

China's Economic and Financial Outlook

2017Q2 (Issue 30)
March 31, 2017

Highlights

- In 2017Q1, the Chinese economy showed apparently more positive factors, with growth driven by “double engines” (both new and traditional ones) instead of “single engine”, and the prosperity cycle picking up continuously. It is expected that in this quarter, economic growth rate may stand at around 7%, up 0.3 percentage points compared with the same period of last year; and CPI will rise by 1.6% or so, down 0.5 percentage points from the same period of last year.
- In 2017Q2, unstable and uncertain factors that influence external environment will still abound. The endogenous driver of economic growth will remain weak; the sustainability of rebounding investments is yet to be tested; and the effect of new policies designed to control the real estate market remains to be seen. In the meantime, with the furtherance of supply-side structural reforms, enterprises will see their profits continue to improve, and emerging industries will grow rapidly. GDP is projected to grow by around 6.9% in Q2, down 0.1 percentage points from Q1, showing a descending trend throughout the year.
- As the economy has stabilized and improved, it is advisable not to ratchet up growth-stabilizing policies in the near future. Instead, focus should be placed on addressing mid- and long-term development issues and asset price bubbles, among others. In terms of fiscal policy, efforts should be made to study the room and feasibility for continuing tax reductions so as to lower tax burdens for all. Monetary policy should remain stable but tighten gradually, with the possibility of rate increases considered when the time comes. Collaboration should be strengthened among government departments to rein in property market bubbles with an iron hand, lest the aberrant development of the real estate sector should ruin the bright prospects of the Chinese economy.

**BOC Institute of International Finance
China Economic and Financial Research
Team**

Team leader: Chen Weidong

Deputy leader: Zong Liang

Team members: Zhou Jingtong

Li Peijia

Gao Yuwei

Li Yan

Liang Jing

Gai Xinzhe

Fan Ruoying

E Zhihuan (Hong Kong)

Chen Zhihua (BOCIM)

Qu Kang (London)

Contact: Zhou Jingtong

Telephone: 010-66592779

Email: zjtlucky@163.com

China's Macroeconomic Early Warning Index

Index Name	2016												2017			
	3	4	5	6	7	8	9	10	11	12	1	2				
1. Industrial added value: monthly year-on-year	●	●	●	●	●	●	●	●	●	●	●	●	●	●		
2. Total retail sales of consumer goods (monthly year-on-year)	●	●	●	●	●	●	●	●	●	●	●	●	●	●		
3. Fixed asset investment: cumulative year-on-year	●	●	●	●	●	●	●	●	●	●	●	●	●	●		
4. Imports: monthly year-on-year	●	●	●	●	●	●	●	●	●	●	●	●	●	●		
5. Exports (monthly year-on-year)	●	●	●	●	●	●	●	●	●	●	●	●	●	●		
6. CPI (monthly year-on-year)	●	●	●	●	●	●	●	●	●	●	●	●	●	●		
7. Loan balances: year-on-year	●	●	●	●	●	●	●	●	●	●	●	●	●	●		
Comprehensive judgment	●	●	●	●	●	●	●	●	●	●	●	●	●	●		
	15	16	14	13	12	12	13	13	13	13	13	14	15			

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

Policy Choices to be Made as Growth is Driven by “Double Engines”

-- China's Economic and Financial Outlook (2017Q2)

In 2017Q1, the Chinese economy showed apparently more positive factors, accompanied by strong supply and demand, with growth driven by “double engines” (both new and traditional engines) other than a single one, and the prosperity cycle picking up continuously. However, a host of issues have caused uncertainty to the stable and healthy operation of economy, such as the possibility of a trade war between China and the U.S., rate hikes by the U.S. Federal Reserve, situation in Northeast Asia, tendency of funds in China flowing out of the real economy and into the virtual one, housing prices surging too fast and frequent occurrence of financial risk events. According to our initial estimate, the economic growth rate may return to the “7” range and stand at around 7% in Q1, up 0.3 percentage points compared with the same period of last year; and CPI will rise by 1.6% or so, down 0.4 percentage points from the same period of last year. In 2017Q2, unstable and uncertain factors that influence external environment will still abound. There is still uncertainty about the domestic economy driven by “double engines” and the sustainability of rebounding investments; and the effect of new policies designed to regulate the real estate market remains to be seen. In the meantime, with the furtherance of supply-side structural reforms, enterprises will see their profits continue to improve, and emerging industries will grow rapidly. Overall, GDP is projected to grow by around 6.9% in Q2, down 0.1 percentage points from Q1. Supposing the economic rally continues, GDP growth is most likely to reach 6.8% or so this year, reversing the slowing trend of GDP growth rate in the past six years, which will formally mark a turning point of the Chinese economy. In terms of policy choices, as the economy has stabilized and improved, it is advisable not to ratchet up growth-stabilizing policies in the near future. Instead, focus should be placed on addressing mid- and long-term development issues and asset price bubbles, among others. In terms of fiscal policy, efforts should be made to study the room and feasibility for universal tax reductions so as to lower tax burdens for all. Monetary policy should remain stable but tighten gradually, with the possibility of rate increases considered when the time comes. Collaboration should be strengthened among government departments to rein in property market bubbles with an iron hand, lest the aberrant development of the real estate sector should ruin the bright prospects of the Chinese economy.

I. 2017Q1 Economic Review and Q2 Outlook

I.1 Operational characteristics of economy in Q1

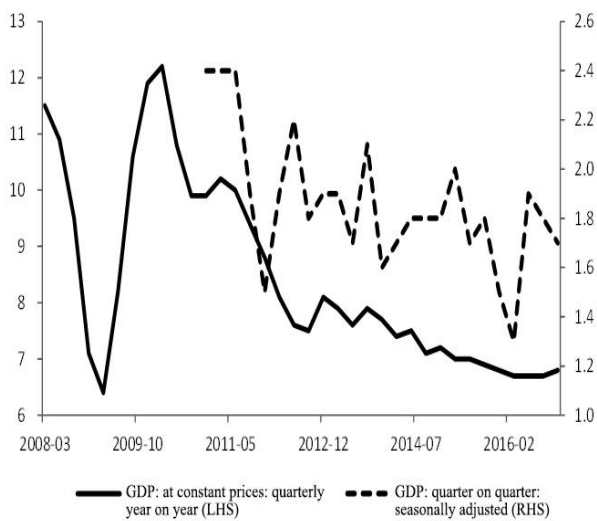
All the key indicators about the Chinese economy improved in Q1, with prosperity cycle rising notably (Figure 2). A benign interaction was taking shape between demand and supply, internal and external demands, emerging and traditional industries. Operational characteristics of the economy include:

First, recovery in business activity backed by strong demand and supply. In terms of demand, investment in the first two months increased by 8.9%, up 0.8 percentage points over the whole year of 2016 (Figure 3), with investments in infrastructure, manufacturing and real estate all accelerating (Figure 4). Investment in infrastructure (excluding power) surged by 27.3% in the first two months, on the back of a 15% growth last year. Among which, the growth rates of investments in water conservancy, environment and public facilities management and in transportation, warehousing and postal services were 10.3 and 9.3 percentage points higher than last year. A stabilizing and improving economy and lower costs for businesses drove up investment confidence and capacity for manufacturing, with investment in the sector rising 4.3% in the first two months, up 0.1 percentage points over 2016. Due to rising housing prices and destocking, growth in real estate

investment also continued the accelerating trend that had started since the second half of last year. Investment in real estate increased by 8.9% in the first two months, up 2 percentage points over 2016. The explosive growth in the sales of excavators reflected speedier investment in infrastructure and real estate from another angle. A total of 22,381 excavators were sold in the first two months, up 55.9% year on year. It should be well noted that private investment which stayed sluggish since last year continued to pick up, growing by 6.7% year on year in the first two months, up 3.5 percentage points over 2016. This indicated recovering investment capacity and confidence of private enterprises with the improvement of business profitability and implementation of policies aimed to promote private investment. In the first two months of the year, exports grew by 4% despite great volatility due to Spring Festival holidays and other factors (exports dropped by 21% in the same period of last year); imports increased by 26.4%, which was attributable to rising prices, but also reflected a recovering domestic economy and strong demand.

Figure 1: China's Quarterly GDP Growth

Figure 2: China's Macroeconomic Climate Early Warning System

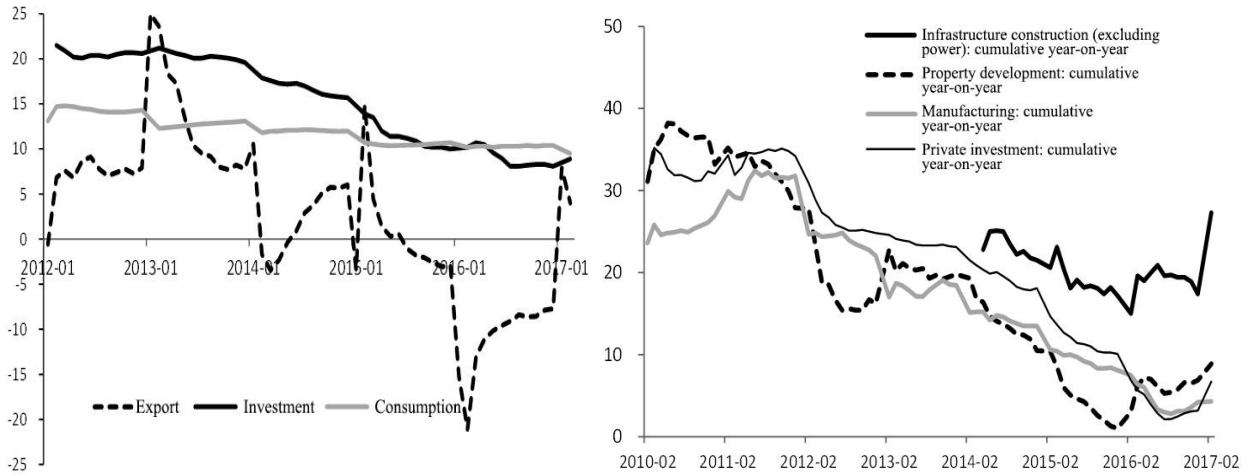


Index Name	2016												2017	
	3	4	5	6	7	8	9	10	11	12	1	2	1	2
1. Industrial added value: monthly year-on-year	●	●	●	●	●	●	●	●	●	●	●	●	●	●
2. Total retail sales of consumer goods (monthly year-on-year)	●	●	●	●	●	●	●	●	●	●	●	●	●	●
3. Fixed asset investment: cumulative year-on-year	●	●	●	●	●	●	●	●	●	●	●	●	●	●
4. Imports: monthly year-on-year	●	●	●	●	●	●	●	●	●	●	●	●	●	●
5. Exports (monthly year-on-year)	●	●	●	●	●	●	●	●	●	●	●	●	●	●
6. CPI (monthly year-on-year)	●	●	●	●	●	●	●	●	●	●	●	●	●	●
7. Loan balances: year-on-year	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Comprehensive judgment	●	●	●	●	●	●	●	●	●	●	●	●	●	●
	15	16	14	13	12	12	13	13	13	13	13	14	15	

Sources: Wind, BOC Institute of International Finance

In terms of supply, industrial added value rose 6.3% in the first two months, up 0.9 percentage points over the same period of last year and 0.3 percentage points over the entire year of 2016. Among which, auto manufacturing, special-purpose equipment manufacturing and general-purpose equipment manufacturing grew by 17%, 11.5% and 10.6% respectively while the manufacturing of computers, communications and other electronic equipment grew by 14.1%; electricity and thermal power production and supply grew by 8.7%. Moreover, situations in Northeast China, a key concern of the country, had improved. The industrial added value of Liaoning declined by 6.9%, down 1.9 percentage points over the decrement a year earlier, while that of Jilin grew by 6.5%, up 4 percentage points year on year. Heilongjiang posted a 1% growth in industrial added value, in contrast to a fall of 0.6% in the same period of last year. In the first two months, the services industry production index grew by 8.2% year on year, up 0.1 percentage points over the same period of last year.

Figure 3: Cumulative Growth Rates of Three Major Demands (%) **Figure 4: Cumulative Growth Rates of Various Types of Investments (%)**



Sources: Wind, BOC Institute of International Finance

Second, growth driven by the “double engines” formed with traditional and emerging industries. The advancement of supply-side structural reforms, entrepreneurship and innovation facilitated continued and faster growth of new sectors and business forms. In the first two months of the year, the added value of the high-tech and equipment manufacturing industries increased by 12.6% and 11.9% respectively, up 1.8 and 2.4 percentage points over last year. Among which, optoelectronic devices, industrial robots and integrated circuits grew by 54.4%, 29.9% and 24.2% respectively. However, consumption grew a bit slower, by 9.5% year on year in the first two months, down 0.5 percentage points from 2016, mainly owing to lessened policy support for acquisition tax on low-emission vehicles, lower subsidy for new energy vehicles, and a relatively high base number last year, among other factors. Meanwhile, the emerging consumer sector and consumption related to housing were booming. Online sales of physical goods, cultural and office supplies, building and decoration materials, and furniture increased by 25.5%, 13.4%, 12.9% and 11.8% respectively. As a result of rising prices, the sales of petroleum and related products grew by 14% year on year in the first two months of 2017, up 12.8 percentage points over 2016. As emerging sectors achieved relatively rapid growth, some traditional industries also grew at a faster pace, thanks to rising prices and improving profits. In the first two months, crude steel production increased by 5.8%, up 11.5 percentage points over the same period of last year; output of steel, coke and aluminum oxide grew by 4.1%, 4.6% and 22.9%, up 6.2, 15 and 20.6 percentage points over the same period of 2016 respectively.

Third, rising inflation and widening “scissors difference” between CPI and PPI. CPI fluctuated radically in the first two months, rising by 2.5% in January but dropping to 0.8% in February. This was mainly attributable to two factors: One is Spring Festival. The Chinese lunar New Year began from February for 2016, but from January for 2017. The disappearance of this factor in February led prices related to festival consumption to fall markedly. For example, prices of food, tobacco and alcohol rose by 5.8% in February 2016, but fell by 2.4% in February this year; household service prices increased by 3.8% in February last year and but merely 2.6% this year. The other factor is warm winter. In contrast to the cold spell and other extreme weather conditions in the winter of 2015, the weather in the winter of 2016 was relatively good as a whole, as there was neither widespread snowfall nor sharp drop in temperature, which did not affect the production or transportation of fresh vegetables. So their prices remained relatively stable without obvious increases during festivals. The prices of fresh vegetables dropped by 14% cumulatively in the first two months of the year, compared with a 23.2% increase in the same period of last year. These two factors resulted in a significantly

varied tail-raising factor in the first two months, which contributed 1.6% to CPI's rise in January, but nil in February. Judging by the CPI basket of eight categories of goods and services, the same pattern prevailed that prices of seven categories rose, with those of one category falling. But the exception category was food this time (whose prices dropped by 4.3%), other than transport and communications (whose prices grew by 1.7%); meanwhile, the prices of services in relation to the upgrading of consumption structures (including health care and education) continued to rise. Despite increasingly tightened policies for regulating the real estate sector since October 2016, sales in some tier-2 cities, tier-3 and tier-4 cities surged rapidly. In the first two months of the year, the area of sold commercial houses in non-major cities grew by 35.9% year on year, up 14.0 percentage points over 2016. Buoyant sales further drove up housing prices. The second-hand housing price index in 70 medium and large cities rose by 0.4% month on month, or 7.9% year on year in February. This also made rent prices surge substantially. The prices of steel and coal were still rising lately, and the tail-raising factor was relatively high (above 6% in January and February and above 5% in March and April). PPI increased by 7.3% year on year in the first two months, while the "scissors difference" between it and CPI further widened.

Overall, in 2017Q1, the macro economy showed apparently more positive factors, with both supply and demand quite strong. The growth was driven by "double engines" (both new and traditional engines) other than a single new one, and the cycle of prosperity picked up obviously. However, a host of issues have caused uncertainty to the stable and healthy operation of economy, such as the possibility of a trade war between China and the U.S., situation in Northeast Asia, tendency of funds in China flowing out of the real economy and into the virtual economy, housing prices surging too fast, probable increase in funding costs and frequent occurrence of financial risk events. By our initial estimate, economic growth rate may return to the "7" range and stand at around 7% in Q1, up 0.3 percentage points compared with the same period of last year; and CPI will rise by 1.6% or so, down 0.4 percentage points from the same period of last year.

I.2 Economic Forecast for 2017Q2

Looking into Q2, the world economy is expected to recover as a whole, with the economy of the Eurozone improving and the U.S. economy continuously strengthening. However, there are still many unstable and uncertain factors about the external economy, including a complicated and changing international environment, intensified conflict between globalization and de-globalization forces, and continuous rate increases by the U.S. Federal Reserve. The endogenous driver of domestic economic growth will remain weak; the sustainability of rebounding investments is yet to be tested; and the effect of new policies designed to regulate the real estate market remains to be seen. In the meantime, with the furtherance of supply-side structural reforms, businesses will see their profits continue to improve, and emerging industries will grow rapidly. Overall, GDP is projected to grow by around 6.9% in Q2, edging down 0.1 percentage points from Q1. Supposing the economic rally continues, GDP growth is most likely to reach 6.8% or so this year, reversing the slowing trend of GDP growth rates in the past six years, which will formally mark a turning point of the Chinese economy. The rationale behind this judgment is: first, the world economy is now climbing out of a cyclic bottom, and the growth rates of major economies including the U.S., Japan and Europe may be higher than last year; second, the country has gradually adapted itself to the political and economic new normal, given the "19th National Congress" of the CPC due to be held in the second half of the year and the government transition next year, both the inner dynamics and external pressures are increasing; third, the objective situation of slower economic growth in recent years and the launch of proactive policies including the elimination of excess capacity have forced emerging sectors and business forms to develop and thrive, and play an increasingly significant role in the national economy.

The domestic economy will show the following trend in Q2:

First, on the demand side, investment will keep growing fast. Investment in infrastructure will maintain a high-growth momentum, and investment in manufacturing will continue to rebound. However, as monetary policy remains neutral and tends to tighten, the sources of funds for fixed asset investment will be restricted. After the Spring Festival, as the property markets in some tier-1 and tier-2 cities heat up again, policies aimed to regulate these markets are still tightening. Since March, more than 20 cities¹ have launched or upgraded home-purchase restriction policies. On March 17, Beijing began to adopt stricter standards for identifying a second home (based on the number of homes already owned and mortgages as well), and lifted down payments ratio for second homes to 60%. It is expected that governments will further tighten control measures in Q2, which will impact the rebound in real estate investment. Still, given a relatively high base in the same period of last year, the growth rate of real estate investment in and after the second quarter will decrease. **Emerging consumer sectors will help consumption remain stable, but it will be constrained by income and high housing prices.** As a result of the upgrading of residents' consumption structure and policy support from the government, new consumer sectors such as culture, sports and entertainment, health care and online retail will keep growing fast, hence driving the steady growth of consumption. The fact that the growth rate of residents' income (6.3%) was lower than GDP growth rate (6.7%) last year will influence the spending power and willingness of residents. Moreover, driven by the property market boom in major cities, the leverage ratio of Chinese residents (household loan/GDP) rises fast, hitting 45% in 2016, up 6 percentage points over the previous year. That means a substantial part of residents' income is used for repaying loans, which will generate a "crowding out effect" on consumption. **Pressure on foreign trade is likely to mitigate.** China's new export order index and the Export Leading Index rose for 2 straight months this year, and the China Composite PMI remains above 53%. Exports are expected to continue to recover and stabilize in Q2, but the growth rate of exports will be slightly lower than Q1, given that exports increased in the same period of last year. Affected by rebounding commodity prices and stabilizing domestic demand, the growth of imports will improve notably at a rate outpacing that of exports.

Second, on the supply side, industrial production will remain stable overall. On the one hand, continued improvement of exports, faster growth of emerging sectors, stepped-up efforts of the government to lower costs, rebounding prices of industrial products and enhancement of enterprises' profitability and expectations will all contribute to the growth of industrial production. The growth rate of finished goods inventories of industrial enterprises has turned from negative to positive since November 2016, and enterprises have started stocking up. The index of manufacturing business activity expectations under PMI went up to 60% in February. On the other hand, the government will continue to press ahead with the initiative to eliminate excessive capacity. The *Government Work Report* proposed further reduction of steel production capacity by around 50 million tons (a higher target than last year's), and elimination of coal production capacity amounting to over 150 million tons. Some sectors featuring low capacity utilization ratios and seriously excess capacity will also be required to eliminate excessive capacity, which means the production of coal, steel and related sectors will continue to grow at low speeds. The further tightening of policies aimed at controlling the real estate sector may lead to decreases in real estate sales and investment, which is un conducive to the growth of upstream and downstream industrial sectors. **The services industry will maintain relatively rapid growth.** Of the major sectors, the growth rate of added value of the real estate sector is expected to fall further in Q2, as the effect of tightening control policies will be shown gradually. Given a lower base in Q2 of last year, the growth rate of the financial industry's added value will rise in comparison with Q1. Overall stable industrial production will drive rapid growth of transport and communications, warehousing and postal services, but the growth rate of the sectors is expected to be lower than Q1 in view of relevant base numbers. Wholesale and retail, hotels and catering

¹ Including Zhuozhou, Laishui, Chongli, Hangzhou, Nanchang, Chuzhou, Sanya, Jiashan, Ganzhou, Qingdao, Nanjing, Beijing, Shijiazhuang, Guangzhou, Zhengzhou, Changsha, Baoding, Chengdu and Xiamen.

industry will grow steadily. Leasing and business services, scientific research and technical services, culture, entertainment and other service sectors will maintain relatively fast growth.

Third, the “scissors difference” between CPI and PPI will shrink, and inflation will be mild and manageable. As seasonal factors disappear, the rise of CPI will be gradually dominated by structural factors, which means the increase rate of CPI will go up moderately (at around 1.8% only) in Q2. Meanwhile, as it is difficult to change the oversupply in sectors plagued by overcapacity in a short period, fixed asset investment can barely recover. The advancement of the initiative to eliminate excessive capacity will prompt more focus to be placed on the balance with a rebound in prices, it is hard to see a continuous and substantial rebound in product prices. Moreover, given a lessened tail-raising factor for PPI in Q2, the increase rate of PPI is projected to fall back a little in comparison with Q1. The “rise and fall” in the growth rate of CPI and PPI will cause the “scissors difference” between the two to shrink, and inflation is mild and manageable overall.

II. 2017Q1 Financial Review and Q2 Outlook

In Q1, financial policy put more emphasis on creating a good environment for enterprises' de-leveraging, suppressing bubbles in the real estate market and preventing financial risks. Firstly, off-balance-sheet wealth management was included in the macro-prudential assessment system, and adjustment to the broad-credit definition officially came into effect. Secondly, the process of “implicit rate increases” started, as the central bank revised up the interest rates of mid-term lending facilities (MLF) and other open market operations. Thirdly, efforts were stepped up to prevent and control financial risks in key areas, with the launch of differentiated credit policy for the real estate sector. Fourthly, the opening up of China's financial market sped up, and the threshold for foreign capital to enter banking, securities brokerage, insurance and other financial sectors was further lowered². In terms of financial operation, with monetary credit growing steadily, credit structures tended to improve; the RMB exchange rate stabilized, and China's foreign exchange reserve picked up. However, making funds flow out of the virtual economy and into the real one remains an arduous task. Due to bond market volatility earlier, bond financing decreased. Tightening liquidity in the money market, rise in market interest rates, rate increase by the U.S. Federal Reserve, and other external factors brought uncertainty to the domestic financial market and monetary policy.

II.1 2017Q1 Financial Review

II.1.1 Monetary credit grew steadily and credit structures continued to improve

By the end of February, M2, the broad measure of money supply, reached RMB158.3 trillion, representing a year-on-year increase of 11.1%, down 0.2 percentage points from the end of 2016. The narrow measure of money supply (M1) increased by 21.4% year on year. Hence the “scissors difference” between the growth rates of “M2-M1” rose from -3.2% last month to -10.3%, ending the tapering trend in the previous 6 months in a row (Figure 5).

² In January 2017, the State Council officially released the *Notice on Several Measures for Further Opening-up and Active Utilization of Foreign Capital*. The Notice came up with measures to further ease the access restrictions imposed on foreign capital to banking financial institutions, securities companies, securities investment fund management companies, futures companies, insurance institutions and insurance agencies, and to remove such restrictions in the areas of accounting, auditing, architectural design and ratings service.

Figure 5: Rising “Scissors Difference” Between Growth Rates of M2 and M1

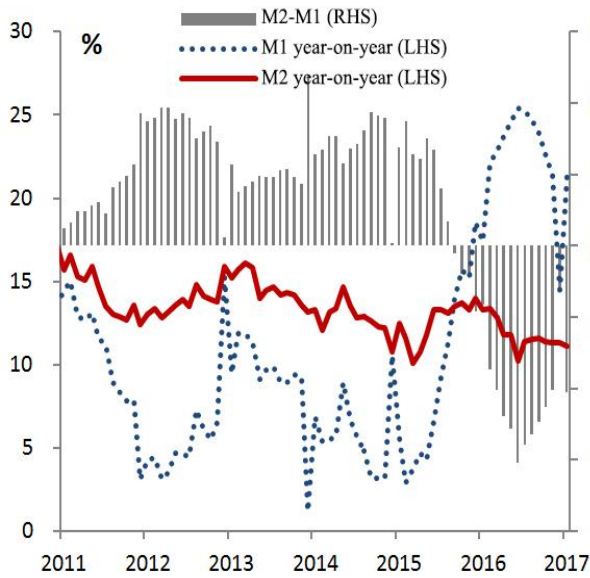
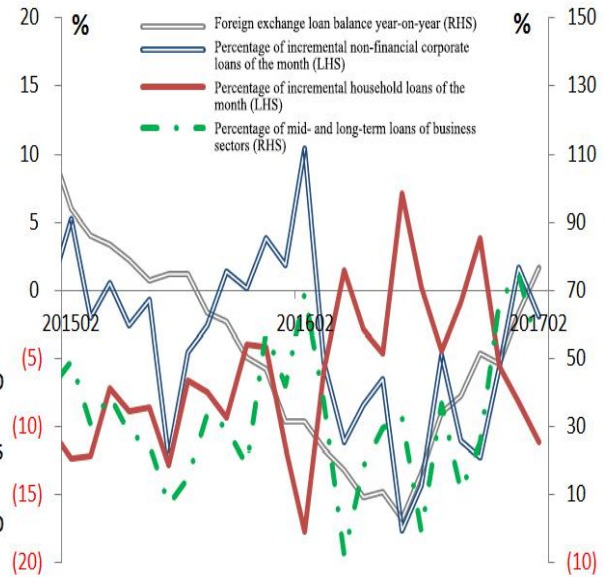


Figure 6: Signs of Improvement in Loan Structures



Sources: Wind, BOC Institute of International Finance

The scale of social financing increased steadily, but direct financing fell. In the first two months of the year, incremental social financing reached RMB4.89 trillion, up RMB677.7 billion compared with the same period of last year. This was mainly associated with the increase in undiscounted acceptance drafts and a rebound in trust loans and foreign-currency loans, which grew by RMB679 billion, RMB337.7 billion and RMB279 billion respectively. Meanwhile, bond financing and equity financing by non-financial enterprises decreased by RMB816.1 billion and RMB14.4 billion respectively compared with the same period of last year. The decline in bond financing was chiefly attributable to bond market turbulence and interest rate rise since the last quarter of 2016, whereas the drop in equity financing was mainly due to new rules on refinancing taking effect. On February 17, CSRC revised some provisions of the *Detailed Implementation Rules for the Non-Public Offering of Stocks of Listed Companies*, explicitly showing its stance on strictly controlling the scale of refinancing in the A-share market. This helped to protect the interests of minority investors, alleviate apprehension about stock market “bloodletting” and reduce arbitrage from price differences; but also generated adverse impact on stock market financing in the short term.

Credit structures tended to improve, with lower percentage of residential mortgages. In the first two months, incremental RMB loans reached RMB3.34 trillion, basically on par with the level of the same period of last year. Credit structures continued to improve: **firstly**, mid- and long-term loans remained stable and increased moderately. In the first two months, the balance of mid- and long-term loans was RMB65.56 trillion, accounting for 59.7% of all the outstanding RMB loans, up 1.2 percentage points over the end of 2016. Incremental mid- and long-term loans in the first two months reached RMB3.19 trillion. **Secondly**, loans of non-financial enterprises rose substantially. In February, incremental loans of non-financial enterprises stood at RMB731.4 billion, representing 62.5% of total incremental loans in the month, up 14.8 percentage points over the end of last year. Such increase was attributable to stabilizing investments, improved profitability of businesses, a recovering real economy, and showed that policies encouraging funds to flow out of the virtual economy and into the real one played an effective role. **Thirdly**, the percentage of residential mortgages dropped. In February, incremental household mid- and long-term loans amounted to RMB380.4 billion, accounting for 32.5% of total incremental loans in the month, down 8 percentage

points from the end of 2016. It should be noted that despite a lower percentage of residential mortgages in the first two months, they still totaled RMB1 trillion, up RMB349.4 billion compared with the same period of last year. **Fourthly**, the demand for foreign exchange loans recovered. By the end of February, the balance of foreign exchange loans rose by 1.7% year on year, ending a continued fall since September 2015, which was mainly due to lower expectations for RMB devaluation.

II.1.2 An “implicit rate increases” cycle began, with liquidity stable but tending to tighten

Since the beginning of the year, market liquidity has become increasingly tight as a result of cash withdrawals during the Spring Festival holidays, tax payments, a decrease in the funds outstanding for foreign exchange and payment of deposit reserves. Against such a backdrop, monetary policy became “half loose and half tight” to stabilize liquidity. On the one hand, liquidity was injected into the market by means of temporary liquidity facilities (TLF) and strengthened reverse repos. On January 20, the central bank employed TLF to reduce reserve requirement ratios for five major banks with precise orientation and time, which was the first time such tool had been used. On the other hand, financial institutions were forced to “de-leverage” through “implicit rate increases” such as raising the interest rate of MLF and net withdrawal of funds from the market. On January 24, the central bank increased the rates of 6-month and 1-year MLFs by 10 basis points. Then on February 3, the central bank revised up the rates of 7-day, 14-day and 28-day reverse repos all by 10 basis points, raised the overnight rate of standing lending facilities (SLF) from 2.75% to 3.10%, and the rates of 7-day and 1-month SLFs by 10 basis points to 3.35% and 3.7% respectively. Overall, supply of money tended to tighten this year. As of March 24, the central bank mopped up RMB735 billion (net) through open market operations. The fundamental objective of such policy mix was to (1) meet the demand for credit extended at the start of the year and during the Spring Festival and ease the phased liquidity squeeze. But given that such liquidity facility shall be repaid when the 28-day term expires, and credit extensions usually peak at the start of the year, such liquidity squeeze would reappear after the Spring Festival; (2) restrict cheap money from flowing into the real estate and bond markets continuously, and encourage funds to flow out of the virtual economy and into the real one.

In terms of market operation, liquidity tended to tighten while remaining stable. **Firstly**, SHIBOR of varying maturities all rose. As of March 14, 2017, overnight SHIBOR averaged 2.3%, up 8 basis points over 2016Q4; 7-day SHIBOR averaged 2.61%, up 17 basis points over 2016Q4 (Table 1). **Secondly**, volatility intensified. In Q1, the volatility of SHIBOR of varying maturities picked up universally compared with all the four quarters of last year, which means greater variance (Table 1). **Thirdly**, the increase in mid- and long-term rates was larger than short-term rates. On March 14, 2017, 3-month SHIBOR rose substantially by 102 basis points over the end of 2016, while overnight and 7-day SHIBOR of the same maturity climbed up by 15 and 11 basis points respectively.

II.1.3 With earlier shocks weakened, the bond market tended to stabilize

After the steep fall³ in 2016Q4, the bond market tended to be stable in Q1. The China Bond Assembled Index rallied after falling, closing at 168.81 points on March 24, down 1.1 points from the end of 2016. The major characteristics of the bond market in the first two months were: (1) declines in bond issues. Total bonds worth RMB1.2 trillion were issued in the two months, down 32.4% compared with the same period of last year. Among which, corporate bonds issued totaled RMB5.54 billion, down 93.4% compared with the same period of last year. (2) Widening credit spreads but narrowing term spreads. Owing to an increase in bond market defaults since 2016Q4,

³ The deep correction of the bond market in 2016Q4 was mainly attributable to tightening monetary policy, inclusion of off-balance-sheet wealth management into MPA, and the outbreak of risk events like agency bond holdings.

the rates on corporate bonds of different credit ratings rose by varying degrees, with spreads widening continuously. By the end of March, the credit spread between 3-year corporate bonds (with AAA rating) and 3-year government bonds hiked by 342.1 basis points. With yields rising overall, the term spread between 10-year and 1-year government bonds narrowed drastically, down 120 basis points from the end of 2016 by the end of March. (3) Frequent occurrence of bond market defaults. Into 2017, 8 bonds defaulted in China, involving a total amount of RMB6.9 billion. (4) Obviously higher rates on bonds issued. By the end of March, the rates on issued government bonds, corporate bonds and enterprise bonds increased by 315, 1283 and 1100 basis points over September 2016, and by 219, 2039 and 797 basis points over 2015.

II.1.4 RMB exchange rates stabilized to some degree, and difference in onshore and offshore exchange rates turned from negative to positive

The RMB exchange rates have gradually stabilized since the start of the year. On March 10, the CFETS RMB exchange rate index and the RMB exchange rate indexes with reference to the BIS basket and SDR basket stood at 93.32, 94.5 and 95.14 respectively, down slightly from the end of last year. On March 24, the central parity rate of RMB/USD stood at 6.8845 per dollar, up 0.76% over the end of last year. The onshore and offshore RMB exchange rate difference turned from negative to positive⁴, i.e. rising from -200 basis points at the end of 2016 to 148 basis points. Such a reversal indicated the offshore market tended to be bullish about the yuan. The current stabilization of RMB exchange rates was chiefly associated with the following factors: (1) a stabilizing Chinese economy, and apparently lower expectations of RMB devaluation. (2) Restriction of abnormal cross-border capital outflows. Personal purchase of foreign exchange has been vet more rigorously since this year, and is forbidden to be used for house purchases or securities investment abroad, or other capital items that have not been deregulated. This dealt a heavy blow to irregularities such as exchange and interest arbitrage, and reduced abnormal cross-border capital outflows at the source. (3) Interest spreads between China and the U.S. The Chinese central bank adjusted exchange rates through interest rates, and guided market rates and the interest rate corridor to move upwards by means of reverse repo, and adjustment to MLF and SLF rates. The stabilization of RMB exchange rates and changes in market sentiment about foreign exchange sale and settlement, among other factors, resulted in a rebound in China's foreign exchange reserve. By the end of February, the official foreign exchange reserve increased by USD6.92 billion over January to stand above USD3 trillion again.

II.2 Financial Forecast for Q2

II.2.1 The “monetary policy tightening” will persist, and money market rates are easier to rise than fall

Three major factors will influence the money market in Q2. **Firstly**, it is highly possible that monetary policy will tend to tighten. This year's *Government Work Report* points out, the expected growth targets for M2 and social financing are both around 12% in 2017, down 1 percentage point from 2016. Moreover, different from the expressions of “keeping the liquidity reasonable and adequate...maintain the steady growth of monetary credit and social financing” in previous years, this year's monetary policy puts more emphasis on “keeping the liquidity basically stable and smoothing monetary policy transmission mechanism”, which means the possibility of monetary policy easing up is small. **Secondly**, external liquidity will tighten. The U.S. Federal Reserve raised interest rates again in March, and it is expected that there will be 2-3 further rate hikes this year. Meanwhile, according to the rate decision of the European Central Bank (ECB) announced on March

⁴ The difference between the onshore RMB spot rate against the dollar in mainland and the offshore RMB exchange rate in Hong Kong; if its value is positive, that means a positive gap, i.e. expectation of onshore RMB exchange rate depreciation is greater than that in the offshore market. And vice versa.

9, ECB revised up expectations of future inflation, and deleted the expression of “employ all the tools available”, which indicates the possibility of further easing by ECB is lower as the European economy is improving, and monetary policy may change direction. Marginal tightening of monetary policy in major economies including the U.S. and Europe will lead to global liquidity squeezes and market rate increases. **Thirdly**, rising inflation will intensify the pressure on interest rate hikes. We expect that in Q2, M2 will grow by 11.2% and social financing increase by 12.5% year on year; the “monetary policy tightening” situation will persist.

II.2.2 With credit growing steadily, credit structures will continue to improve under the “credit-stabilizing” trend

In Q2, there will be more favorable conditions for credit growth, as the macro economy continues to stabilize with a huge financing demand for infrastructure investment. Moreover, it is difficult for the financing function of stock markets and bonds to recover in a short period, therefore it is necessary for credit to continue to play its role. But given a stable but tightening monetary policy, it is unlikely for credit to grow substantially. So it is expected that RMB loans will increase by around RMB4 trillion in Q2 and incremental loans will approach RMB12 trillion for the year. **Firstly**, loans of non-financial enterprises will continue to pick up, mainly attributable to a stabilizing economy, improvement of business profitability and recovery of private investment. **Secondly**, there is still huge financing demand for infrastructure investment. It is planned to complete railway construction investments worth RMB800 billion and highway and waterage investments worth RMB1.8 trillion this year, which need to be backed by large amounts of credit funds. **Thirdly**, growth of residential mortgages will slow down. With the launch of a new round of policies aimed to strictly control the real estate sector since March, the growth of residential mortgages is expected to slow down markedly in Q2. **Fourthly**, new industries, new consumer sectors, new countryside and green finance will develop at a faster pace. With all-for-one tourism, artificial intelligence and fifth-generation mobile communication, among others, written in the *Government Work Report* for the first time, it is projected that new industries, infrastructure, new consumer sectors, new tourism and green finance may top the list of financial services needs this year.

II.2.3 Factors stabilizing RMB exchange rates will increase, but the bond market will remain sluggish

Factors that help keep RMB exchange rates stable will continue to increase in Q2. On the one hand, the rate increase by the U.S. Federal Reserve in March will halt the rising trend of the dollar index. The most pessimistic moment for RMB exchange rates and capital flight has passed. On the other hand, a number of favorable factors have decided the RMB exchange rates will remain basically stable and in a reasonable balance, such as gradually stabilizing economic growth, resumed increase in China's foreign exchange reserve, and the difference between onshore and offshore RMB exchange rates turning from negative to positive. In the medium term, as the supply-demand imbalance in the domestic forex market has not changed fundamentally, the rate hike policy of the U.S. Federal Reserve and the trend of the dollar index will affect expectations of RMB exchange rates.

In the short term, the bond market will remain sluggish for some more time. More signals of a stabilizing economy, marginal tightening of liquidity and rising inflation expectations will ratchet up the pressure on rate increases. Moreover, as credit risk can barely be mitigated this year, the furtherance of de-capacity and de-leveraging will lead to a rise in the default risk of relevant enterprises. In the medium term, there will be some favorable factors for bond market development. Firstly, the overall macroeconomic environment is better than last year, and there is little chance for the quality of credit assets to further deteriorate significantly. Secondly, the bond market is opened up wider at a fast pace, which helps attract capital inflows. Premier Li Keqiang expressed at the press

conference on March 15 that China planned to pilot a “Bond Connect” programme between Hong Kong and the mainland this year, therefore, access to the domestic bond market by international investors will be further facilitated. Thirdly, interest rate bonds will remain the safe haven for capital with a low-risk appetite.

Table 1: Forecasts on China's Major Economic and Financial Indicators in Q2 and 2017 (%)

Indicator	2013 (R)	2014 (R)	2015 (R)	2016 (R)	2017		
					Q1 (E)	Q2 (F)	Full Year (F)
GDP	7.8	7.3	6.9	6.7	7.0	6.9	6.8
Industrial value added of enterprises above designated size	9.7	8.3	6.1	6.0	6.2	6.2	6.1
Value added of the services sector	8.3	7.8	8.2	7.8	8.2	8.1	8.1
Fixed asset investments	19.6	15.7	10.0	8.1	8.8	8.6	8.5
Total retail sales of consumer goods	13.1	12.0	10.7	10.4	9.5	9.5	9.8
Exports	7.8	6.0	-2.9	-7.7	2.5	2.5	1.0
Imports	7.3	0.5	-14.3	-5.5	26.0	15.0	12.5
Consumer Price Index (CPI)	2.6	2.0	1.4	2.0	1.6	1.8	2.0
Producer Price Index (PPI)	-1.9	-1.9	-5.2	-1.4	7.5	6.3	5.5
Broad money supply (M2, ending balance)	13.6	12.2	13.3	11.3	11.2	11.2	11.5
Private financing size (existing)	17.5	14.3	12.4	12.8	12.5	12.5	12.5

Source: BOC Institute of International Finance

III. Macroeconomic Policy Orientations

III.1 Fiscal policy: quicken the pace of expenditure, and boost the effectiveness of policies

In Q2, fiscal policy will stick to the keynote of “proactive and effective” so that measures can produce the desired results at the earliest possible time. In addition, efforts will be made to maintain the rapid growth of major expenditures for science and technology, social security, health care and indemnificatory housing, among others.

First, continuously implement a proactive fiscal policy, and quicken the pace of expenditure.

On the one hand, press ahead with tax and fee reductions. This year's *Government Work Report* set out the target of further reducing enterprises' tax burdens by around RMB350 billion and enterprise-related charges by around RMB200 billion, cancelling or stopping the collection of 35 enterprise-related administrative and undertaking fees by central government departments and institutions, and cutting charging items by at least one half. On the other hand, properly expand the scale of expenditures and quicken the pace of expenditure. The fiscal deficit ratio will remain at 3% this year, and play an active role in increasing aggregate demand appropriately. The pace of fiscal expenditures has evidently accelerated in the last three years, with Q2's posting higher percentages in full-year fiscal expenditures than previous years. This year's fiscal expenditures are expected to speed up in Q2 as well.

Second, improve the VAT rate structure, and lower the tax burden of micro and small-sized enterprises. After the blanket launch of the pilot program to replace business tax with VAT last year, four tax rates, namely, 6%, 11%, 13% and 17%, are applicable to general taxpayers. Next, the

government will better implement and improve policies for the pilot program, simplify the VAT rate structure, improve the VAT deduction chain and merge the four rates into three on the basis of accurately calculating tax burdens. The government will once again widen the scope of micro and small-sized enterprises entitled to the reduction of income tax by half (whose annual taxable income is expanded from below RMB300,000 to below RMB500,000), in a bid to support the development of micro and small-sized enterprises more forcefully. Furthermore, raise the weighted deduction ratio (from 50% to 75%) on research and development expenses of small and medium-sized technology enterprises so that they can operate with less burden.

Third, enhance the effectiveness and accuracy of policies. The government will channel more funds into the areas of overcoming weaknesses, adjusting structures, promoting innovation and improving people's livelihood, especially in support of poor and less-developed regions and weak sectors of the national economy. This year, the central government sets aside RMB507.6 billion in investment funding from its budget to strengthen the building of key projects in the areas of rail transit, civil aviation and telecom infrastructure. The government will improve the mechanisms of taking targeted measures to alleviate and eliminate poverty and ensure relevant funds are used precisely to help resolve practical problems for the poor; ramp up investments to improve people's livelihood including education, health care, provision for the aged and living environment in rural areas; advance development targeting weaknesses in the public service sectors and increase effective supply.

Fourth, strictly regulate borrowing of local governments. In the past two years, local government debts in the amount of RMB8.1 trillion were swapped, which decreased interest expenses by more than RMB500 billion and allowed the debt risk of local governments to be properly controlled. In line with budget deficit arrangements, the government will issue dedicated local bonds worth RMB800 billion this year for capital expenditures with certain revenue items, which can increase aggregate demand. Next, by adhering to the approach of "opening the front door but shutting the back door", the government will continue to press ahead with local government debt swaps, improve the early warning, supervision, emergency response and accountability mechanisms for local government debts, crack down on guarantees for illegal borrowing, step up investigation and punishment of such behaviors, and comprehensively strengthen risk prevention and control in respect of local government debts.

Fifth, accelerate the launch of PPP projects, and track the progress and standardization of such projects. As of the end of 2016, projects registered on China's comprehensive PPP information platform numbered 11,260, involving total investments of RMB13.5 trillion. Among which 1,351 signed projects, with total investments of RMB2.2 trillion, were carried out. Compared with 2015, the number of projects launched and the investment scale increased more than four-fold. Going forward, on the basis of summarizing the experience of early-stage PPP projects, the government will deepen public-private partnerships, implement and improve policies and measures aimed to promote private investment, and improve preferential policies on prices and taxes. Local governments are required to take a lead in championing good faith and protect the legitimate rights and interests of private capital, not to change agreements at random or ignore historical issues due to government transitions.

III.2 Monetary policy: remain prudent overall, with faster pace of implicit rate increases

In Q2, under the background of a stabilizing economy, given continuously surging housing prices in some cities, high financing costs of enterprises and lingering pressure on RMB exchange rate depreciation, while maintaining the policy tone of being prudent, monetary policy will focus on risk prevention and control, including suppressing bubbles and stabilizing exchange rates, and guide funds to flow out of the virtual economy and into the real one by strengthening policy tool mixes

and differentiated residential mortgage regulations.

First, efforts will be further intensified. In order to curb asset price bubbles, monetary policy will remain prudent, with less likelihood of reserve requirement ratio cut. However, in the event of soaring money market rates and sharp decline of monetary base like funds outstanding for foreign exchange, the central bank will inject liquidity by stepping up open market operations in order to keep liquidity basically stable.

Second, the pace of implicit rate increases will quicken, with open market rates and mortgage rates likely to rise further. If the prices of real estate and other assets continue to surge, and expectations of RMB exchange rate depreciation pick up again, the possibility of the central bank raising the rates of MLF and reverse repo again to reduce the financial arbitrage space and increase the appeal of domestic assets cannot be ruled out. In fact, the central bank raised the reverse repo rate on March 16 to counter the adverse impact brought by the rate increase of the U.S. Federal Reserve. Moreover, the central bank can also require banks to lower the concessional degree of mortgage rates or raise residential mortgage rates through window guidance and other means.

Third, improve the regulatory framework for cross-border capital flows, and properly manage expectations of RMB exchange rates. The first is to monitor and judge the direction of capital flows regarding customers' cross-border transactions and maintain policy consistency for customers with actual demand. The second is to intensify punishments and raise arbitrage costs for foreign exchange purchases with false trade backgrounds or unknown purposes. The third is to strengthen uniform monitoring of cross-border capital flows and transactions in the money market, capital market, forex market and insurance market, and work out effective countermeasures to address capital exodus pressure.

Fourth, reinforce differentiated residential mortgage control, and further raise the credit threshold and expand the scope of cities subject to mortgage restrictions. After the Spring Festival, the property markets in some tier-1 and tier-2 cities heated up again, and sales in tier-3 and tier-4 cities also picked up. It is expected that the government will further reinforce differentiated credit control, raise the credit threshold, including the standards for identifying a second home, down payments, and loan rates, and expand the scope of cities subject to purchase and mortgage restrictions with some tier-3 and tier-4 cities to be included as well.

Disclaimer

This report is prepared by BOC Institute of International Finance. The information contained in this report is from publicly available sources.

The views or estimates contained in this report only represent the judgment of the author as of the date hereof. They don't necessarily reflect the views of BOC. BOC Institute of International Finance may change the views or estimates without prior notice, and shall not be held liable for update, correction or revision of this report.

The contents and views in the report are for information purpose only and do not constitute any investment advice. No responsibility is held for any direct and indirect investment consequences as a result of the information provided in the report.

The copyright of this report is exclusively owned by BOC Institute of International Finance. No individuals and institutions shall be allowed to copy, reproduce and publish the whole or part of the report without written consent. In case of quotation, reference to BOC Institute of International Finance shall be given, and any quotation, abridgment and revision that deviate from the original meaning of the report shall be prohibited. BOC Institute of International Finance reserves the right to take legal actions on any violation and any quotation that deviates from the original meaning of the report.



BOC Institute of International Finance

1 Fuxingmen Nei Street, Beijing, 100818 China

Tel: +86-10-66592779

Fax: +86-10-66030183