level. Equal attention should be paid to both “bringing in” and “going global”, the sedimentation of advanced production factors such as design, research and development and marketing should be accelerated and new advantages amid international competition should be cultivated to extend to the mid/high end of global value chain. While consolidating “Made in China” and “Processed in China”, focus shall be put on advancing “Created in China”, “Marketed in China” and “Brand of China”.

Third, the middle-income group shall be expanded to promote consumption-driven growth.

The theoretical hypothesis on income inequality undermining economic growth holds that income inequality will impair economic growth either by adopting distributive tax transfer policies that reduce initiative of investors, or by decreasing the opportunities for the poor to invest in projects of high return and high growth, or by curbing consumption demand and intensifying economic fluctuation. Expanding the middle-income group not only helps transform China's economic growth mode and development mode (consumption-driven), but also acts as the buffer zone of social stability and the prerequisite of political democracy. Though the size of the group in China has kept increasing in the past few years, its share remains small and the group needs be further expanded in the future by increasing the income of urban and rural residents, rationally setting the minimum threshold for personal income tax and devising the tax rate structure and narrowing the income gap across regions and between urban and rural areas, among others.

Fourth, actions shall be taken proactively to create a new external environment favorable to the development of China.

In the past thirty years or more, the external environment for China's development was admirable and loose in general, but looking forward, we face many challenges and the external environment is expected to be tight as a whole. In the future, it is imperative to accurately evaluate the world's economic and political situations as well as to evaluate the changes and take actions proactively based on our own realities to construct a new environment favorable to the development of China under new circumstances. The first is to make sound top-level design on “what to pursue and abandon” according to the demand and conditions of China in participation in global labor division and clarify the strategic direction and focus. The second is to actively utilize multilateral platforms such as G20, IMF, World Bank and Financial Stability Board (FSB) to participate in international economic and financial policy coordination in an all-round way and to put China's advantage of discourse power in new platforms including Asian Infrastructure Investment Bank, Silk Road Fund and BRICS Development Bank into full play. In this way, we can improve China's position and role in international rule making and transform from a follower and executor of international economic and trade rules to a leader and rule-maker. The third is to enhance regional economic and financial cooperation through “the Belt and Road” Initiative and accelerate RMB internationalization to boost China's influence across the world.

Fifth, the principle that finance shall always serve real economy must be followed unswervingly.

Finance and real economy are interdependent. In the future, financial development shall unswervingly observe the principle of serving real economy. The first is to put into place a financial institution system compatible with small and micro businesses and start-ups and take the degree of closeness with real economy as the guidance for the direction of financial reform. The

second is to reasonably position financial institutions, establish regulation guidance and administration systems and further match financial products and services with capital demand. The third is to guide the support of financial innovation for real economy and reduce the financing cost for enterprises. The fourth is to speed up establishment of an integrated statistical monitoring system covering all the financial institutions and transaction behaviors to accurately understand the degree of support offered by finance for real economy and prevent capital from “deviating from real economy”. The fifth is to improve the ability of service enterprises in “going global”. A country with highly internationalized finance and stronger service ability can have its economy globalized more easily. As Chinese enterprises “go global” to invest and RMB internationalization speeds up, Chinese financial institutions, with no doubt, have accumulated the conditions and foundation for entering the mainstream market. The institutions should constantly improve their ability in rendering services globally and strive to play a bigger role in local economic and financial development.

V. Case Study: Causes, Impact and Related Recommendations of “Stalling” of Private Investment

Since the beginning of this year, the growth of private investment in China has noticeably slowed down, attracting wide attention from the entire society. Regionally and industrially speaking, the central and eastern areas and the tertiary and secondary industries are the ones that mainly contributed to the growth slowdown. The growth slowdown in private investment is not helpful for achieving various economic and social targets such as stabilizing growth, adjusting the structure and creating more jobs, it is urgent for the government to promote a decrease in the business costs of private enterprises, reduce the obstacles to access private capital, step up financial support and improve the level of service for private capital, so that companies will be more enticed to invest in the future.

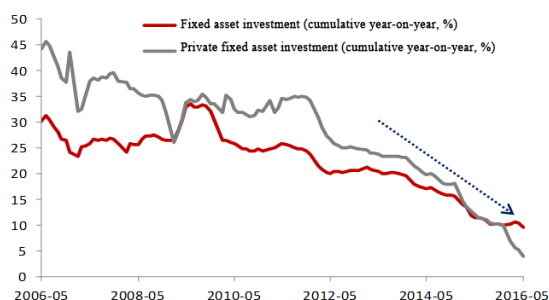
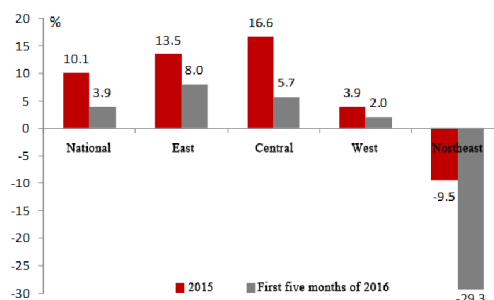
V.1 Private investment has “stalled” year to date.

In recent years, the Chinese economy continued to gear down in speed and it was not surprising to see investment growth slow down. However, since the beginning of this year, private investment's rapid drop in its growth rate and its share in total investment narrowed, both became the focus of the market's attention and aroused major attention from the government.

Private investment started to grow slower than total investment in a rare way. Since the outbreak of the global financial crisis in 2008, private investment growth is able to plunge and show the trend of “stalling”. As the government launched the RMB4 trillion stimulus package, private investment rapidly developed into a U-turn shape and its growth had been greater than total investment ever since. However, since 2012, growth of private investment gradually approached total investment and in 2015, the two almost became identical, with the former standing higher than the latter by only 0.1 percentage point. Since the beginning of 2016, private investment growth turned slower than total investment, which was quite rare in the recent ten years. During the first five months, it only grew by 3.9%, down 6.2 percentage points over the same period of last year's. During the same period, though growth of total investment also slowed down, it was only lower than last year's by 0.4 percentage points.

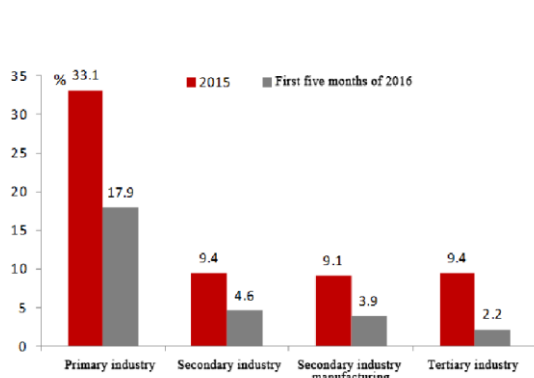
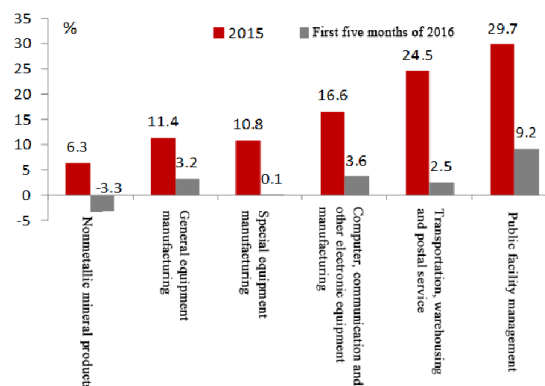
Slowdown of private investment growth was mainly contributed by central and eastern areas. As calculated, compared with 2015, central areas caused the growth of private investment to drop by 3.2 percentage points and eastern areas caused it to decline by 2.5 percentage points. Take Henan Province, a big economic power in the central areas of China, for example, during the first five months of this year, private investment grew by 4.8% year on year and the growth rate dropped by 11.8 percentage points than last year's, dragging down national private investment growth by 1 percentage point. During the first four months of this year, private investment in the

Shandong Province, a big economic power in the east of China, grew by only 2% and the growth rate declined by 11.4 percentage points than the growth rate of the same period of the year before, dragging down national growth by 1.2 percentage points. Private investment in Beijing even experienced negative growth and during the first five months, the investment decreased by 6.9% year on year and the growth rate plunged by 32.7 percentage points over last year's, dragging down national growth by 0.3 percentage points. Private investment growth dropped by the smallest margin in western areas and the investment decline considerably expanded into the northeast. As the two were both small in volume of investment, but the aggregate caused national private investment to fall by 0.6 percentage points.

Figure 25: Private Investment Growth “Stalling”

Figure 26: Private Investment Growth by Region


Sources: Wind, BOC Institute of International Finance

The tertiary industry dragged down private investment growth by a larger margin than the secondary industry did. According to calculations, the tertiary industry exerted the greatest impact on the private investment growth slowdown and resulted in the growth to slow down by 3.3 percentage points, while the secondary industry dragged down the growth by 2.4 percentage points and the primary industry by only 0.5 percentage points. To be specific with industries, amid the tertiary industry, transportation, warehousing, postal and public facility management dragged down total private investment growth by 1.5 percentage points; among the secondary industry, nonmetallic mineral products, general equipment manufacturing, special equipment manufacturing, computer, communication and other electronic equipment manufacturing dragged down the growth by 1.2 percentage points in aggregate.

Figure 27: Private Investment Growth by Industry

Figure 28: Private Investment Growth of Some Sectors


Sources: Wind, BOC Institute of International Finance

V.2 Low return on investment and limited opportunities curbed private investment.

Enterprise cost continues to climb and the profit margin of private investment declines. Take private industrial enterprises for example, during the first four months of this year, their main business cost rate was 87.5%, higher than the rate of 2012, 2013, 2014 and 2015, showing a trend of increase annually. Though this year, profit growth of private enterprises slightly sped up, in terms of profit margin of main business revenue, profitability of private investment turned weaker. During the first four months, profit margin of main business revenue of private industrial enterprises was 5.64%, down by 0.79, 0.69, 0.4 and 0.37 percentage points than 2012's, 2013's, 2014's and 2015's respectively. Despite the lack of statistics on the losses of private enterprises, both the number of unprofitable industrial enterprises above a designated size and the amount of loss continued to expand this year. During the first four months, the amount of loss reached RMB363.2 billion, up 7.5% year on year, and the number of unprofitable enterprises was 68,769, up 0.6%.

Public-interest industries have a high access threshold and thus limited appeal for private capital. Except for industries suffering from overcapacity and insufficient demand, those that dragged down private investment growth were mainly transportation, warehousing, postal and public facility management. Because these industries work for the public interest, these industries traditionally relied on government funds and investment from state-owned enterprises, were poor in profitability and were opened to private capital to a limited extent. Recently, it was discovered in a survey conducted by the inspection groups of the State Council that national policies on encouraging private investment were not thoroughly implemented in some local areas and that “glass doors” and “revolving doors” still existed to different degrees in some areas and industries. The pilot PPP mode has been making attempts to explore the introduction of private investment, but the progress is slow, with only a few achievements having been met.

Figure 29: Profit Status of Private Industrial Enterprises

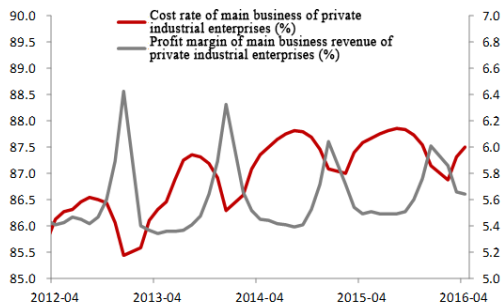
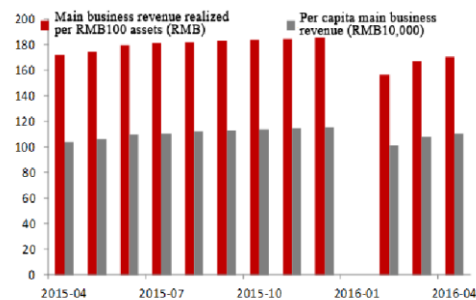


Figure 30: Business Efficiency of Private Industrial Enterprises



Sources: Wind, BOC Institute of International Finance

Overcapacity is both severe and difficult to reverse and business efficiency of enterprises has declined. Given that some industries in China are obsolete, inefficient and high in ineffective capacity, the task of de-capacity remains arduous. In the industry of flat glass, a typical nonmetallic mineral product, ineffective capacity reached up to 259 million weight cases in 2015, accounting for 23.1% of total capacity. Because of the sluggish economy, it's increasingly more difficult for enterprises to collect sales payment. During the first four months of this year, collection of accounts receivable by private industrial enterprises above a designated size took 27.7 days on average, 2.5 days longer on average than what it took in 2015. During the same period, business efficiency of enterprises distinctly declined and ability of capital and labor in earning income dropped. Finished goods turnover rate of private industrial enterprises took 12.3 days, 0.7 days

longer than what it took in 2015; main business revenue realized per RMB100 assets and per capita main business revenue were RMB170.8 and RMB1,104,000, lower by RMB15.1 and RMB48,000 than in 2015 respectively.

International market demand is weak and willingness for private investment is insufficient. As global economic growth lacks impetus and international trade continues to shrink, related goods in China encounter the dilemma of exporting. Take several industries experiencing major decline in private investment for example, in 2015, the export delivery value of nonmetallic mineral products, general equipment manufacturing and special equipment manufacturing was decreased by 4.3%, 4.9% and 3% and the decrease was higher than the overall export delivery value of industry by 2.5, 3.1 and 1.2 percentage points respectively. During the first five months of this year, export delivery value of nonmetallic mineral products, general equipment manufacturing, computer, communication and other electronic equipment manufacturing dropped by 3.2%, 6.3% and 4% and that decline was greater than the overall export delivery value of industry by 1.7, 4.8 and 2.5 percentage points respectively. Under the circumstances of decreased export and insufficient new orders, the initiative of private capital in expanding investment will be undermined.

As foreign direct investment grows at an ultra high speed, private capital will turn overseas to seek new opportunities. As labor cost rises and the real effective exchange rate of RMB appreciates, the comparative advantage that some industries have in China amid international competition will be weakened. Also given the fact that there are fewer investment opportunities of high profit in China, increasingly more enterprises (including private ones), start to “go global” (to invest globally). During the first five months of this year, China's foreign direct investment reached USD73.52 billion, increased by 61.9%, or USD28.11 billion on a yearly basis. The growth was higher than the level of 2015 by 47.2 percentage points and if calculated at the average exchange rate, it was equivalent to 1% of domestic fixed asset investment for the same period.

Figure 31: Export Delivery Value of Some Industries Decreasing Year on Year

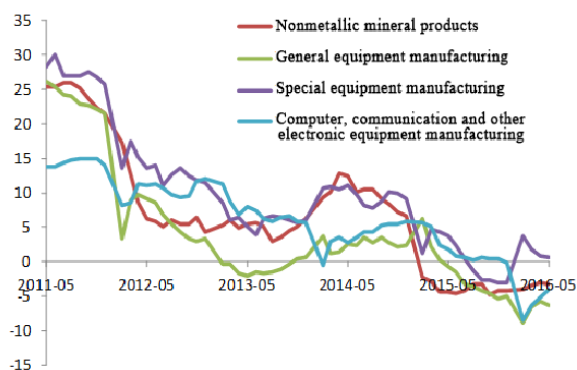
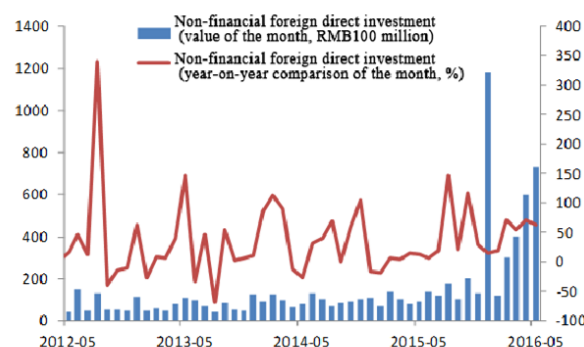


Figure 32: Foreign Direct Investment Increasing



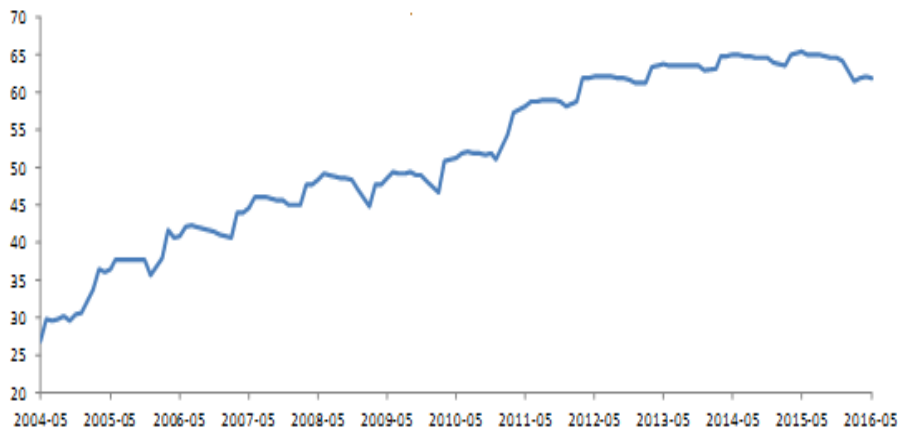
Sources: Wind, BOC Institute of International Finance

V.3 Slowdown of private investment growth undermines economic growth engines.

In the short term, the slowdown of private investment growth intensifies the pressure of economic downturn. Over the past decade, as the strength of private economies was constantly increased, the share of private investment to total investment was considerably increased, elevated from 35.6% in 2005 to 64.2% in 2015. However, since the beginning of this year, the share has started to narrow and has dropped to 62%, directly causing the growth of total investment to slow down. As calculated, growth of total investment for the first five months of this year dropped by 0.4 percentage points over last year's and private investment alone dragged down the growth of

total investment by 3.9 percentage points. If no active effort is made to strengthen macro-economic control, further enforce policies on stabilizing growth, promote budgetary investment or have investment by state-controlled enterprises grow in an expedited manner, total investment will decline by a larger margin and the growth target set at the beginning of the year will be very unlikely to be reached.

Figure 33: Change in the Share of Private Investment in Total Fixed Asset Investment (%)



Sources: Wind, BOC Institute of International Finance

In the mid and long term, the slowdown of private investment growth impairs the ability to sustain economic growth. Investment demand at present determines the production capacity of the future economy and is the basic condition for adding new supply with higher quality. As private investment becomes increasingly more important in the total investment of China, its considerable growth slowdown means that part of its capacity will have to either be postponed from being put into production or transferred overseas. This will not only affect satisfaction of new demand, but also slow down the pace of innovation-driven development.

Besides, the slowdown of private investment growth restrains the number of new jobs. As accelerated de-capacity will cause some enterprises to be shut down, employees to be laid off and millions of fresh graduates join the labor force, the plunging of private investment will cause the number of jobs to decrease, making it more difficult to solve the issue of employment and will cripple the accumulation of human capital.

V.4 Policy recommendations

Adhering to the decisive role of the market in resource allocation does not mean that government should be indifferent to private investment. Experience shows of some successful economies that have active and effective industrial policies playing a significant role in promoting the growth of emerging industries and driving those economies out of downturns. In order to address the current dilemma of the slowdown in private investment growth, government policies also need to take effect immediately.

First, business cost of private enterprises shall be lowered. Efforts shall be made to control the growth of the minimum wage, establish and implement a counter-cyclical social security fee payment mechanism and reduce the effect of wage rigidity in aggravating enterprises' burden during times of economic downturn. Policies of tax reduction and fee clearance shall be forcefully pushed, and policies that entitle small business to tax reductions and exemptions should be expanded in scope. For areas where real estate price excessively rises, measures such as land supply increases and guidance for pricing shall be taken to control excessively rapid increases of a

house's rent. Under the precondition of improving tolerance of nominal exchange rate fluctuations, keeping RMB's real effective exchange rate stable or promoting it to decrease moderately is beneficial to enterprises that participate in international labor division and competition.

Second, obstacles of market access for private capital shall be reduced. Behaviors of seeking gain at the expense of the people shall be reduced and those benefiting the people shall be encouraged. The state-owned enterprise reform shall be accelerated to promote state-owned capital to gradually withdraw from competitive sectors and state-owned enterprises to reduce operation in non-main business sectors. Multiple forms of public-private partnership (PPP) shall be explored to strike a balance between public interest and profit-making. PPP is integral to achieving this breakthrough, but the effects of the pilot programs are not ideal yet and therefore it's urgent to encourage local areas to take actions proactively to solve related problems and to make successful examples and that way experience can be accumulated as early as possible. For sectors that were previously forbidden to enter or difficult to participate for private enterprises such as telecommunication, power, railway, road, oil, petrochemical and municipal utilities, more private capital shall be introduced and the ways of governance and control by state-owned capital shall be improved.

Third, the financial system in support of private enterprises shall be perfected. Because China's credit system is not mature yet, a sound credit environment has not been formed yet. An incentive for keeping committed and a punishment for breaking contracts is needed. Financial support offered to private enterprises is limited. Projects helpful for accelerating innovation, creating more jobs and improving people's livelihood need to be started right now so that they will not be late. Given so, it is necessary to speed up the establishment of a system that combines direct and indirect financing for small to medium enterprises, put into place a multi-layer financial institution system dedicated to the enterprises and will encourage the use of the internet and big data sites to better serve private enterprises in credit enhancement and financing.

Fourth, the ability of the government to serve private enterprises shall be improved. At present, the government is making great efforts to promote the reform of "delegating power while improving regulation and optimizing service", but streamlining administration and delegating more powers to lower-level governments does not mean omission, but a reduction of administrative approval and other institutional transactional costs is needed to simplify procedures and improve efficiency for private enterprises to invest. Besides improving the efficiency of investment approval, the government should also ensure fair and orderly competition among enterprises, build up a unified and orderly market within the country, develop a sound infrastructure for the hard environment (such as roads and communication) and a favorable soft environment (such as policies, legislation, human resources and intellectual property rights protection) and actively provide private enterprises with investment services in technology and information.

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