



China's Economic and Financial Outlook

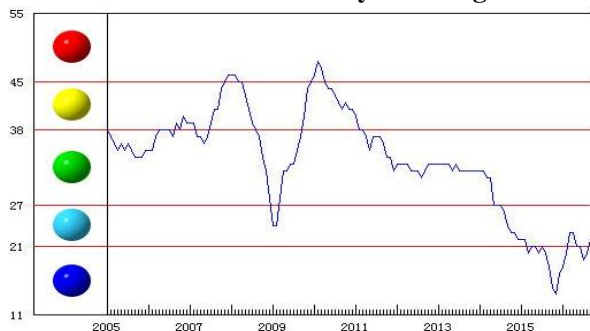
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Highlights

- In 2016, the Chinese economy continued to grow steadily, with downward pressures mitigated somewhat, under the influence of the cumulative effects of policies to stabilize growth, continued heating up of the real estate market and rising commodity prices. It is projected that the full-year GDP will grow by around 6.7%, and CPI rise by about 2.0%, both within the target ranges set by the government.
- In 2017, China will press ahead with supply-side reforms, and witness further transitions from old growth engines and models to new ones. The national economy is expected to stabilize as a whole, with GDP to grow at around 6.7%, on par with that of 2016, and CPI to rise by about 2.5%. However, more complicated and ever-changing development environments and conditions at home and abroad will definitely lead to greater uncertainty.
- Despite a trend of stabilization in the Chinese economy, greater uncertainty still weighs on economic growth rate. Macro policy should focus on stabilizing growth, suppressing bubbles and preventing risks. China should maintain a proactive fiscal policy, and is likely to further strengthen such a stance; monetary policy will remain moderate and adequate, and is unlikely to either tighten or loosen substantially. In advancing the “elimination of excess capacity, deleveraging, destocking, cutting costs and overcoming weaknesses”, China will attach more importance to steering industrial transformation and upgrading, and to coordination and collaboration among policies during supply-side reforms, and put more stress on controlling house prices, destocking and establishing relevant mechanisms in its efforts to regulate the real estate sector.

China's Macroeconomic Early Warning Index



Red: Overheated; Yellow: Hot; Green: Normal; Light blue: Cool; Dark blue: Super-cooled

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Forge Ahead amid Greater Uncertainty

— China's Economic and Financial Outlook (2017)

In 2016, under the influence of the cumulative effects of policies to stabilize growth, continued heating up of the real estate market and rising commodity prices, the Chinese economy continued to grow steadily, with downward pressures mitigated somewhat. The overall performance beat market expectations, featuring “three stabilizations and three progresses”. It is estimated that the full-year GDP will grow by around 6.7%, and CPI rise by about 2.0%, both within the target ranges set by the government. In 2017, China will press ahead with supply-side reforms, and witness further transitions from old growth engines and models to new ones. The national economy is expected to run steadily as a whole, with GDP to grow at around 6.7%, on par with that of 2016, and CPI to rise by about 2.5%. However, despite a trend of stabilization in the Chinese economy lately, more complicated and ever-changing development environments and conditions at home and abroad will definitely lead to greater uncertainty, which in turn will weigh on economic growth rate in 2017. In light of the above, macro policies should focus on stabilizing growth, suppressing bubbles and preventing risks. China should maintain a proactive fiscal policy, and is likely to further strengthen such a stance; monetary policy will remain moderate and adequate, and is unlikely to tighten or loosen substantially. In advancing the “elimination of excess capacity, deleveraging, destocking, cutting costs and overcoming weaknesses”, China will attach more importance to steering industrial transformation and upgrading, and to coordination and collaboration among policies during supply-side reforms, and put more stress on controlling house prices, destocking and establishing relevant mechanisms in its efforts to regulate the real estate sector.

I. Economic Review and Outlook

I.1 Operational characteristics of economy in 2016: "three stabilizations and three progresses"

In 2016, the external environments for the Chinese economy remained complicated and volatile, and the recovery of the world economy was weaker than expected. But under the influence of the cumulative effects of policies to stabilize growth, continued heating up of the real estate market and rising commodity prices, China's economy continued to grow steadily, with downward pressures mitigated somewhat, and taking on the characteristics of “three stabilizations and three progresses”.

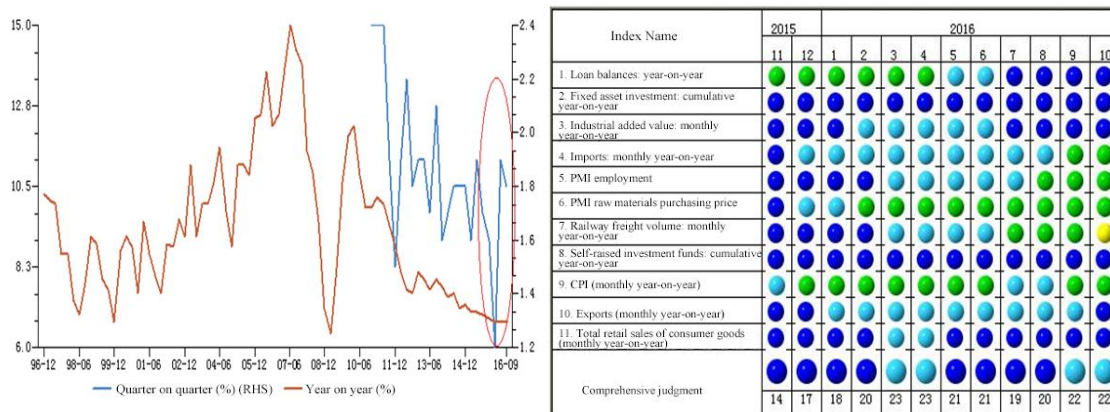
"Three stabilizations". First is stable growth. The Chinese economy remained very stable in 2016, which was different from the overall slowdown in GDP growth of the previous year. The first three quarters all saw GDP growing at 6.7% (Figure 1), with GDP growth in the fourth quarter and for the whole year estimated to be around 6.7% as well, within the target range (6.5%-7%) set at the beginning of the year by the government. The growth rate was basically consistent with our prediction (6.8%) made at the end of 2015. Second is stable employment. The first three quarters witnessed an increase of 10.67 million jobs nationwide, attaining the full-year target in advance (10 million). In addition, the registered unemployment rate (4.04%) in urban areas was slightly lower as compared with the same period of last year, while the surveyed unemployment rate (4.97%) remained basically steady. Third is stable prices. CPI rose steadily in 2016, while PPI ended a 54-month negative growth (see below for details).

"Three progresses". First is swift change in economic structure. The economic growth appeared "calm" in 2016, but structural change was "surgent" indeed, which was chiefly reflected in: the rapid growth of the consumer and services sector contributing more to economic growth; faster development of the productive services sector, and accelerated growth of the equipment manufacturing, hi-tech and new-energy vehicles industries; and further slowdown in the growth rate

of traditional sectors including mining, and six major highly energy-consuming sectors. Second is notable improvement of enterprises' profits. Industrial enterprises saw their profits pick up in 2016, which grew by 8.6% in the first ten months (compared with a 2% drop a year earlier). The losses of money-losing enterprises decreased by 7% in the first three quarters (compared with a 26.9% increase a year earlier). Third is faster advancement of supply-side structural reforms, with material progress made in "eliminating excess capacity, deleveraging, destocking, cutting costs and overcoming weaknesses". Steelmaking, coal and other related industries completed over 80% of their tasks of reducing overcapacity, faster than expected. The supply and demand relationship of industries plagued by overcapacity has changed, leading prices to rebound. Property sales picked up speed, with the area for sale and inventories reduced notably. The financing costs and taxes for businesses decreased. Investment in less developed sectors such as agriculture, water conservancy and education grew rapidly, mostly at a rate of above 20%.

As our China's macroeconomic early warning system shows, the Chinese economy turned around in the second half of 2016, climbing from the "super-cooled" zone into the "cool" zone. Of the major economic and financial indexes, railway freight volume, imports and PMI employment, among others, picked up apparently, showing signs of warming in the economy. But investment, consumption, industrial added value and exports, among others, still remained in the "super-cooled" zone (Figure 2).

Figure 1: China's GDP Growth Trend **Figure 2: China's Macroeconomic Early Warning Index System**



Sources: Wind, BOC Institute of International Finance

I.1.1 Domestic demand slowed down but tended to stabilize, with exports to bottom out gradually

Investment growth slowed down but tended to stabilize. 2016 is the seventh straight year for investment growth to slow down. In the first ten months of 2016, investment grew by 8.3% year on year, with the growth rate down 1.7 percentage points from the previous year, which was the main contributor to slowing economic growth. In the first three quarters, capital formation contributed to GDP growth by 2.5 percentage points, down 0.5 percentage points from last year. The slowdown in investment was mainly due to: (1) a substantial decrease in the growth of private investment as a result of poor profit prospects, insufficient market confidence and lack of investment motivation for private capital; (2) a remarkable slowdown in investment growth in manufacturing caused by structural problems including overcapacity, high costs and high leverage ratios; and (3) plummeting investment in Northeast China because of greater economic difficulty in the region.

There were also three "highlights" despite an overall slowdown in investment growth: first, the

recovery of the real estate markets in tier-1 and tier-2 cities drove a substantial rebound in investment in the sector; second, fiscal funds, special construction funds and PPP projects (among others) worked together to propel faster investment in infrastructure; third, accelerated industrial restructuring contributed to faster investment growth in the modern services sector.

The growth rate of consumption decelerated moderately. Despite a slight slowdown, the growth of consumption remained steady on the whole in 2016. The first ten months saw a year-on-year growth of 10.3%, down 0.4 percentage points as compared with last year. Due to the slowdown in investment, the contribution of consumption to GDP growth rose materially to 71% in the first three quarters, up 9.1% over last year. Of the major categories with sizes reaching specified thresholds, consumption growth in nearly all categories slowed down. More specifically, building & decoration materials, furniture and traditional Chinese and Western medicines led consumption growth, whereas communication equipment, gold, silver and jewelry, and cultural and office goods posted the greatest slowdown in consumption growth. The largest contributors were automobiles, oil and foodstuffs, clothing, shoes, hats, knitwear and textiles. Moreover, online retail continued with high-speed growth, but such growth also slowed down notably. In the first ten months, retail sales of goods and services online increased by 25.7% year on year, down 7.6 percentage points as compared with 2015.

Exports tried to bottom out while imports continued the rebound. In the first ten months of 2016, exports of goods decreased by 8.2% year on year in dollar terms, with the decrease rate 5.6 percentage points higher than last year; and imports declined by 7.5% year on year, with the decrease rate 8 percentage points lower than last year. More specifically, first, overseas market demand determined the dip of exports. PMI of the global manufacturing industry started to fall from 2015, but bottomed out in the second quarter of 2016, supporting global trade to stabilize. China's export growth gradually stabilized in the second and third quarter of the year after hitting the bottom at the end of 2015 and the beginning of 2016. The trend of exports was basically consistent with changes in overseas market demand. The exports of South Korea, which is closely linked to China in terms of international division of labor, also took on similar features. Second, general exporting trade outdid the rest, and private enterprises became the key exporting force. Third, a stabilizing domestic economy and a rally in commodity prices ensured a satisfactory growth rate of imports.

I.1.2 Industrial production rose amid stability, and a substantial fall in the financial sector dragged down the growth of the entire services sector

At the beginning of 2016, as demand remained weak overall, the growth rate of industrial added value fell back considerably to stand only at 5.4% in the first two months, down 1.4 percentage points as compared with the same period of last year. Yet under the influence of stability-promoting policies, rebounding product prices and warming of the real estate market, industrial production recovered somewhat after March as compared with the beginning of the year; its growth rate in the first ten months was 0.2 percentage points higher than the first quarter. The feature of "being stable" was particularly evident since the second half, with the cumulative growth rate maintained at 6% each month.

Emerging industries, equipment manufacturing, and the production and supply of power, gas and water were key pillars for steady industrial growth. Meanwhile, consumer goods manufacturing slowed down moderately on the whole. The growth rate of agricultural and non-staple food processing, food manufacturing, and wood processing picked up as compared with the same period of last year, whereas that of textile, furniture, sports and entertainment, and other manufacturing sectors all decelerated.

There was also a general substantial slowdown in the production of resources-based and highly energy-consuming heavy industries, and industries obsessed with overcapacity polarized. The growth rate of added value of nonmetal mineral products and metal products manufacturing was 0.2

and 1.2 percentage points higher than the same period of last year. But the growth rate of added value of mining, ferrous metal and nonferrous metal processing, among others, all slowed down; particularly for sectors related to steelmaking and coal, the decrease rate of added value's growth rate was relatively high as a result of the efforts to eliminate excess capacity.

Industrial enterprises saw the improvement of their profits, driven by some heavy industries, equipment manufacturing and hi-tech sectors. Under the combined effects of a stabilizing economy, rally in product prices and lower costs, the profits of industrial enterprises grew faster in 2016, with a growth rate of 8.6% in the first ten months, 10.6 percentage points higher than the same period of last year. Of the heavy industries, coal mining and processing, ferrous and nonferrous metal processing, nonmetal mineral products manufacturing, petroleum processing and chemicals manufacturing contributed 78.5% cumulatively to the growth rate of industrial profits. Whereas the contributions from car making, computers, communications and electronics, electric machinery and equipment, and pharmaceuticals accounted for 40.9%.

The slowdown in the growth of the services sector was mainly owing to the fallback in the financial industry. The services sector grew by 7.6% in the first three quarters, 0.8 percentage points lower than the same period of last year; but its contribution to GDP stood at 58.3%, 4.6 percentage points higher than the same period of last year. Of the key services sectors, the growth rate of added value of the financial industry dropped from 17% in the first three quarters of 2015 to 6.3% in the same period of 2016, making it the major factor dragging down the overall growth of the services sector for 2016.

I.1.3 PPI finally turned positive on the back of stable prices and less deflationary pressures

Prices remained stable in 2016 with less deflationary pressures, under the influence of a stabilizing economy, booming consumption and rising energy and raw material prices. In the first ten months, CPI rose by 2% cumulatively, up 0.6 percentage points over the same period of last year; PPI decreased by 2.5% cumulatively, the decrease rate was 2.6 percentage points less than the same period of last year, and the year-on-year growth rate thereof stayed positive for two consecutive months.

First, CPI showed a "U"-shaped trajectory, but the causes of the two "peaks" varied. Overall, CPI remained high at the beginning and the end of the year, but hit the trough at mid-year. But the factors that influenced food prices differed greatly in the first and second half of the year. The pork price cycle and rising vegetable prices were mainly responsible for food price changes in the first half of the year; whereas vegetable and fruit prices rebounded in the second half, especially in the fourth quarter, as weather turned cold. In addition, the pickup of CPI in September and October was also associated with constantly rising service prices, the increase rate of which was even higher than that of consumer goods prices. This, on the one hand, reflected the fact of an aging population, a decrease in the number of migrant workers from rural areas, dwindling demographic dividend, and constantly rising labor costs in China; on the other hand, it showed, as the economy entered a new phase with economic restructuring underway, the services sector grew rapidly, with the supply and demand markets both booming.

Second, PPI growth rate finally turned positive as commodity prices rose. The decrease rate of PPI continued narrowing in 2016, and in September the index finally turned positive, ending a 54-month row of negative growth. This was both related to a remarkable increase in the demand for energy and raw materials due to a stabilizing economy, substantial growth of infrastructure investment and warming of the real estate market; and also to a decrease in supply concerning certain industries as a result of the advancement of supply-side reforms and the initiative to eliminate excess capacity. Such "increase and decrease" resulted in changes in the supply and demand relationship of relevant industries, hence continuously pushing prices higher.

Third, price scissors between CPI and PPI continued to shrink with deflationary pressures mitigated notably. As PPI finally turned positive after its decrease rate kept narrowing and CPI remained stable overall, the difference between their increase rates was much smaller, standing only at 0.9% in October, compared with 7.2% one year ago. As a key indicator for judging economic stability and recovery, the price scissors shrank, hence the drag-down effect of PPI on CPI diminished and even disappeared, and deflationary pressures in the areas of consumption and production were both reduced, which was significant to boosting the confidence of businesses and improving production and operation. But with PPI turning positive, its increase rate may exceed that of CPI in future, which then would generate pressures to push up CPI.

I.2 Economic Forecast for 2017

The year of 2017 will witness the continued division of policies worldwide and further intensification of gaming between forces on the sides of globalization and deglobalization. The fact that the U.S. President-elect Donald Trump will come into power will bring material uncertainty to the American and global economic, trade and political landscapes. It is also a critical year for China's initiative to build a moderately prosperous society, and the Chinese economy will further accelerate the transition from old dynamics and models into new ones. The overall economy is expected to stabilize, but uncertainties still abound. For the economy to remain steady, it is necessary to pay special attention to the following issues: (1) changes in America's economic, trade and investment policies after Donald Trump assuming office, the Brexit process, inconsistency in the economic trends and macro policies of different countries; (2) relatively great uncertainty as to whether investment in infrastructure construction can maintain high growth of around 20%, and whether the rally in real estate investment can sustain as new policies for regulating the real estate sector will affect market expectations; (3), whether industrial production and investment in manufacturing will continue to recover will be affected by continued elimination of excess capacity in the manufacturing sector and the sustainability of a rising PPI; (4) Risks associated with RMB exchange rate fluctuation and cross-border capital flows still exist. Financial risks like high leverage ratio of enterprises and increasing tendency among them to take funds out of the real economy to be invested in the virtual economy, will have potential impact on economic stability. All in all, GDP growth is expected to be around 6.7% for 2017, basically on par with 2016.

I.2.1 Growth of investment will stabilize gradually

The factors below will affect investment growth in 2017. Judging by the will to invest, notable acceleration of profit growth of enterprises will encourage investments. Profit growth of industrial enterprises turned positive in 2016, with growth rate up by over 10 percentage points year on year. Judging by investment projects, special engineering projects of 11 categories will be launched, and efforts stepped up to invest in areas with weaknesses. Judging by investment funds, fiscal funds, special construction funds and private capital will continue to back up investment; the PPP model in particular will play a critical role in promoting the steady growth of investment. In terms of investment categories, first, investment in manufacturing will gradually stabilize, thanks to the rebound of product prices, improved profits of enterprises, and steady progress made in eliminating excess capacity and destocking. In effect, investment in manufacturing already showed signs of stabilization in the last two quarters of 2016. Second, the latest round of measures to regulate the real estate sector has tightened the financing chain of property developers, and even required self-owned funds be used to bid for land; as a result, the inhibiting effect on the investment in the real estate and its related sectors will gradually materialize. Third, investment in infrastructure is under pressure to slow down given limited fiscal backing, tight funding sources, and a relatively high growth rate in 2016. Fourth, faster upgrading of residents' consumption structure makes it possible for investment in science, education, culture and health care, business services, sports and entertainment and other services sectors to maintain high-speed growth. Furthermore, following a

steep fall in 2016, investment in northeastern provinces including Liaoning is likely to rebound.

I.2.2 Consumption will keep growing rapidly

The factors below will affect consumption growth in 2017. In terms of the consumption structure, constant introduction of new products, business forms and models in this domain will promote growth. In terms of consumer sentiment and confidence, residents' consumption will and confidence have both improved. As a survey of depositors by the central bank shows, consumption will has peaked lately since the second quarter of 2009; moreover, consumer confidence index, satisfaction index and expectation index all rose. In terms of income, the growth of residents' income has slowed down, which will weaken its support to consumption. In terms of consumption policies, the effect of the policy to cut the vehicle purchase tax has played out, so the growth rate of car consumption (accounting for around 27% of the total) is likely to slow down; the implementation of the new policies designed to regulate the real estate sector will undermine the accelerated growth of housing-related consumption (accounting for around 10% of the total) such as building and decoration materials, furniture and household appliances. In addition, consumption in respect of oil and foodstuffs, clothing, shoes and hats and communication equipment may pick up after a slowdown in growth; while consumption of petroleum and its products (accounting for around 13% of the total) may continue with restorative growth.

I.2.3 There is still a long way for foreign trade to stabilize and recover

There is still a long way for foreign trade to stabilize and recover in 2017, as the influence of external factors is greater than internal factors, and import conditions are better than export ones. First, that the world economy may improve as compared with 2016 will not necessarily drive Chinese exports significantly. IMF and the World Bank both anticipate a moderate growth of the world economy amid stability in 2017, which is good news to China's foreign trade. However, recovery of homebuilding and prospective incentive policies for infrastructure construction in the United States and a pickup in commodity prices only have limited direct impact on China's exports. Second, signs of anti-globalization continue to emerge. The Brexit and America's presidential election also showed the rise of protectionism and populism; the repatriation of American enterprises as advocated by Donald Trump will generate negative impact directly on trade. Third, uncertainty will constantly restrain the recovery of trade orders. At the moment, a series of factors point to greater uncertainties, such as volatility in the exchange rate market, divided expectation for inflation, Donald Trump's policies still in the making, rate increase by the U.S. Federal Reserve, and general elections in some European countries. All these will fragment trade orders, complicate exchange rate risk, prompt corporate supply chain management to degenerate from globalization into localization, hence resulting in the reduction of supply chain-based trade. Fourth, imports will mostly reflect the steadiness of domestic economy. Stabilization of industrial production and high growth of infrastructure investment will continue to support the demand for commodities, and make imports outdo exports.

I.2.4 Industrial production will largely stabilize, while a decrease in the growth rate of the real estate sector will restrict rapid growth of the services sector

In 2017, on the one hand, industry is confronted with some unfavorable factors: first, uncertainty abounds about the world economy and trade; second, a slowdown in the growth of residents' income and rising leverage ratios may constrain consumption and relevant manufacturing sectors; third, the continuation of policies aimed to regulate the real estate market is detrimental to industrial production in upstream and downstream sectors; fourth, the situation of oversupply in coal, steelmaking and related sectors will not change overall, elimination of excess capacity will proceed continuously, and production of relevant industrial sectors will maintain low-speed growth.

On the other hand, there are still some favorable conditions: first, the transformation and upgrading of traditional industries and cultivation of emerging industries will accelerate; the optimization and adjustment of industrial structure will help industry to grow steadily; second, prices of industrial products may continue to pick up, and the government will step up efforts to promote cost reduction in 2017, which is conducive to the continued improvement of profitability of enterprises; third, the inventory pressure on industrial sectors is lower, as the inventory of finished products decreased by 0.3% in the first ten months of 2016, with the decrease rate narrowing by month; it is highly probable that inventories will be replenished in 2017.

A fallback in the growth of the real estate sector is a chief inhibiting factor to the rapid growth of the services sector. Hence preventing asset price bubbles becomes a policy priority. It is expected that policies aimed to regulate the real estate market will continue in 2017, sales growth is likely to slow down materially, and growth of the real estate sector will decelerate. At an executive meeting of the State Council in October 2016, it was proposed to increase effective supplies through reform and innovation in the area of consumption, especially services, which is instrumental to the steady growth of wholesale and retail, hotels and catering. General stability of industrial production will spur faster growth of transportation, warehousing and postal services. For the financial sector, the adverse factor lies in the difficulty for the scale of new loans to rise further and the expansion in the size of local government debt swaps, which will influence revenue growth of the banking industry. But a relatively low base of stock market trading volume and accelerated development of the insurance and bond markets are conducive to a pickup in the growth of the financial sector. In view of the above, the growth of the financial sector may speed up.

II. Financial Review and Outlook

II.1 Operational characteristics of finance in 2016

In 2016, China continued to implement a prudent monetary policy with more emphasis on flexibility and adequacy. With one reserve requirement ratio cut at the start of the year and a macro prudential assessment system in place, the scale of monetary credit and social financing grew steadily and rapidly, with financing costs lowered. The interest rate corridor mechanism produced preliminary results; money market interest rates remained at low levels. Stock markets developed steadily, with the median level of stock indexes up moderately; the RMB exchange rate dropped but remained stable, with two-way swings more apparently; the bond market remained bullish, driven by the three factors of weak fundamentals, strong reforms and risk aversion. Financial reform sped up again; the “Shenzhen-Hong Kong Stock Connect” program was approved for launch; and new headway was made in the opening up of the bond market and product innovation. However, as the real economy was affected by the initiative to eliminate excess capacity, and inadequate private investing activities, new problems surfaced, including funds flowing out of the real economy and into the virtual economy, weak growth of corporate credits, mortgages growing too fast, greater devaluation pressure on RMB, and an increase in bond defaults.

II.1.1 Money supply was at an appropriate level with financing costs lowered

By the end of October 2016, M2, the broad measure of money supply, increased by 11.6%, and the balance of RMB loans grew by 13.1%, down 1.7 and 1.2 percentage points respectively from the end of last year. The existing social financing increased by 12.7% year on year, up 0.3 percentage points over the end of last year (Figure 3). Overall, money supply was at an appropriate level, basically in line with the credit demand of the real economy.

Figure 3: Key Money Supply Indexes

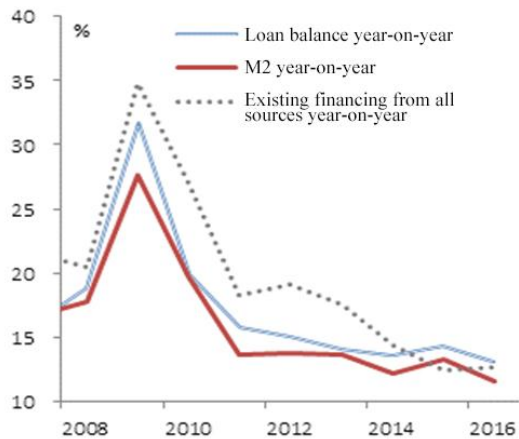
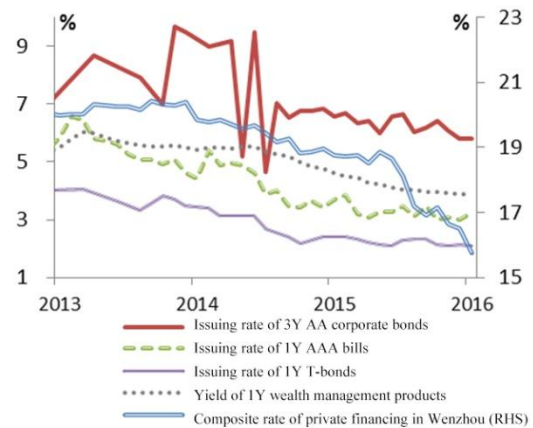


Figure 4: Issuing Rates and Yields of Major Financial Products



Sources: Wind, BOC Institute of International Finance

The cost of social financing decreased, and the difficulty for enterprises to access funding and high financing costs for them were alleviated. At the end of September 2016, the weighted average loan rate of financial institutions was 5.22%, down 0.05 percentage points from the end of last year; the proportion of the loans whose interest rate are above the benchmark rate also declined from the peak of 73.7% to 60.4% in November. At the end of November, the issuing rates of 1-year T-bonds, 1-year AAA bills and 3-year AA corporate bonds were 2.1%, 3.24% and 5.8% respectively, down 0.3, 0.6 and 0.9 percentage points respectively from the end of last year; while the expected yield of 1-year RMB-denominated bank wealth management products stood at 3.9%, down 0.6 percentage points from the end of last year (Figure 4).

The proportion of direct financing rose, while off-balance-sheet financing shrank. In the first ten months, social financing increased by RMB11.7 trillion cumulatively. Of which RMB loans also rose and accounted for 73.8%, up 0.5 percentage points over the end of last year. Direct financing (stock market and bond market financing) accounted for 27.3%, up 3.3 percentage points over the end of last year. Among off-balance-sheet financing, the total size of entrusted loans and trust loans recovered, accounting for 11% and 3.7% of total social financing in the first ten months, up 0.7 and 3.4 percentage points over the end of last year. The size of bills financing decreased substantially in the same period, with additional bills financing accounting for -15.5% of social financing, mainly attributable to the fact that regulatory authorities stepped up regulation of the bills business. Foreign currency loans decreased at a slower pace; foreign exchange loans fell by 7.7% year on year, down 1.9 percentage points from the end of last year. The accelerated repayment of foreign debts by economic entities reduced to a certain degree.

With scissors forming between M1 and M2, the pressure on funds flowing out of the real economy and into the virtual economy increased. 2016 witnessed such phenomena as M1 grew much faster than M2. The causes thereof include: first, some enterprises were not confident about investment and hence converted long-term capital to large amounts of demand deposits; second, house prices in tier-1 cities surged rapidly, some funds might flow into the real estate market in various forms; third, local government debts produced a substitution effect on credit, and money creation capacity dropped, resulting in slower growth of M2. As of November 17, a total of RMB5.85 trillion local government bonds were issued, 1.5 times the size of last year.

Loan growth was uneven, and credit growth of non-financial enterprises was weak. On the one hand, home mortgages grew fast. In the first ten months, new household loans accounted for 48.6% of the

aggregate new loans, up 15.6 percentage points over 2015. On the other hand, the growth of credit to non-financial enterprise was weak. In the first ten months, new loans to non-financial enterprises accounted for 51.3% of the aggregate new loans, down 11.6 percentage points as compared with the end of last year, at a historic low since 2006.

II.1.2 Money market interest rates were less volatile, featuring short-term rises and long-term falls

In 2016, the central bank ironed out short-term interest rate fluctuations caused by internal and external factors by cutting the deposit reserve ratio, adjusting the methods for deposit reserve assessment, and normalizing open market operations, with interest rate volatility lowered markedly. But since the third quarter, the one-year time deposit interest rate moved up slightly, and short-term interest rates rose but long-term interest rate fell. In the second half of 2016, monetary policy focused more on reducing leverages, preventing risks and stabilizing exchange rates. The central bank guided financial institutions to deleverage at a faster pace by locking up short-term funds and extending long-term funds including 6-month and 1-year MLFs. On November 21, 2016, overnight Shibor rose by 28BPs over the end of 2015, but 3-month Shibor fell by 115BPs from the end of 2015.

II.1.3 The bond market remained bullish, driven by the three factors of weak fundamentals, strong reforms and risk aversion

The bond market sustained its bullish performance from 2015 into 2016, under the influence of relatively weak fundamentals of the economy, speedier opening-up of the market and rising risk aversion of capital. At the end of November, the all-bond index stood at 172.6, up 4.9 percentage points over the end of last year. But the bond market also underwent a correction in the fourth quarter, as a result of increasing signs of a stabilizing economy and tightening liquidity in the money market. First, bond issues accelerated, and bond yields featured low absolute yield, term spread and credit spread. Second, innovation in bond products sped up, panda bonds and green bonds increased rapidly. Non-performing assets securitization, after being suspended ten year ago, was relaunched in May 2016; credit default swaps and credit-linked notes, among others, were approved in September. In the first ten months, China issued green bonds totaling USD21.9 billion, becoming the world's biggest market for green bond issues. Third, new progress was made in the opening-up of the bond market. Since the start of the year, regulators have released a number of documents concerning the issue. So far, the bond market has basically been opened up to all the investors, with no quota limits, and a filing-based management mechanism in place. Fourth, default risk increased, with an obvious rise in the number of defaults in the bond markets. In the first ten months, there were 53 bond defaults, involving an aggregate amount of RMB28 billion, 2.4 times the total of last year.

II.1.4 Stock markets fluctuated within a narrow range, and tighter regulation promoted the healthy development of the markets

China's stock markets experienced great volatility in the first quarter of 2016, due to market correction pressures, exchange rate depreciation impacting risk appetite and misfire of the circuit breaker mechanism. Then the markets began to stabilize, attributable to all-round tightening of regulation, gaming of existing funds in the markets, and improving profits of listed companies; fluctuation within a narrow range became the keynote of market performance for the year. Specifically, first, stricter regulation to stabilize the markets was the theme of this year's policies. Since 2016, CSRC has filed 52 cases regarding operational risk, with the number up 68% year on year; and issued new rules on mergers & acquisitions, back-door listing and asset management products, among others, in a bid to crack down on speculation in shell stocks, and lower the leverage of financial products. Second, market capitalization gradually went up amid volatility, but with relatively low activity. The P/E ratio of the Shanghai Composite Index dropped to 12 at the start of

2016 after hitting 20 in the bull market of 2015, and then climbed to 16 amid fluctuation, which was still higher than the P/E ratio of less than 10 when the bear reigned. Yet market activity did not pick up notably at the same time. The weekly swing of the Shanghai Composite Index gradually shrank in 2016, and hit historic lows at the moment, almost at the same level as in the bull market in 2014. Third, the “Shenzhen-Hong Kong Stock Connect” program was about to be launched soon. After being approved by the State Council in the third quarter, the program was due to be officially launched on December 5, with all technical preparations in place.

II.1.5 The yuan devalued against the dollar, and exchange rate expectations remained steady overall

The exchange rate of the yuan against the dollar fell in 2016 and dipped below 6.6, 6.7 and 6.8 consecutively. On November 18, the yuan-dollar central parity rate stood at 6.8796, down 5.47% from the beginning of the year (6.5032), approaching the full-year decrease of 2015. On November 11, the RMB exchange rate index released by CFETS, and based on the BIS and SDR currency baskets dropped by 5.97%, 5.63% and 2.68% respectively, compared with the start of the year.

The continued devaluation of the yuan was mainly caused by: (1) a stronger dollar. The latest improvement of data on the American economy and higher possibility of a rate increase at the end of the year pushed up the dollar index to breach the 100 reading; (2) Brexit and other incidents caused sharp volatility in international foreign exchange markets, resulting in currency devaluation of varying degrees in many countries; (3) funds outstanding for foreign exchange have been constantly on the decline since 2016, raising RMB devaluation expectations to a certain degree. Moreover, the sovereign bond yields of some countries including the United States rebounded, raising the pressure on capital outflows; while regulators also intended to boost tolerance of exchange rate fluctuations in the cycle of a strong dollar, and allow markets to play a greater role in foreign exchange supply and demand so as to further enhance the flexibility of two-way movements of the RMB exchange rate.

II.2 Financial Forecast for 2017

II.2.1 The implementation of policies to deleverage will further improve the credit structure

In 2017, there is a remote chance for monetary credit to further expand under the influence of eliminating excess capacity in the real economy, removing bubbles from the real estate sector and deleveraging in the financial sector; instead growth will slow down but remain stable. Given that stock markets will further stabilize, and the bond market is under greater pressure for corrections which will not be volatile though, the capital market will play a stronger role in supporting financing of the real economy, and direct financing will take up a larger proportion. Meanwhile, as the real estate market cools down, investment in infrastructure further grows, and emerging industries are forming at a faster speed, the credit structure will improve as compared with 2016. It is expected that M2, existing social financing scale and RMB loans will increase by approximately 11.5%, 12.5% and RMB11 trillion respectively in 2017.

II.2.2 Liquidity may remain in a tense balance, and interest rates stay at low levels and move within a narrow band

Interest rates are expected to fluctuate within a narrow band, and liquidity may remain in a tense balance in 2017. Globally, the monetary policy direction of major economies is still uncertain, and a series of unstable factors will raise potential risks in the financial sector. Meanwhile, as the US Federal Reserve is anticipated to raise interest rates, market sentiment changes and cross-border capital flows will intensify the siphoning off of market liquidity. Domestically, there are chiefly three factors influencing liquidity: first, monetary policy will continue to focus more on deleveraging,

preventing risk and stabilizing exchange rates in order to address high leverages in the bond market and asset price bubbles, among other issues; second, relevant authorities will resort to deposit reserve ratio reductions prudently given the liquidity gap caused by a continued drop in funds outstanding for foreign exchange; third, the full implementation of macro prudential assessment (MPA) for regulation purposes may intensify volatility in market liquidity and interest rates. But we should also note that with the diversification of operational tools of monetary policy and the maturities thereof, the presetting and fine tuning capacity of monetary policy is also improving; in addition, with faster research on and improvement of the interest rate corridor mechanism, the capability of relevant authorities to regulate interest rates will be continuously enhanced. So we predict short-term interest rate volatility will be better controlled without great shocks.

II.2.3 With greater pressure on market corrections, bond market yields tend to rise

Given that the dollar will remain strong and China's monetary policy aims at deleveraging in a moderate way, market liquidity in 2017 is expected to be tighter than 2016. The central bank increases capital supply mainly by means of MLF, while high funding costs will restrict the room for interest rates to go down. Meanwhile, in view of increasing signs of a stabilizing economy, inflation expectations will be more evident than 2016, which will raise the pressure for interest rates to go up. In addition, stricter regulation will generate adverse impact on bond allocations of institutions. But there are also a number of favorable factors for the bond market: first, the situation of weak economic growth will hardly change, and interest rate bonds will remain the haven for risk-averse funds; second, the bond market has become more internationalized after RMB joined SDR, so international investors' zeal for bond allocations will not change fundamentally; third, innovation in bond products continues to speed up; PPP projects are likely to proceed along with further development of the capital market; implementation of relevant policies will accelerate in 2017; all this will encourage funds of all types to enter the bond market. Overall, it is easier for bond market yields to rise than to fall in 2017, but growth will be moderate only; there is limited room for credit spreads to narrow.

II.2.4 Stock markets will swing within a narrow range and climb up brokenly

Stock markets will continue to swing within a narrow range and climb up in a broken way. First, rotation of the major categories of assets may help improve fund conditions in the stock markets. As the bond market and real estate market are already at historic high levels, stock market valuation is still safer in comparison, with a certain distance from historic highs. Asset rotations will become a key driving force for the stock markets. Second, the convening of the 19th National Congress of CPC in the second half of the year will help boost market confidence. Third, supply-side structural reforms will proceed steadily, which helps improve the risk appetite of markets and facilitate rotations among stocks concerning new consumption, new industries and new supply. Yet it is also difficult for the stock markets to build a momentum and rise substantially in 2017. First, the overall monetary climate will remain prudent, with liquidity in a tight balance, which may underpin the stock markets but cannot push them up. Second, it is hard for business profits to improve better than expected as in 2016. Third, it takes a relatively long time to restore the microstructure of market. From the unusual volatility in 2015 to the fast fallback at the start of 2016, large numbers of investors were locked up in a narrow zone in terms of microstructure; therefore it requires a relatively long active phase of markets and the full participation of optimistic investors for the market structure to be restored.

II.2.5 The yuan-dollar exchange rate against dollar may go down mildly, with the role of markets more highlighted

The yuan-dollar exchange rate against dollar will still be under certain downward pressure in 2017, but there will be no continued one-way drops; the exchange rate may maintain two-way movements

within a wide range. Internationally, the US Federal Reserve is likely to continue with rate hikes in 2017, generating constant pressure on the yuan-dollar exchange rate; meanwhile, the after-effects of Brexit still exist and economic recovery in Europe and Japan is yet to be clarified. These uncertainties may aggravate market volatility at any time. Domestically, surging asset prices have further raised the risk of more bubbles, whereas the likely fallback in asset prices will increase the pressure on RMB devaluation. But on the other hand, it is still uncertain whether the Trump administration can notably boost the American economy after he takes office and then speed up the normalization of the Federal Reserve's monetary policy; moreover, the dollar index will show a two-way fluctuation with the rate increase expectations digested. So, the pressure on RMB devaluation will decrease along with that. Supposing there is no huge imbalance between supply and demand in the foreign exchange market, the central bank will strengthen the market's role in determining the exchange rate, and further boost the flexibility of the exchange rate's two-way movements. With the enhancement of macro prudential management capability for cross-border capital flows, we predict there will be no steep one-sided fall in the yuan-dollar exchange rate.

Table 1: China's Major Economic and Financial Indicator Forecasts for 2016-2017 (%)

Indicator	2013 (R)	2014 (R)	2015 (R)	2016					2017 (F)
				Q1 (R)	Q2 (R)	Q3 (R)	Q4 (E)	Full year (E)	
GDP	7.7	7.3	6.9	6.7	6.7	6.7	6.7	6.7	6.7
Industrial value added of enterprises above designated size	9.7	8.3	6.1	5.8	6.1	6.1	6.1	6.0	6.1
Value added of the services sector	8.3	7.8	8.3	7.6	7.5	7.6	7.6	7.6	7.6
Fixed asset investment	19.6	15.7	10.0	10.7	8.1	7.1	8.6	8.3	8.3
Total retail sales of consumer goods	13.1	12.0	10.7	10.3	10.2	10.5	10.1	10.3	10.2
Exports	7.8	6.0	-2.9	-9.6	-3.9	-7.0	-6.8	-7.3	-2.0
Imports	7.3	0.5	-14.3	-13.4	-6.7	-5.3	-3.8	-7.0	1.0
Consumer Price Index (CPI)	2.6	2.0	1.4	2.1	2.1	1.7	2.1	2.0	2.5
Producer Price Index (PPI)	-1.9	-1.9	-5.2	-4.8	-2.9	-0.8	1.5	-2.3	2.0
Broad money supply (M2, ending balance)	13.6	12.2	13.3	13.4	11.8	11.5	11.8	11.8	11.5
Private financing size (existing)	17.5	14.3	12.4	13.4	12.3	12.5	13.0	13.0	12.8

Source: BOC Institute of International Finance

III. Major Concerns about the Economic and Financial Sphere in 2017

III.1 There is still room to stabilize growth through fiscal policy, but there are also challenges

As monetary policy remains prudent, a proactive fiscal policy is still a key pillar for stabilizing growth. There is room for China to stabilize growth through fiscal policy in 2017, but that is not

without challenges. On the basis of fiscal and debt risks being under control, the deficit ratio may rise as compared with 2016, in line with the regulatory thinking of raising the deficit ratio for a period of time. The additional deficit will be mainly used to make up for reduced revenue and guarantee the government's expenditure responsibility; hence the funds earmarked for infrastructure will be limited. Only by virtue of other channels can public finance support investments in infrastructure construction of a specific scale, such as special financial bonds and PPP projects. Overall, the above approaches bring incentives and hope for stabilizing growth through fiscal policies. But as the results of fund operations and PPP projects' implementation remain to be seen, it is still uncertain as to how well they can work.

III.2 Non-financial enterprises face mounting pressures to repay debts

In recent years, the debt issue of China's non-financial enterprises has raised concerns both at home and abroad. Some calculations failed to take into account China's special financial structure, while some others simply equaled macro debt ratio with enterprises' solvency. Moreover, the optimum level of debt is not defined in theory or practice; and debt levels of enterprises vary in different countries and at different development stages.

It is true that the debts of enterprises in China increased fast, and some industries and regions are under greater pressures to repay debts. In 2007, the debt ratio of non-financial enterprises in China was only 79.3%, but surged to 160% by the end of 2015, up around 80.7 percentage points in a time of seven years, ranking second by increase rate. The highly leveraged enterprises are mainly from sectors plagued by overcapacity, real estate, foreign trade, consumer sectors and other traditional manufacturing industries. In addition, some state-owned enterprises, and those in old industrial bases in Northeast China are generally under greater pressure to repay debts.

III.3 Risks associated with the RMB exchange rate and cross-border capital flows rise

In 2017, the RMB exchange rate will still face certain devaluation pressure and the risk of capital flight. Given an increasingly complex external development environment (including a strong dollar, after-effects of Brexit, and regime changes in some countries), a strong dollar and expectations for rate increases by the US Federal Reserve will still be the most critical factors that contribute to short-term volatility in the RMB exchange rate. Meanwhile, short selling abroad, centralized currency exchanges by residents and market panic may intensify exchange rate fluctuations. A continuously low RMB exchange rate and capital outflows may become self-reinforcing and generate a superimposed effect, possibly causing some capital to leave China. As of the third quarter of 2016, the size of domestic RMB-denominated financial assets held by overseas institutions and individuals reached RMB3.3 trillion, down 15.2% year on year.

IV. Macro Policy Preference

IV.1 A proactive keynote will continue to reign, with a more effective fiscal policy implemented

In order to stabilize growth and facilitate supply-side reforms, fiscal policy is expected to maintain a loose keynote in 2017.

First, optimize the fiscal expenditure structure, and actively increase effective supply. Overcoming weaknesses should remain a key priority of fiscal policy: press ahead with major infrastructure projects at a faster pace, expand investments that help to accelerate poverty relief programs and fill the gap between urban and rural development; increase investments in areas concerning people's livelihood such as education, healthcare and caring for the aged; promote innovation in mechanisms and systems, and boost the execution rate of PPP projects.

Second, proceed with tax cuts and expense reductions continuously, and promote economic growth

and structural upgrading. Continue to improve the VAT deduction chain; step up efforts to clean up and regulate fee charging and funds concerning enterprises; improve tax incentive policies at a faster pace like incubators of hi-tech and technological enterprises; guide and encourage consumer demand in the areas of intelligence, health and green. In addition, after the all-round implementation of replacing the business tax with VAT, reform of direct taxes such as the real estate tax and individual income tax will become a key priority in the future.

Third, further improve the local government debt management system, and strictly control all types of potential risks. Some problems continue to surface at the moment, such as lower solvency and debt risk exceeding the warning level in some regions, flawed PPP-related policies and rules, supervision and management, local governments borrowing in disguised forms and providing guarantees for financing illegally. The government will put in place a rigorous accountability mechanism as soon as possible, and reinforce punishments to illegal borrowing.

IV.2 Monetary policy tends to be more prudent, with more efforts to prevent risks in key areas

Monetary policy will be more prudent in 2017, with focus placed on risk management in key areas such as exchange rate and asset prices.

First, the probability of reserve requirement ratio or interest rate cuts is low. Given that the dollar is highly likely to remain strong in 2017, there may be a turning point in liquidity worldwide, which will greatly impact China's formation of monetary base, international balance of payments and financial stability. Hence China is expected to postpone the loosening of its monetary policy, and the probability of reserve requirement ratio or interest rate cut is low in the first half of the year.

Second, multi-pronged measures will be taken to prevent the risk of overshooting in relation to the RMB exchange rate. China will make efforts to keep the central parity rate steady, raise the range of two-way movements of the RMB exchange rate to release devaluation pressure amid fluctuation; enhance tolerance of exchange rate volatility, and alleviate the pressure of excessive drain of foreign exchange reserves. Besides, the grey channels for capital outflow will be cracked down and controlled to reduce the pressure on RMB devaluation.

Third, proactively cultivate market-based benchmark rates and yield curves and manage liquidity appropriately. The central bank will broaden the scope of collaterals, lower the interest rates of MLF and other facilities, and raise the ability of the banking sector to provide low-cost funding to the real economy through the flattening of yield curves.

IV.3 Realize macro strategic effects by advancing the “three strategies”

First, strive to make breakthroughs in the reinvigoration of Northeast China. The CPC Central Committee issued the *Several Opinions on Comprehensively Rejuvenating Northeast China and Other Old Industrial Bases* in 2016. On that basis, 2017 will be a crucial year for the rolling implementation of a new round of Northeast China rejuvenation strategies. First of all, accelerate the implementation of the 36 finalized key tasks, which involves improving mechanisms and systems, facilitating restructuring and encouraging innovation and entrepreneurship; second, start construction of 33 key projects covering transportation, energy and water conservancy; third, build a pilot FTZ in Liaoning, and promote cooperation between East China and Northeast China; fourth, set up an industrial rejuvenation fund for Northeast China, establish the first local privately-owned bank, and step up efforts for transfer payment and PPP implementation.

Second, further accelerate the implementation of the “three strategies”. In 2017, China will vigorously facilitate the construction of a number of flagship projects with strong demonstration effects and promote its successful experience in other countries and regions, and facilitate the formulation and implementation of key plans including the New Eurasian Continental Bridge, China-

Central Asia-Western Asia Economic Corridor, China-Indo-China Peninsula Economic Corridor, China-Pakistan Economic Corridor and Bangladesh-China-India-Myanmar Economic Corridor.

As for the coordinated development of Beijing-Tianjin-Hebei province, substantial progress will be made in the relocation of administrative institutions under the Beijing municipal government in 2017 in order to divert the “non-capital” functions of the city, and achieve key breakthroughs in transport integration, eco-environment protection and industrial upgrading and transfer.

As for the building of the Yangtze River Economic Belt, it is important to play the leading and driving role of megacities such as Shanghai, Wuhan, Chongqing, Nanjing, Hangzhou and Chengdu by virtue of the Yangtze River golden waterway, realize interaction and collaboration among city clusters, including the Yangtze River Delta, middle reaches of the Yangtze River, Chengdu-Chongqing, Changsha-Zhuzhou-Xiangtan, enhance interlinked development capacity within and between city clusters, and make notable progress in ecological protection, innovation-driven growth and industry clustering in 2017.

Third, play the leading role of national new districts, pilot areas and demonstration areas by adhering to pilot tests and single-point breakthroughs. In 2017, China will bring into fuller play the trailblazing role of 18 national new districts, 11 pilot free trade zones (seven of which will be confirmed soon), and 17 national demonstration areas for independent innovation, and summarize experience that can be replicated and promoted in respect of systems and mechanisms, laying the foundation for a new round of reform, opening up and innovation.

IV.4 Put more emphasis on guiding industrial transformation and upgrading, and on the coordination and collaboration of policies in advancing “eliminating excess capacity, destocking, deleveraging, cutting costs and overcoming weaknesses”

In terms of eliminating excess capacity: 2017 marks the second year for advancing the task of eliminating outdated capacity in the sectors of coal and steelmaking; eliminating excess capacity remains a priority. Meanwhile, more emphasis will be placed on enhancing intelligent levels and product quality, renovation and upgrading for the purpose of energy conservation and environmental protection to facilitate the transformation and upgrading of industries plagued by overcapacity. Given fast rising coal prices since August 2016, it is expected that the pace of eliminating excess capacity will be adjusted in 2017, and more emphasis placed on coordination with a quick rebound in prices, with some premium capacity and effective supply to be released in an orderly manner.

In terms of destocking: first, city-specific policy implementation remains a key approach for regulating the real estate sector. Policies will continue to tighten for tier-1 and some tier-2 cities in an aim to curb over-investment and speculation and irregularities. Second, meeting housing needs is the crucial basis for the regulation of the real estate sector. Third, the long-term mechanism of promoting the healthy development of the real estate market will be advanced continuously, including fostering and developing the rental housing market, facilitating the establishment of a national real estate inventory and transaction monitoring platform, and promoting the uniform registration of immovables nationwide.

In terms of deleveraging: The *Opinions on Proactively and Appropriately Reducing the Leverage Ratios of Enterprises* released in 2016 put forward seven measures for enterprises to deleverage, while the *Emergency Response Plan for Local Government Debt Risk* has made arrangements for preventing regional systemic risks, the specific measures of which will be implemented substantially in 2017, with special attention paid to preventing the potential financial risk arising therefrom, and coordinating with the reorganization and restructuring of enterprises, cost reduction, transformation and upgrading of enterprises, and elimination of excess capacity, among other work.

In terms of cutting costs: The *Work Plan for Reducing the Cost of Real-Economy Enterprises* released in 2016 has made detailed arrangements for lowering six types of costs for enterprises including taxes, financing, institution-based transactions, man power, energy and logistics; it is expected that cost reduction work will be more comprehensive and systematic in 2017, and pressed ahead with greater intensity.

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