Institute of International Finance

China's Economic and Financial Outlook

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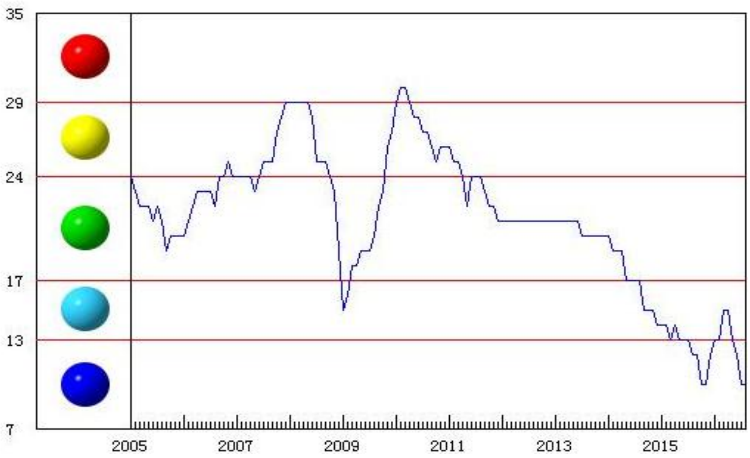
Highlights

●In 2016Q3, China maintained overall stability of economic development under the influence of cumulative effects of previous policies, a booming real estate market and rebounding energy and raw materials sectors. Recently, as major economic indicators such as investment, consumption, industrial production and power generation begin to stabilize, economic downward pressure has been mitigated. The Q3 GDP is expected to grow by around 6.7%, the same as in 2016H1.

●In 2016Q4, it is expected that exports will continue picking up, investments and emerging industries will be supported by more effective fiscal policies, consumption and service sectors will grow steadily and the economy will maintain stable in the near term. GDP growth for the full year will be about 6.7%, within the target range set by the government at the beginning of the year.

●The housing market is increasingly booming. M1 grew much faster than M2 as a result of increasing proportion of corporate demand deposits and citizens tending to use more money to buy houses, implying great economic and financial risks. Macroeconomic policies are urgently needed to balance stable growth and asset price bubbles. In order to overcome the dilemma of depressed real economy but "hot" virtual economy, fiscal policies should provide stronger support to "weak" fields. A moderate and neutral monetary policy with the combination of regulatory policies is required to channel funds from virtual to real economy. The government should also lower the reserve requirement ratio in a hedging manner at the right timing based on market liquidity changes.

China's Macroeconomic Early Warning Index



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Alert to Potential Risks in Economic Stabilization

---China's Economic and Financial Outlook (2016Q4)

In 2016Q3, China maintained overall stability of economic development under the influence of cumulative effects of previous policies, a booming real estate market and rebounding energy and raw materials sectors. Recently, as major economic indicators such as investment, consumption, industrial production and power generation began to stabilize, economic downward pressure has been mitigated, but the bottom is yet to form. The Q3 GDP is expected to grow by around 6.7%, flat with 2016H1. Looking into 2016Q4, it is expected that exports will continue picking up, infrastructure investment and emerging industries, etc. will be supported by more effective fiscal policies, consumption and service sectors will grow steadily and the economy will maintain steady in the near term. GDP growth for Q4 and the full year will be around 6.7% (the same as the previous forecast), within the target range set by the government at the beginning of the year. It is noteworthy that the housing market is continuously rising, driven by multiple factors including house destocking, increased money supply and change of expectations. M1 grew much faster than M2 as a result of increasing proportion of corporate demand deposits and citizens tend to use more money to buy houses, implying great economic and financial risks as funds is more tending to shift from real to virtual economy Macroeconomic policies are urgently needed to balance stable growth and asset price bubbles. In order to overcome the dilemma of depressed real economy but "hot" virtual economy, fiscal policies should provide stronger support to "weak" fields with larger spending. Monetary policies should not be loosed on all fronts; rather, a moderate and neutral monetary policy with the combination of regulatory policies is required to channel funds from virtual to real economy. The government should also cut the reserve requirement ratio (RRR) in a hedging manner at the right timing based on market liquidity changes.

I. Economic Review and Outlook

I.1 Operational characteristics of economy in 2016Q3

In 2016Q3, China's economy runs stable as a whole (Figure 1). Recovery of external demands, depreciation of RMB and low base number of the previous year enabled the alleviation of the downward pressure on exports. Meanwhile, driven by cumulative effects of previous policies, a booming real estate market and rebounding energy and raw materials sectors, major economic indicators such as investment, consumption, industrial production and power generation began to stabilize, and the growth rate of private investment also ceased its month-on-month decrease; leading indicators such as PMI and Export Leading Index also indicated continuous economic recovery recently. The Q3 GDP is expected to grow by around 6.7%, the same as in 2016H1 (aligned with our previous expectation). At the same time, the irrational housing price surge in some cities, the rapid growth of M1 which largely outpaced M2, sharp rise of some energy and raw material prices as well as external uncertainties are calling for urgent attention. The house destocking and economic recovery backed by rapid increase of residential leverages are insecure and unsustainable, implying great potential risks.

Figure 1: Quarterly Growth of China's GDP

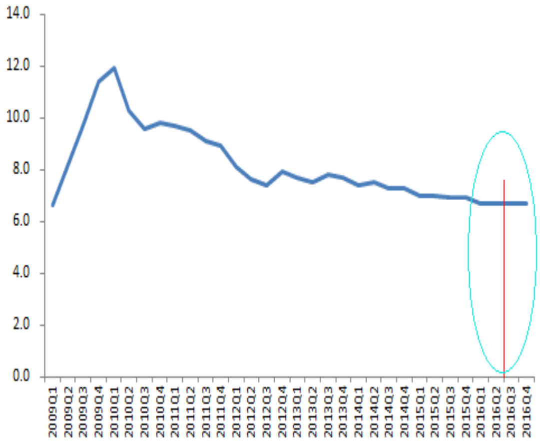
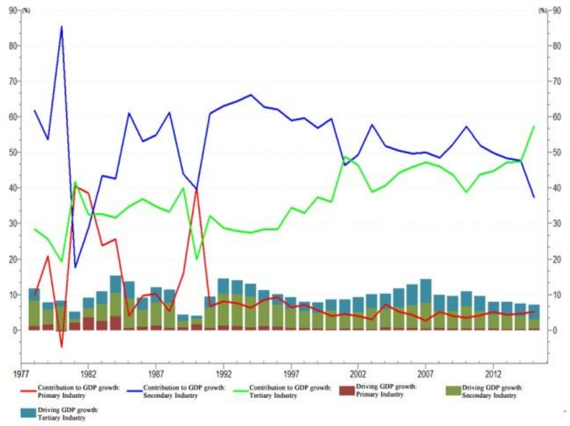


Figure 2: GDP Growth Contribution of the Three Industries



Sources: Wind, BOC Institute of International Finance

I.1.1 Investment grew slowly but steadily and exports bottomed out

Investment growth presented a sign of stabilization, with growth of investment in real estate and infrastructure accelerated in August. In Q3, investment in fixed assets continued to slow down, growing by 8.1% in the first eight months, 0.9 percentage points lower than in 2016H1. Yet, the investment growth in August was obviously quickened; the growth rate of 8.2% was 4.3 percentage points higher than that in July, and also higher than in May and June. Meanwhile, private investment also ceased declining and turned around from negative to positive growth. In August, it grew by 2.3%. The slow but steady growth of investment, private investment in particular, is a major signal for economic stabilization. Of course, it is hard to determine whether there is a fundamental investment turnaround based only on the single-month data. Sustainability of the trend remains to be seen. By industries, investment in real estate and infrastructure picked up in August. By regions, investment reduction in Northeast China narrowed in the past two months, but it still dropped by 30% or so. Particularly, investment in Liaoning Province fell sharply by around 60%, dragging down the national investment growth rate by 3.3 percentage points.

Consumption growth stepped up, especially in construction & decoration and automobile sectors. In July, the growth rate of total retail sales in social consumer goods flat-lined with that in Q2, but in August it grew much faster. The two-month aggregate grew by 10.4% year on year, up 0.2 and 0.1 percentage points from Q2 and H1, respectively. From a category-specific point of view, **firstly,** retail sales of residence-related construction and decoration materials and furniture grew robustly, driven by the continuously strong sales of houses in tier-1 and tier-2 cities. In July and August, the retail sales of construction and decoration materials grew by 15.7% on average while that of furniture increased by over 12%. **Secondly,** auto sales, the largest consumption segment, picked up speed in July and August, with average retail sales growth at 11.2%, up 3.4 percentage points from both 2016Q2 and 2016H1. **Thirdly,** sales of petroleum and related products turned from negative to positive growth in July and August, increasing by 0.5% year on year in aggregate, in contrast to negative growth in the first and second quarters. **Fourthly,** growth of online sales slowed down. In the first eight months, online retail sales of goods and services grew by 26.7% year on year, 1.5 percentage points less than in 2016H1 after a two-month straight decrease.

Exports growth rate bottomed out while that of imports turned positive for the first time. In Q3, China witnessed improvement in goods imports and exports, with August figures outperforming the market expectation. In August, China's exports declined by 2.8% year on year (denominated in USD, the same below), 2.6 percentage points higher than that in July (-5.4%) while imports grew by 1.5% year on year, up 14 percentage points from July (-12.5%), representing the first positive import growth year to date. Specifically, **on the one hand**, stabilization of demands from major trade partners mitigated the export decline. In August, China's exports to all major trade partners increased from July. The decline of aggregate exports to the US, EU, Japan, South Korea, Taiwan and ASEAN was down 4 percentage points, pulling the overall export decline down 2.4 percentage points. **On the other hand**, steady growth of domestic industrial production and recovery of industrial product prices propelled the turnaround of import growth rate. In August, imports of iron ore, crude oil, coal and lignite and plastics grew faster than in July by 15.7, 22.4, 52.3 and 9.5 percentage points respectively, all of which gained significant growth year to date.

I.1.2 Industrial production edged up and service sector maintained steady growth

Industrial production stayed flat overall with slight rise in Q3 due to stabilization of demand and improvement of profitability. In the first eight months of 2016, industrial added value increased by 6% accumulatively, the same as in 2016H1 while it rose by 6.3% in August, up 0.3 and 0.2 percentage points from July and the same period last year.

The upturn of industrial sector continued. First, emerging industries and equipment manufacturing industry embraced rapid growth. From January to August, the accumulative growth rate of pharmaceutical manufacturing and computer communication & electronic equipment manufacturing rose by 0.2 and 0.6 percentage points from 2016H1 respectively. The accumulative growth rate of auto manufacturing in the first eight months was 2.9 percentage points higher than in 2016H1, which was attributable to the low base number a year earlier and market condition improvement, etc. The production of general-purpose equipment and special-purpose equipment also stepped up. Meanwhile, new products consistent with the direction of industrial and consumption upgrading witnessed vigorous growth. Production of industrial robots, integrated circuit and new energy vehicles grew by 33.1%, 17.9% and 84% accumulatively in the first eight months.

Second, price rise mitigated pressure of industries with overcapacity and capacity utilization of some sectors was improved. In Q3, the prices of coal, cement, glass and other products rallied; steel price fell slightly from early September, but the price index was still up 12.5% from the end of June. In the meantime, capacity utilization of some sectors continued to improve. As at early September, capacity utilization of float glass increased by 1.4 percentage points from June. In addition, operating rate of blast furnace, float glass and coking enterprises rose respectively by 1.1, 1.2 and 1.9 percentage points from June.

Third, profitability of industrial enterprises kept enhancing. In Q3, PPI decline slowed down year on year and the index increased month on month, which facilitated growth of sales to some extent. Moreover, enterprise cost was reduced further. Particularly, against main business revenue of RMB100, the cost was RMB86.08 in July, down RMB0.42 over the same period last year and the decrease was wider by RMB0.31 compared with June. Higher revenue and lower cost enabled enterprise profitability to quickly pick up. Enterprise profit grew cumulatively by 6.9% in the first seven months, up 0.7 percentage points than in 2016H1.

Value added of the service sector maintained steady growth. Q2 saw a growth of 7.5%, slightly down 0.1 percentage points from Q1. **In terms of consumer services,** wholesale and retail grew faster in Q2, driven by slow growth of consumption, up 0.7 percentage points from both Q1 and the same period last year. In Q2, accommodation and catering services grew by 6.8%, 1 percentage point higher than the same period last year. Both sectors are expected to maintain the same growth rate with Q2, provided that consumption grew steadily on the whole. Due to the high base number in the same period last year, real estate sector saw a growth of 8.8% in Q2, 0.3 percentage points lower than in Q1. Since May, sales area and sales volume of the real estate sector have risen rapidly, but with a slower speed. Taking into consideration of the high base number in the same period last year, it is expected that real estate growth in Q3 will be slightly slower than in Q2. **In terms of producer services**, transportation, warehousing and postal service gained growth of 5.7% in Q2 backed by stable industrial production, which was faster than in Q1 and the same period last year by 2.4 and 1.7 percentage points respectively. Q3 is predicated to enjoy a slightly faster growth than in Q2. Affected by the large base number of the same period last year (19.3%), growth of financial industry slowed down to 5.3% in Q2; it is expected to grow slower in Q3 than in Q2 by a narrow margin, given the still large base number in 2015Q3 (16%). Overall, it is predicated that the service industry will grow by around 7.4% in Q3, slightly slower than in Q2.

I.1.3 Consumer price grew slower and the price scissors between CPI and PPI narrowed

In Q3, CPI slowed its pace of rising due to slower growth of food price and dwindling of carryover effect. In July, CPI rose by 1.8%, 0.1 percentage points lower than in June; it increased by 1.3% in August, down 0.5 percentage points from July, hitting record low since last October. In the same period, PPI decrease slowed down, down by 1.7% and 0.8% respectively in July and August, 0.9% lower than the previous month. The difference between CPI increment (1.3%) and PPI increment (-0.8%) stood at 2.1% in August, which was significantly lower than in June by 2.4 percentage points. The narrowing trend of "price scissors" between CPI and PPI was opposite of the same period last year.

First, two factors led to monthly decline of consumer price growth and made it stay below 1%. On the one hand, food price rise markedly slowed down. In July, year-on-year rise of food prices lowered by 1.3 percentage points from June and in August (1.3%) the figure fell by another 2 percentage points from July, which directly resulted in 0.38 percentage point reduction of CPI increment from the same period last year. On the contrary, non-food prices rose by 1.4% in both July and August, even exceeding the growth in Q2 (1.1%). **On the other hand,** the carryover effect trailed off. Carryover effect of August CPI was 0.3%, 0.45 percentage points lower than in July. Assuming the carryover effects are the same, CPI increase in July and August would be basically flat; the carryover effect in July was also down 0.31 percentage points from June.

Second, PPI decrease continued to narrow, resulted primarily from recovery of producer prices. In Q3, PPI decrease continued to narrow due to price rise of coal, steel and crude oil. In July and August, PPI declined by 1.7% and 0.8% respectively, lower by 0.9 percentage points than the previous month. By category, the slower decrease of producer prices, with a weight of 74.6% in the PPI basket, contributes mainly to the monthly decline of PPI decrement (Table 1). PPI decrement in the first eight months was lessened by 2 percentage points over the same period last year. In particular, PPI decrement of the mining sector in the first eight months was down significantly 7.4 percentage points, of which, PPI fell by 3.2% in August, less than a year earlier by 17.7 percentage points! However, consumer PPI barely changed, posting a decrease of 0.2% in the first eight months, basically flat with the same period last year.

Table 1: PPI Changes in Recent Years by Category (%)

Year	PPI	Producer goods	Producer goods			Consumer goods	Consumer goods			
			Mining industry	Raw material industry	Processing industry		Foods	Clothing	Daily necessities	Durable consumer goods
2012	-1.7	-2.5	-2.4	-2.0	-2.7	0.8	1.4	2.1	0.9	-0.9
2013	-1.9	-2.6	-5.7	-3.1	-2.0	0.2	0.7	1.2	-0.1	-0.9
2014	-1.9	-4.3	-6.5	-3.0	-1.8	0.0	0.2	0.7	0.1	-0.8
2015	-5.2	-6.7	-19.7	-9.5	-4.3	-0.3	0.0	0.7	-0.7	-0.8
2015 (Jan.-Aug.)	-4.9	-6.3	-19.3	-9.0	-3.9	-0.2	0.0	0.6	-0.6	-0.8
2016 (Jan.-Aug.)	-3.2	-4.3	-11.9	-6.9	-2.6	-0.2	0.4	0.8	-0.3	-1.6

Sources: Wind, BOC Institute of International Finance

I.2 Economic Forecast for 2016Q4

I.2.1 Three major uncertainties exist amidst overall stability of economic growth

Looking into 2016Q4, stronger fiscal policies will provide support to infrastructure investment and emerging industries, and service industry and consumption will also grow steadily, thus stabilizing the overall economic operation. However, going ahead, there are three major uncertainties regarding the sustainability of economic stability. The first is the continuity of industrial recovery. Against the backdrop of de-capacity, price rise of energy and raw materials will propel industrial recovery. The sustainability of this trend mainly depends on the degree of down-going effect brought by de-capacity and recovery effect arising from price rise. If the down-going effect overtakes recovery effect, industrial production will face downward pressure; otherwise, it will maintain the recovery trend. The second factor is the balance between destocking and increase of leverages. Destocking here primarily refers to digesting housing inventory. Driven by the combination of destocking, ease monetary policy and change of expectation, some regions have seen spike of housing prices this year; the interaction of destocking and leverage increase resulted in irrational surge of housing prices across China. In the past two months, a new round of soaring prices aggravated the fund shift from real economy to virtual economy, which in turn significantly increased economic operation cost nationwide, depleted China's mid and long term growth potential and enlarged the gap between the rich and the poor. It is indeed a tricky thing to strike a balance among destocking, bubble burst and steady growth through macroeconomic policies. Excessive suppression over the real estate sector will put the already weak economy under greater pressure; yet it is also not wise to let it go unchecked and take on too many leverages, as it may incur greater economic and financial risks. The third is the continuously expanding "scissors" between M1 and M2 growth rate, as a result of increasing proportion of corporate demand deposits and citizens spending more money in buying houses. This phenomenon needs special attention, because M1 always grew much faster than M2 prior to each historical financial crisis. Based on all factors and operation results of the economic early warning system, we predict that the GDP growth rate will be around 6.7% in Q4 and the full year, which is within the target range set by the government at the beginning of the year and also consistent with our year-beginning forecast.

I.2.2 Investment growth is expected to stabilize and even recover, while foreign trade has already been in the process of resurgence

Investment growth is expected to stabilize and even recover. First, newly-commenced projects have grown robustly, providing strong support to investment recovery. In the first eight months, planned investment in newly-commenced projects increased by 22.7% year on year, 20 percentage points higher over the same period last year; planned investment in constructions under progress grew by 8.8% year on year, up 3.7 percentage points higher over the same period last year, marking recovery in three consecutive months. **Second**, Public-Private-Partnership (PPP) projects achieved higher implementation rate, driving fast growth of investment in infrastructure and related projects. Upon review and approval of the third batch of PPP demonstrative projects, the government will intensify efforts to carry out the projects, raising the project implementation rate accordingly. **Third**, as profit of industrial enterprises has turned from negative to positive growth, the number of loss-making enterprises was far less in the latest three months than the same period last year; together with accelerated process of destocking and de-capacity, investment motivate and desire is expected to recover gradually. **Fourth**, slower growth of funding sources is a major obstacle to investment growth. In the first eight months, growth of investment funding sources fell by 1.8 percentage points from 2016H1, also a decrease in two consecutive months.

Consumption will maintain steady growth. First, consumer confidence will be enhanced and expectation improved. In this July, consumer confidence index and expectation index improved by 3.9 and 3.7 respectively over the last month. Both indicators hit the record high since June 2015, and picked up for two months in a row. **Second**, housing consumption is expected to maintain rapid growth. In July and August, sales area and sales volume of commercial housing rose by 19.3% and 30.2% year on year, which will promote the robust retail sales growth of construction and decoration materials and furniture. **Third**, auto sales may decline. Benefiting from the low base number, car sales enjoyed compensatory growth in 2016, keep rising month after month since April. The base number was raised due to the fast growth in 2015Q4; as a result, the accelerated growth of car sales is hard to sustain, and it may fall in 2016Q4. **Fourth**, due to reduction in incremental number of new online shoppers, retail sales growth of online goods and services tends to decelerate.

Foreign trade has been in the process of recovery but there is still a long and arduous way to go. In the previous report, we predicted that foreign trade had been on the way of recovery in spite of potential twists and turns in the near term. We maintain this judgment for Q4. From a positive perspective, consensus is reached that foreign trade is under way of recovery. In August, foreign trade data changed for the better significantly, with export growth of general trade and processing trade easing slower and Export Leading Index rising for the past two months, sending relatively positive signals. However, we should be cautiously optimistic about the strength and vigor of recovery, and aware of the infirm foundation of recovery. Currently, global trade is trending down from the core, with numerous uncertainties in global economy, and its recovery strength is constrained by the overall environment. Recently, we have witnessed the surprising political event of Brexit and economic shock from weaker-than-expected August non-farm payroll employment of the U.S. All these may indicate a long way of stabilization and recovery, even with twists and turns every now and then.

I.2.3 Industrial production will remain stable, but impact of focusing on promoting de-capacity needs attention

Positive factors underpinning overall stability of industrial production do exist. First, the strong growth of infrastructure investment and real estate sales remains a key driver of industrial development, especially for traditional industrial sectors. **Second**, with lower pressure of inventory, enterprises will continue to cut cost and improve profit, which will in turn help them regain confidence in production. Yet at the same time, the advancement of de-capacity may pull down industrial production in Q4. As at the end of July, only 47% and 38% of the full-year goal for steel and coal capacity exit was completed, meaning that the second half year will face heavier pressure of de-capacity. Based on comprehensive analysis, industrial production is expected to grow by around 6.2% in Q4.

I.2.4. Commodity prices will stay at a low level, with less possibility of a surge

Several factors may boost CPI rise in Q4. First, steady economic growth, increasing market demand, potential rise of crude oil, coal and steel prices, and possible shift of year-on-year PPI growth from negative to positive in the next one or two months will impose upward pressure on CPI. Second, month-on-month CPI growth remained positive in August. Particularly, growth of food prices turned from negative for the past five months to positive (0.4%), and this trend may sustain in future. Third, housing price has roared since beginning of this year and still faces great upward pressure. Nevertheless, dwindling of carryover effect and slower income growth have eliminated the pressure of CPI surge. CPI is expected to rise by 1.6% or so in Q4 and around 1.8% throughout 2016, representing higher growth over 2015 (1.4%), but still lower than the control target set by the government at the beginning of the year (3%).

II. Financial Review and Outlook

In Q3, China's financial reform was reaccelerated, building of green financial system stepped up and Shanghai FTZ RMB-denominated bond business was launched. Meanwhile, financial operation embraced more positive signals, monetary policy maintained a neutral and moderate position, monetary loan rebounded and loan structure tended to improve; stock market fluctuation narrowed, bullish trend of bond market continued and market players were more adaptable to two-way fluctuations of RMB exchange rate. However, declining private investment, weak real economy financing demand and enhanced "siphonic effect" of real estate fund have combined to result in many problems in financial sector, including accelerated leverage adding of residents, excessive proportion of individual mortgage loan and heavy pressure from capital outflows.

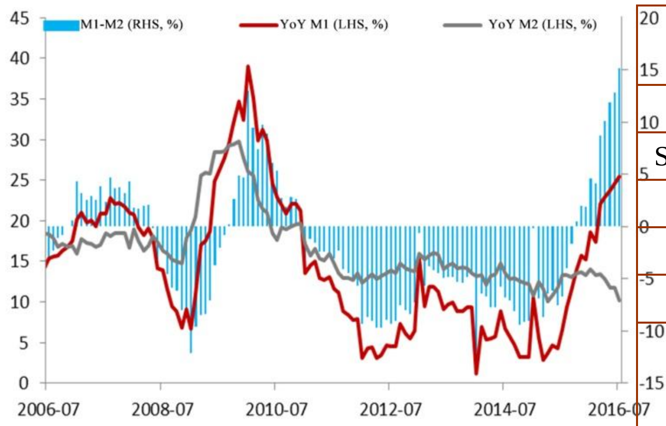
II.1 Financial Review of 2016Q3

II.1.1 "M1-M2" Growth "Scissors" narrowed and loan structure improved

Since Q3, due to the large base number in the same period last year and reduction of funds outstanding for foreign exchange, money supply and credit growth once slowed down noticeably, but the condition was improved in August. At the end of August, M2 grew by 11.4%, up 1.2 percentage points from the end of July; existing private financing size rose by 12.3%, flat with the end of June. Currently, monetary credit growth presents the following features:

"M1-M2" growth "scissors" narrows, but there is still an obvious trend of funds flowing from real to virtual economy. In August, "M1-M2" growth scissors narrowed to 13.9% from 15.2% in July (Figure 3). At the end of August, M2 grew by 11.4%, up 1.2 percentage points from the end of July, which was mainly attributable to fast loan rebound of non-financial enterprises and stronger monetary derivative ability. Financial history of various countries tells us that "M1-M2" growth "scissors" are typically accompanied by depression of real economy, excessive prosperity of the housing or stock market, fund shift from real to virtual economy or "liquidity trap" (Table 2). Intensive attention should be paid to "M1-M2" growth "scissors".

Figure 3: "M1-M2" Growth "Scissors"



Sources: Wind, BOC Institute of International Finance

Table 2 International Experience on "M1-M2" Growth "Scissors"

	Start time	End time	Period (month)
Japan	1991/06	2006/10	185
South Korean	1999/04	2005/10	79
Indonesia	1999/11	2005/08	70
Thailand	1999/05	2006/01	79
Malaysia	1999/05	2004/07	63
US	1985/07	1987/10	28
	1990/11	1995/04	54
	2008/09	2015/09	85
China	2015/10		11

Private financing size grew steadily, with direct financing rising faster. In the first eight months, incremental private financing amount accumulated to RMB11.7 trillion, an increase of RMB1.15 trillion over the same period last year. Specifically, direct financing (bond and stock of non-financial enterprises) increased by RMB1.12 trillion over the same period last year while off-balance-sheet financing fell by RMB465 billion. Private financing size rebounded in August, mainly caused by slower decrease of bill financing, and increase of loan and enterprise bond financing. In August, incremental undiscounted bank acceptance bills reduced by RMB37.7 billion, contributing the most to private financing recovery. Affected by recovering credit demand of non-financial enterprises and still high proportion of housing loans, incremental RMB loans in August posted RMB796.9 billion, accounting for 34.8% of private financing increment in the month. Incremental enterprise bond financing rebounded to RMB330.6 billion in August, accounting for 11.4% of private financing increment in the month; marked resurgence of enterprise bond financing was related to the booming of credit bond market.

Loan structure tended to be improved but housing loan still took a large portion. Thanks to financing cost reduction and gradual profitability enhancement of enterprises, credit demand of non-financial enterprises rebounded in Q3, thus driving RMB loan to stabilize and to grow. RMB loan structure had two major features. **One was that** non-financial enterprises' incremental loans turned from negative to positive, but were still far lower than historical average. In August, incremental loans from non-financial enterprises accounted for 12.7% of new loans in the month, turning around from the negative loan increment in July, but still far lower than the historical average (around 70%). **The second was that** percentage of residential mortgage loan fell slightly, but it still stayed at a high level historically. In August, mid and long term residential loans (primarily housing mortgage) took up 55.5% of new loans in the month, remaining at a high level since 2010, though down 47 percentage points from the previous month.

I.1.2 Monetary market interest rate stabilized on the whole, and the interest rate corridor mechanism yielded initial results

Since Q3, interbank market liquidity has been ample overall. Major operation characteristics were as below. **First,** monetary market witnessed active transactions. In July and August, trading volume of the monetary market accumulated to RMB143.5 trillion, up 47.5% year on year. Overnight instruments are the focus of market trading. In July and August, interbank borrowing and **overnight** pledged repo instruments accounted for about 89% on average. **Second**, maturity structure of monetary policy instruments was further diversified. The central bank collectively conducted medium-term lending facility (MLF) with the term of 6 months and 1 year, and re-launched 14-day and 28-day reverse repos, which enhanced mid and long term liquidity. **Third**, the central bank locked up short-term funds and released long-term liquidity, leading to interest rate showing a tendency of rising for short-term funds and decreasing for long-term funds. Meanwhile, the central bank stabilized market expectation by increasing the frequency of open market operations and optimizing maturity structure of various instruments. As a result, interest rate suffered no wide fluctuations and the corridor mechanism achieved initial success.

I.1.3 Bond market reform accelerated and the bullish trend continued

Bullish trend of the bond market continued in Q3, because of the accelerated reform and enhanced risk hedging function against Brexit. As at September 23, 2016, all-bond index recorded at 173.0, about 3 points higher than at the end of June. The development of bond market was characterized by the following points. **First**, opening up of bond market further accelerated and management of RQFII was shifted from approval to the combination of filing and approval. **Second**, RMB-denominated bonds became more diversified, SDR bond issuance began and green bond expanded. On August 12, the World Bank was permitted to issue SDR-denominated bonds in China's interbank bond market, which will promote RMB internationalization. In the first seven months, China has issued nearly RMB120 billion green bonds, accounting for 44% of total global issuance in the same period, making it the largest green bond market in the world. **Third**, interest rate of government bonds declined amidst fluctuations and credit spread fell to a low level. In Q3, yield rate of government bonds with various maturities headed downward. On September 23, yield rate of 1-year government bond closed at 2.1584%, down around 23 BPs from the end of June 2016, while that of 10-year government bond was down 11 BPs. Meanwhile, in the face of weak demand from real economy and relatively adequate liquidity, major financial institutions increased the weight of credit debt, leading to gradually decreasing credit spread. On September 23, credit spread of 5-year corporate bond rated at AA and AA+ was 47.2 BPs, down 48 BPs from the end of June.

II.1.4 Fluctuations continued in the stock market, with a slightly higher range

In Q3, China's A-share stock market basically maintained the range-bound trend of Q2, which was in line with our expectations in the previous report. On September 23, Shanghai Composite Index closed at 3034, up 3.5% over the end of June; SZSE Component Index gained 1.2% over the end of June to close at 10610. On the whole, three characteristics of the Q3 stock market merit attention. **First**, the fluctuation range rose on a whole. In Q3, Shanghai Composite Index fluctuated between 2900 and 3100. Similar to Q2, the stock prices had a cap and a floor; what's different was that the range went upward by about 100 points over Q2. **Second**, the increasingly stricter regulatory requirements impacted risk appetite and upward momentum. In spite of the higher range, overall market vitality failed to improve significantly in Q3. CSRC introduced new requirements on restructuring, M&A and back door listing and other stringent measures to crack down on shell resources-related stock speculations. These moves lowered investors' risk appetite and fund allocations in the market became more prudential. Three, the long-planned "Shenzhen-Hong Kong Stock Connect" was officially approved in Q3. Yet it is unable to reshape the overall market layout in the near term due to distinct differences in investment philosophy between Shenzhen and Hong Kong. Seen from the experience of "Shanghai-Hong Kong Stock Connect", cumulative net buying amount was less than RMB50 billion to date and the daily trading volume took only 1-2% of Shanghai stock market, imposing little impact on the overall market.

II.1.5 RMB fluctuated both ways against USD and flexibility of exchange rate was further enhanced

In Q3, RMB fluctuated both ways against USD as a result of the aftermath of Brexit, the Fed rate hike and change in foreign exchange supply and demand. Main characteristics were as follows. First, RMB fluctuated both ways against USD more widely, impacted by the mechanism featuring "closing exchange rate + exchange rate change of a basket of currencies". For instance, in early July, the middle rate of RMB against USD fell below 6.9, hitting the record low since October 2010, driven by global exchange market volatility, a stronger US dollar, dividend payout of listed companies and strong FX purchase demand for overseas study. However, with effects of the above factors gradually trailing off, RMB/USD middle rate closed at 6.6511 at the end of the month, appreciating by 0.69% from mid-July and depreciating slightly by 0.02% from early July. Flexibility of exchange rate was further enhanced. Second, RMB exchange rate index had its rise and fall. At the end of July and the end of August, CFETS RMB Index stood at 95.34 and 94.33 respectively, representing a month-on-month appreciation of 0.34% and depreciation of 1.06%. RMB exchange rate index maintained a stable trend overall.

II.2 Financial Forecast for 2016Q4

II.2.1 Monetary credit recovery lacks of endogenous momentum, and steady growth will be the keynote

Considering the large base number of M2 in the same period last year, reduction of funds outstanding for foreign exchange, sluggish private investment, weak demand for loans from non-financial enterprises, as well as the squeezing effect of local debt replacement on credit demand, monetary credit is expected to **grow** steadily for some time, with little possibility of a sharp rebound, and M2 growth might be lower than 13%, i.e. the target set at the year beginning, especially given the economic stabilization and roaring housing prices. However, there are multiple favorable conditions for monetary credit growth. **The first is that** industrial production and consumption growth has outperformed expectation; **another is that** financing demand of infrastructure investment has become stronger; **lastly,** real estate credit demand is still robust. It is predicted that money supply and credit growth will recover in Q4, and M2 rise by 12% and existing private financing size by 13% at the year end.

II.2.2 Market liquidity will remain moderate and money market interest rate experience narrow volatility

On one hand, China's funds outstanding for foreign exchange decreased by RMB191.895 billion month on month at the end of August, a 10-month decrease consecutively, which will still negatively affect fund supply for a long time. In addition, as the Fed is still likely to raise interest rate in December and RMB is about to join the SDR, **the central bank will use open market operations, MLF and other instruments more often to curb market liquidity volatility**, so as to maintain stability of RMB exchange rate. On the other hand, as 14-day and 28-day reverse repos are re-launched, maturity structure of the central bank's monetary policy instruments will be more diversified, which will further improve the pertinence and effectiveness on curbing liquidity volatility. Also, the improved interest rate corridor mechanism will help better control short-term interest rate fluctuation and maintain stability of core interest rates.

II.2.3 Bond market will start deleveraging, with main tune being high-level consolidation

In Q4, there will be two favorable factors for the bond market. **First**, the green bond policy system will be more matured. **Second,** the bond market will still be rather attractive, given the low global interest rate, heavy downward pressure of China's economy and fund shift from real to virtual economy. Unfavorable factors are listed below. **First**, regulatory requirements are more stringent. *Guidelines on Settlement Risk Control of Bond Pledged Repos*, *Template for Investor Protection Provisions* and other regulatory rules have been promulgated successively, putting the overly high leverage ratio in the bond market at the risk of correction. The new regulatory rules on business of fund companies’ subsidiaries, securities firms’ asset management business and bank wealth management business introduced earlier will also reduce the incremental funds in the bond market. **Second**, pressure of capital outflows and housing market bubbles will leave little room for easy monetary policy. It is highly likely that the Fed will raise interest rate within the year, which will impose pressure on RMB depreciation and impair the attractiveness of domestic bond products. Overall, further decline of secondary market yield rate is barely possible, with the main tune being high-level consolidation.

II.2.4 Stock market finds it difficult to change the range-bound pattern, and the fluctuation range is likely to expand

In Q4, the stock market will still be trapped in volatility, with no obvious trend forming, and the range is likely to expand. Several factors restrain the stock market from trending upward significantly. **First,** stronger signal of economic bottoming has weakened the expectation for further relaxed monetary policy, hence scarce incremental liquidity funds. **Second,** given that recently regulators emphasized the importance of preventing and mitigating financial risks repeatedly, regulatory requirements are expected to tighten further in Q4. **Third,** the uncertainty in US interest rate hike might trigger market volatility. On the other hand, the stock market also faces a range of favorable factors. **First,** enterprise profit will continue the recovery trend in Q4, providing firm rising momentum for the stock market. **Second,** rotation of the largest category of assets may help improve fund status of the stock market. In Q4, the bond market will change from high-level rise to high-level consolidation, and the real estate market is facing pressure of policy adjustment, which may accordingly channel some funds to the stock market, thus improving its liquidity and vitality.

II.2.5 RMB/USD exchange rate has limited downward room and is likely to maintain the wide range-band fluctuation

In Q4, RMB/USD exchange rate has limited downward room, in spite of the depreciation pressure, and is likely to maintain the wide-range fluctuation. Major reasons are as below. Domestically, Chinese economy embraced positive changes in August, and trade surplus is expected to increase. Internationally, global uncertainties keep simmering, and Fed rate hike in December is still possible, which will bring heavier pressure on capital outflows and RMB depreciation. Yet, as spread between 10-year Chinese government bond and US treasury bond stays at 100 BPs, one rate hike will have limited impact on RMB exchange rate. In addition, favorable factors, including RMB’s inclusion in SDR currency basket in October and accelerated opening up of domestic bond market, will strengthen RMB allocation demand from overseas institutions. In general, RMB will not continuously depreciate against USD; instead, it will stabilize within a reasonable and balanced range.

Table 4: China's Major Economic and Financial Indicator Forecasts for 2016Q4 and 2017 (%)

Indicator	2014 (R)	2015 (R)	2016					2017 (F)
			Q1（R）	Q2（R）	Q3（E）	Q4(E)	Full year (E)	
GDP	7.3	6.9	6.7	6.7	6.7	6.7	6.7	6.7
Industrial value added of enterprises above designated size	8.3	6.1	5.9	6.1	6.2	6.2	6.1	6.0
Fixed asset investment	15.7	10.0	10.7	8.4	6.7	8.0	8.1	8.0
Total retail sales of consumer goods	12.0	10.7	10.3	10.2	10.5	10.5	10.4	10.5
Exports	6.1	-2.9	-9.6	-4.8	-4.2	-4.3	-6.0	1.6
Imports	0.4	-14.2	-13.4	-6.6	-4.8	-4.0	-7.1	2.0
Consumer Price Index (CPI)	2.0	1.4	2.1	2.1	1.5	1.6	1.8	2.0
Producer Price Index (PPI)	-1.9	-5.2	-4.8	-2.9	-1.0	0.5	-2.1	1.0
Broad money supply (M2, ending balance)	12.2	13.3	13.4	11.8	11.6	-	12.0	12.0
Private financing size (existing)	14.3	12.4	13.4	12.3	12.5	-	13.0	13.0

Source: BOC Institute of International Finance

III. Macro Policy Preference

Thanks to the effect of a series of polices introduced earlier to stabilize economic growth, the economy presents signs of stabilization recently. At the same time, the real estate market is reviving with continuously rising housing prices, driven by de-capacity and many other factors; with the relief of de-stocking pressure comes rapid growth of residential leverage ratio; increasing proportion of corporate demand deposits and more money used by citizens to buy houses have resulted in far faster growth of M1 than M2, implying great economic and financial risks. In the near future, the macro policies should prioritize the balance between maintaining steady growth and suppressing asset bubbles.

III.1 Multiple measures should be taken to expand the room for steady growth backed by "loose fiscal policy"

First, the role of "loose fiscal policy" in stabilizing growth should be further leveraged. In the face of slower manufacturing growth and weak private investment, infrastructure investment remains the key to steady growth. Fiscal expenditure should be further increased to promote infrastructure investment, making it stay at a certain level. Fiscal revenue growth is difficult, given the policy-driven revenue reduction; however, the fiscal deficit ratio of 3% set at the beginning of the year should be maintained, to step up expenditure and ensure rigid spending on infrastructure and people's livelihood.

Second, stronger support should be provided to "weak" fields. In the process of advancing supply-side reform, supporting the weak fields should be the focus of fiscal policies. It will help motivate rational and effective investment and increase effective supply simultaneously, thus creating new momentum for economic growth. The government should increase expenditure, centered with major projects involving poverty relief, water conservation and reinforcement, key infrastructure construction as well as cultivation of emerging industries and new growth engines. More targeted construction funds should be arranged in an accelerated manner, to vigorously support the weak and key fields.

Third, fiscal policy should be further loosed by virtue of PPP projects As at the end of this July, there were 10,170 projects in the PPP project repository of the Ministry of Finance, with total investment amount exceeding RMB12 trillion. Also, the participation of non-SOEs kept increasing, and the implementation rate of registered projects rose at a faster pace. In the near future, with the gradual improvement of PPP supporting regulations, financing models and exit mechanism, demand for local PPP projects will be stronger, making PPP a potentially pivotal underpinning force for "loose fiscal policy".

III.2 Monetary policy should be neutral and moderate, dos and don'ts

The imbalance of money allocations between virtual and real economy may lead to various potential risks and leave limited room for further loosing monetary policy. The monetary policy must focus on priorities, so as to get out of the dilemma of depressed real economy and "booming" virtual economy.

First, interest cut will be on the shelf for some time. Major considerations are as below. First, with recent improvement of macroeconomic data, it's highly probable that Q4 will witness steady economic growth. Second, the benchmark interest rate is at historical low, leaving limited room for further cut. Third, given the overheating real estate market with surge of housing prices, it's not proper to cut interest rate, as it is a strong signal. Fourth, strong expectation on potential Fed's interest hike (especially after the American Presidential Election) brings about RMB depreciation pressure, and which will be further aggravated in the case of interest cut.

Second, the RRR will be lowered in a hedging manner at proper timing. The RRR can be lowered once in a hedging manner, based on the decrease of funds outstanding for foreign exchange and maturity of MLF, among other instruments, on the premise of no excessive money supply. In addition, banks are currently facing significantly narrower interest spread and greater operation pressure. Compared with MLF and open market operations, RRR reduction will enable the replacement of some high-interest fund (interest rate of 3-month MLF is 2.75% and that of 7-day reverse repo is 2.25%) with low-interest assets (the mandatory RRR is 1.62%), thereby effectively reducing banks' cost of debt and creating conditions for them to better serve the real economy.

Third, more attention should be paid to maturity structure of interest rates in the process of liquidity management. Since the beginning of this year, especially Q3, open market operations have become more flexible. Open market money supply has been adjusted based on market liquidity to effectively mitigate market volatility. For the next step, the government should pay more attention to price-based liquidity adjustment while further improving the quantity-based liquidity adjustment mechanism. First, 14-day and 28-day reverse repos and frequent but small-amount MLF operations should be regularized. Second, the government should strengthen price-based adjustment to properly lower interest rate of MLF and other instruments while cooling the bond market with higher short-term interest rates. In other words, it should improve banks' ability to meet low-cost fund demand of the real economy through flattening the yield curve.

Fourth, the central bank's management framework over collaterals should be improved. This year, large-scale local debt replacement (about RMB5 trillion) has played a positive role in relieving local governments' debt service pressure. However, for banks, local debts can neither be used as collaterals in the open market like government debt nor traded in the secondary market. In addition, banks are increasingly dependent on fund borrowings from the central bank via open market operations. Yet with more money borrowed, there will be more government debt collateralized and less current assets at the disposal of banks. Finally, banks will face greater pressure in meeting the regulatory requirement on liquidity coverage ratio (LCR). This in return aggravates the conflict between open market operations and liquidity regulation. The central bank may choose to moderately expand the scope of collaterals and include the large-scale replaced local debts into collaterals for open market operations. In the future, the replaced bonds may be allowed to trade in the secondary market, to improve their liquidity.

III.3 Coordination and cooperation among monetary policy, regulatory policy and real estate policy should be strengthened to channel funds from virtual to real economy

The causes of fund shift from real to virtual economy are complicated. In general, it relates not only to the poor profitability of real economy but also to overly fast price rise of real estate and other assets. It's not practical to solve the problem only by using monetary policy. It is suggested that monetary policy should be coordinated better with regulatory policy, real estate policy and industrial policy, etc. to drive the fund flows from virtual to real economy. First, more differentiated financial control measures should be adopted to guide the allocation of financial resources, optimize asset structure and balance the financial sector and real economy; second, a monitoring system over virtual economy operation should be established to curb self-aggrandizement of virtual economy, narrow blind zone of regulation and the room for hedging and improve the consistency of regulatory rules; third, the government should find out the residential leverage ratio and mortgage burden in regions with roaring housing prices and use supply-demand adjustment tools in combination with other measures in regions with outstanding problems, including increase of land supply and policies with restrictions on housing loans and housing purchase quota; fourth, the government should guide financial innovations, encouraging good ones and containing bad ones, to make them better serve the real economy; fifth, potential risks in Internet finance should be duly guarded against.