



## Global Economic and Financial Outlook

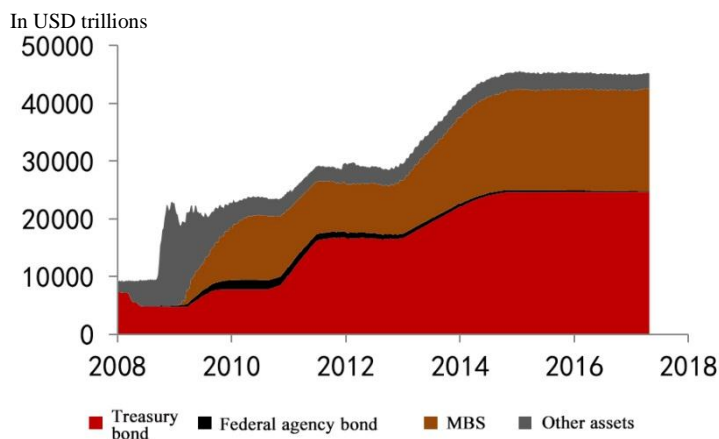
2017Q3 (Issue 31)

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### Highlights

- The first half of 2017 saw continued recovery of world economy, pickup in economic and trade activities in major economies, and two interest rate hikes by the Fed. As the uncertainty in policies decreases, global financial stability becomes stronger.
- Looking ahead, we insist that the global economy will be better in 2017. However, the discussion and implementation of Fed's policy normalization plans, uncertainty in Brexit and geopolitical conflicts may pose risks.
- Continued divergence in global economic recovery further differentiates monetary policies of major economies. The present report analyzes the trend in economic and monetary policies of major economies including the U.S., Europe and Japan.
- The economic situation in some Latin American countries such as Brazil and Argentina improves. However, against the backdrop of low commodity prices, trade protectionism of the U.S., and the Fed's interest rate hike and policy normalization, the economic recovery of Latin America is still gloomy.

### Structural Changes in the Assets of the Fed's Balance Sheet



Sources: Wind, BOC Institute of International Finance

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## Potential Policy Normalization Casts a Shadow on Global Economy

### -- Global Economic and Financial Outlook (2017Q3)

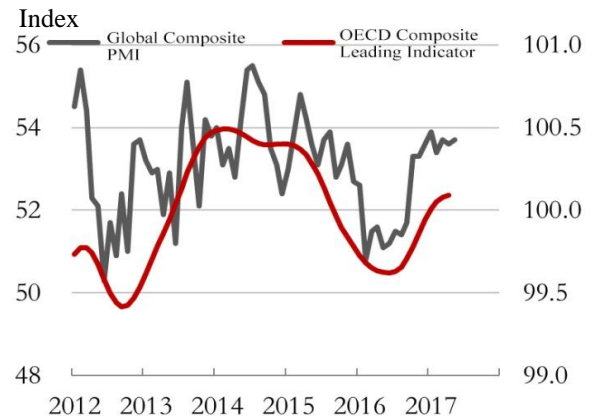
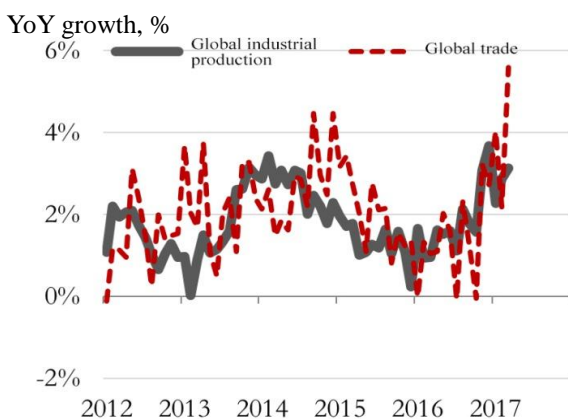
The world economy continued to grow mildly in the first half of 2017. The Fed has increased interest rate twice. The European market was disturbed by the general elections of the UK and France. Meanwhile, Japan’s economy continued to recover. Global financial stability strengthened, while financial markets in some regions remained volatile, which is highlighted by the downward movement of USD exchange rate. Against the background of rising inflation and steady decrease of unemployment rate, the relaxed monetary policy of worldwide is facing a new shift, and the policy normalization plans of the Fed are on the agenda. After eight years of weak recovery, will the world economy again fall into distress due to imbalanced policies? Will the financial markets thereby see fluctuations again?

#### I. Global Economy Faces New Uncertainties amid Mild Recovery

##### I.1 Mild Recovery of Global Economy Continues

High-frequency data of Real Economic Activity and Climate Survey Indicators show that, from the latter half of 2016 till today, the global economy has been gradually getting over a six-year low-speed growth. Seen from some "hard facts" such as industrial production, trade and investment, data by Q1 suggested that global economy is growing at a faster speed, hitting a six-year high (Figure 1); judging from some "soft indicators" such as Purchasing Managers’ Index (PMI), Consumer Confidence Index (CCI) and OECD Composite Leading Indicator (CLI), the sound momentum of global economic growth continues in Q2 (Figure 2). By initial estimate, the quarter-on-quarter growth rate of the global GDP in 2017Q2 will be around 3.0%, and the year-on-year growth rate be about 2.9%, both basically flat with the previous quarter. Some of the factors behind the continued economic recovery include: First, various policies have supported rapid growth of investment in infrastructure of regions along the Belt and Road, especially in China, giving a strong boost to trade; Second, policies in the U.S. and developed European countries become less uncertain, enhancing the confidence of investors and consumers; Third, commodity prices have picked up, fueling the economic growth of the Middle East, Africa and Latin America.

**Figure 1: Global Industrial Production & International Trade**      **Figure 2: Global Composite PMI & OECD Composite Leading Indicator**



Sources: CPB, OECD, Wind, BOC Institute of International Finance

In 2017, the global economy may start with a higher growth and then slow down. We maintain our forecast of a growth rate at around 2.8% for 2017. Though reaching a six-year high, such a speed is still below the growth potential. The global economy is still less likely to enter a strong recovery cycle, which is mainly attributable to: First, policy adjustment of major economies. The Fed is on the eve of interest rate rise cycle and policy normalization, which will stifle the development of U.S. and even the world economy. Given de-capacity and de-leveraging approaches as well as real estate regulatory policies, China will be able to maintain steady growth, but accelerated growth is hardly possible. As China and the U.S. contribute almost half to the world's economic growth, the whole world will be shadowed by policy normalization. Meanwhile, the growth of Europe and Japan will remain less-motivated despite continued mild recovery in economy. Second, although investment in infrastructure promoted by the Belt and Road Initiative is gradually driving the global economy, the geopolitical situation in the Middle East is becoming unstable, and the commodity market sees more supply than demand, which remain to be further adjusted. This will discourage private investment in this region, and it remains to be seen when international investors will change the wait-and-see attitude. In addition, affected by the sluggish commodity market and depressed external demand of major economies, the recovery of Africa and Latin America will be weak.

## **I.2 High Attention Shall be Paid to Three Major Uncertainties in the Future**

**First, uncertain macro policies of the U.S.** The strong personal traits of U.S. President Donald Trump bring great uncertainties to policies. The policies he advocates are contradictory, while bring various challenges to the globalization process. Such contradictions lie in more infrastructure investment and comprehensive tax cut as against rising government debts of the U.S., interest rate hike and policy normalization as against policies to weaken U.S. dollar and promote export, and perking up the manufacturing section as against tightening immigration control. Uncertainties in the U.S. macro policies will obviously influence the global economy.

**Second, uncertain Brexit process of the UK.** From Brexit referendum to the recent failure in the early general election of Theresa May administration, the Brexit process is twisted. The UK has triggered Brexit negotiations with the EU, but the future is indeterminate due to the following factors: (1) The contradiction between the will of the UK government to push forward the process of leaving the EU and the turning of public opinions. Results of the recent early general election and opinion poll suggest that, over half of the citizens are positive about the EU, indicating that Brexit may not be the mainstream of public opinions since the participation rate of the referendum is not high. (2) The possibility of the UK and the EU to make compromises in negotiations. The UK wants to gain benefits while leaves the EU; meanwhile, the EU may impose punishment so as to refrain other countries from following suit. The wrestling between the two will inevitably continue. (3) The reform within the EU and the outlook of changes in political landscape. The recent general elections in the Netherlands and France set the EU at ease. However, the Brexit negotiations may be affected by the approaches taken by the EU to practically push forward reform and consolidate integration. On the whole, there are still great uncertainties about policies of Europe.

**Third, uncertainties caused by geopolitical conflicts and terrorism spread.** Recently, the geopolitical conflicts in the Middle East represented by the diplomatic break with Qatar by Middle East countries, the terrorism spread in Europe and the U.S. represented by a series of terrorist attacks in the UK and the geopolitical wrestling between the U.S. and Russia will inevitably shake the confidence of local investors. While bringing uncertainties to the short-term economic recovery, such conflicts are long-term problems facing global governance and threats to global economic recovery, which will exert continued negative impacts on the sustainable development of the world economy.

## II. New Risks Call for Attention amid Strengthening of Global Financial Stability

### II.1 Policies of Developed Countries Become Less Uncertain and Financial Risk Indicators Turn More Stable

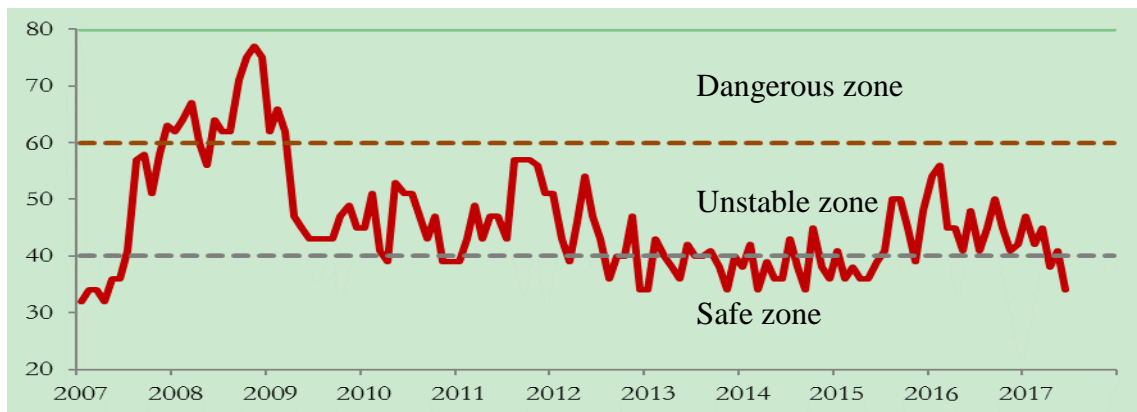
In 2017 Q1 and Q2, uncertainties in the macro policies of developed economies and the world at large fell back from a high level, as the Fed's interest rate hikes meet expectations of the market. Donald Trump's election as the U.S. President, nuclear threats from North Korea, geopolitical conflicts in the Middle East and other political uncertainties have exerted limited impact on the financial market of the U.S. and other major financial markets of the globe, market fluctuations remain at a historical low, and the confidence of investors stay at a historical high. Investors put relatively high expectations on the effects of Trump's economic policies, and remain confident about the role play by central banks in maintaining the stability of financial markets.

The stock markets perform well. The Volatility Index (VIX), dispersion and relevance of the U.S. and European stock markets are at a historical low. Low dispersion, especially low relevance play a major positive role in maintaining market stabilization. As investors stay highly optimistic about the future and boosted by Trump's policies, the PE of major stock markets keep climbing, far exceeding historical levels.

Bond markets are relatively stable. The Merrill Lynch Option Volatility Estimate (MOVE) Index, a measure of the normalized implied volatility on Treasury options, remains at a historical low in the first half of 2017, and is likely to fall further. There is a high growth in bond issuance worldwide, with most of the funds used for refinancing, share repo, M&A and dividend payment and a small proportion for capital expenditure, which is 3% in the U.S. and Europe and 6% in emerging markets. The credit cycle of U.S. companies is maturing, and the corporate leverage ratio, especially the liability-income ratio is higher than the pre-crisis level, approaching a historical high. Despite relatively stable delinquency rate and default rate overall, performances of different sectors are divergent. Specifically, the default ratio of metal, energy and mineral resource sectors, especially of the non-investment grade go up.

Overall risk of financial markets has dropped in 2017Q2, showing increased stability. The month average of the U.S. Risk of Financial Crisis Index (ROFCI) we designed fell from 44.66 to 37.66, from the unstable zone back to the safe zone (Figure 3). In Q2, bank shares are more volatile, and money market of non-financial enterprises is the major market seeing risk go up and stay at a high level; while the inter-bank funding market, the risk of systematic default of banks and the USD foreign exchange market are the major ones seeing declined risk and restoring stability. In Q3, ROFCI is likely to fluctuate between the unstable zone and safe zone.

Figure 3: Trend of ROFCI Movement of the U.S.



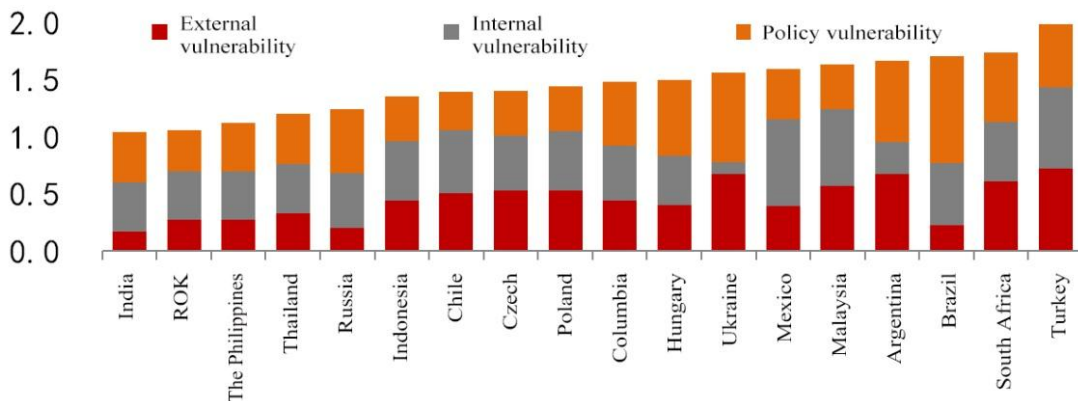
Source: BOC Institute of International Finance

## II.2 Emerging Economies See Stable Financial Vulnerability Overall

In the beginning of 2017, emerging markets witnessed rebounded prices of energy and other commodities, improved growth expectation, and reduced spillover impact from the U.S. new administration, which led to the steady recovery, falling risk premium and volatility as well as accelerated net inflows in non-resident bonds and stock investment of emerging markets. With accelerated economic growth of emerging markets, the overall credit conditions of the banking sector, especially the credit demands and standards may improve in Q3. IFF expects the total non-resident capital inflows of emerging markets to increase from USD718 billion in 2016 to USD970 billion in 2017; meanwhile, the capital outflows are expected to go down, which may lead to a decrease in net annual capital outflows of emerging markets. However, the capital inflows of emerging markets may be impeded if the Fed starts to reduce the holdings of Treasury bonds.

Generally speaking, the financial vulnerability of emerging markets in Q2 is stable. In comparison, in Q2, there is no least vulnerable country anymore; vulnerable countries still take a major part; and there are still little most vulnerable countries. Countries with most external vulnerability are Turkey, Ukraine, Argentina and South Africa; those with most internal vulnerability are Mexico, Turkey and Malaysia; those with most policy vulnerability are Brazil, Ukraine, Argentina and Hungary; and taking all the indicators together, Turkey remains as the most vulnerable country (Figure 4).

Figure 4: Comparison of Vulnerability Indicators of Emerging Markets in 2017Q2



Sources: IIF, BOC Institute of International Finance

Impacts of external political risks may continue in Q3. Uncertain U.S. policies, obstacles in international trade growth, and geopolitical conflicts are likely to become the main concerns of investors and the banking sector of emerging markets. In the meantime, rising interest rate and appreciating USD will increase the USD-denominated refinancing burden of emerging markets. Over USD1.1 trillion foreign-currency bonds and loans will mature in emerging markets at the end of 2017, which may become a major source of credit risk. Countries seeing highest growth in foreign currency dominated debts are Argentina, Columbia, Mexico, Turkey, South Africa and Chile.

## II.3 New Risks Threaten Future Global Financial Stability

On the positive side, global monetary and financial environment will stay accommodative in general, economic activities in the U.S., Europe and emerging markets will increase and deflation risk will drop, all beneficial to the stability of financial markets. The relevance of global stock markets may continue to fall, helpful to reduce the sheep flock effect of the capital market and systematic risks. As the cash balance of U.S. enterprises is at a record high and income and profit growth trends to accelerate, we will see the decrease in corporate leverage ratio and the

improvement in solvency and credit quality. Thanks to relatively low leverage ratio and adequate capital in the global banking sector, serious credit grudging and crisis are unlikely to happen. Systematic risk indicators of the U.S. banking sector have improved. The European banking sector has also made progress with growth in stock prices. Looking ahead, as economic growth picks up speed and long-term interest rate goes up in the future, the banking sector of major markets is likely to see further increase in income and stability.

On the negative side, uncertainties in policy still pose the highest risk. Especially, if the policies of U.S. and other major economies noticeably deviate from market expectations, there may be market turbulence and substantial growth in risk premium and volatility. Continued climbing of PE ratio of U.S. and other developed markets suggests weaker risk awareness of investors and lack of preparation for future market fluctuations. On the basis of low returns from corporate bond financing, interest rate hike in the future will further weaken the solvency of enterprises. The debt burden of U.S. enterprises will therefore rise, probably causing the systematic risk in the U.S. Such enterprises are mainly concentrated in energy, real estate and public utilities sectors, among others. As the structural problem and excessive public debts of the European banking system can be hardly resolved within a short period, unstable political situation could again undermine financial stability.

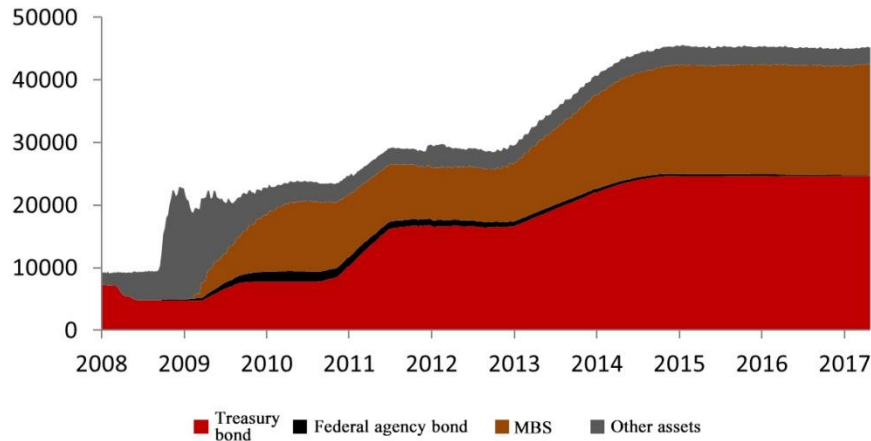
As for emerging markets, deterioration of trade conditions will pose a greater threat to countries with close trade ties, intensify enterprise fragility, and possibly cause the debt at risk of the most problematic enterprises to jump by USD130 billion, reaching USD230 billion (IMF, April 2017). Moreover, such trends as trade protectionism and de-globalization could reduce global trade growth, hamper cross-border capital flow, and affect the new capital inflows of emerging markets. Meanwhile, appreciation of US dollar and interest rate hike will further lower the solvency of debtors of USD-denominated loans from countries other than the U.S., especially from emerging markets.

### **III. Possible Path of the Fed's Policy Normalization and Its Spillover Effects**

#### **III.1 Reasons for Policy Normalization**

After the global financial crisis and economic depression in 2008, the Fed reduced policy interest rate and adopted the quantitative easing(QE) by purchasing large-scale asset to stimulate the economy. QE policy led to a drastic expansion in the Fed's balance sheet. As at June 14, 2017, the Fed's total assets skyrocketed five times, from some USD0.9 trillion before the crisis to USD4.5 trillion (Figure 5); the proportion of total assets in GDP soared from 6% to 24%. As the U.S. economy is basically recovered, making it unreasonable to stick to the asset scale of a historical high which was targeted at addressing the crisis and recession, the Fed starts to end the ultra-easy monetary policy and return to a normal monetary policy. In the meantime, attention shall be drawn to the fact that the U.S. stock market outperforms its economic growth, three major stock indexes are higher than the pre-crisis level, the risk appetite of investors has been restored long before, and the pursuit of high returns leads to increasing financial risk. Given the above, monetary policies shall be prepared to prevent the next recession.

**Figure 5: Changes in the Assets of the Fed's Balance Sheet**  
(In USD100 millions)



Sources: Wind, BOC Institute of International Finance

### III.2 Possible Path of Policy Normalization

According to the Fed's 2014 Policy Normalization Principles and Plans, the timing of changing the reinvestment policy (i.e., reducing the balance sheet) will depend on how economic and financial conditions and the economic outlook evolve, that is, when the restart of QE is not so necessary. On the FOMC meeting held in March 2017, officials of the Fed suggested to start balance sheet shrinkage when the federal funds rate rises to a certain level. The Fed has once made a survey in this regard, with results showing that: the forecast value of primary dealers and investors in the bond market mainly fall between 1.26% and 1.75%, with the median value of 1.51%; the time of balance sheet shrinkage will be around 2017Q4 or 2018H1.

The most uncertain and controversial part is the scale of assets the Fed plans to maintain in the future, which is the most critical factor of the normalization plans, since it directly affects the scale and approach of shrinkage. A reasonable level of balance sheet shrinkage depends on a lot of factors and is also influenced by the market. Overall, the asset scale is unlikely to fall back to the pre-crisis level, and it is generally believed that a relatively large scale is to be maintained. Major reasons lie in the following aspects:

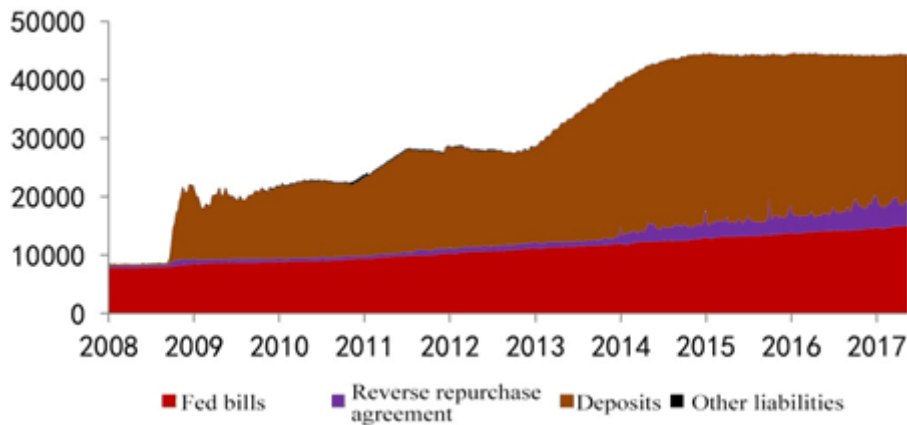
**First, the proportion of the Fed's assets in the GDP.** According to a study made by Professor Ferguson from Harvard University on balance sheet size of central banks of 12 developed economies, assets of those central banks usually account for 10%-20% of the GDP, while in the history of balance sheet shrinkage by the Fed, the proportion usually went down and stayed at around 6%. Currently, assets of the Fed accounted for around 25% of the GDP, higher than the level of the Great Depression and World War II, which was 22%. Therefore, it is expected that the shrinkage this time plans to reduce the figure to below 10%. Based on this estimation, at least USD2.7 trillion of USD-denominated assets will be cut, including USD1.77 trillion of MBS and nearly USD1 trillion Treasury bonds.

**Second, the scale of liabilities of the Fed.** Liabilities of the Fed are mainly in the form of bills, deposits and reverse repurchase agreement, with relatively certain bills and uncertain bank reserves. Bank reserves rose drastically after the crisis due to of the Fed's policy on interest paying, surging from less than USD10 billion in 2007 to USD2.2 trillion at present (Figure 6). According to the Policy Normalization Principles and Plans issued at the FOMC meeting held in June, the level of reserve balances will mainly reflect the Committee's decisions about how to implement monetary policy most efficiently and effectively in the future.

If the Fed plans to completely resume the open market mode, it needs to substantially cut excess reserves after policy normalization. If it sticks to the current regulating mechanism adopting the interest rates of reserves and overnight reverse repo as the ceiling and floor of interest rate corridor, it needs to maintain adequate excess reserves and asset size. According to the estimates of Ben Bernanke, former Chairman of the Fed, if the current mechanism is maintained, the reserve balance will exceed USD1 trillion. On this basis, the Fed needs to hold reserves of at least around USD1 trillion, higher than the pre-crisis level, which means that the liabilities of the Fed will be around USD3.3 trillion, and it needs to cut USD1.2 trillion of assets.

**Figure 6: Changes in the Liabilities of the Fed's Balance Sheet**

(In USD100 million)



Source: Wind, BOC Institute of International Finance

**Third, the maintenance of financial stability by the Fed.** To keep a relatively large balance sheet is probably helpful for financial stability. In future recession, the balance sheet will probably be frequently employed as a tool of monetary policy, which requires the Fed to hold a certain size of assets. Moreover, apart from the size of balance sheet, duration management is gradually becoming a major tool of the Fed's monetary policy, and such tool requires the Fed to maintain a relatively large amount of securities of varying maturities.

**Given above, if the Fed sticks to the mechanism of regulating interest rate corridor with monetary policy, the cut will be relatively limited, at around USD1.2 trillion; if the previous open market mode is adopted, the cut will be around USD2.7 trillion. For the time being, Yellen prefers the latter one, i.e., to drastically cut securities.**

In terms of the policy normalization approaches and procedures, in theory, the following ways are available: First, active reduction, which means to directly sell the securities it held in the market; Second, natural reduction, which means to stop the reinvestment of principal payments received on securities held by the Fed; Third, shortening the duration of securities it held by buying short-term securities and selling long-term ones, to accelerate the speed of natural reduction. According to the Policy Normalization Principles and Plans issued by the FOMC in June, the Fed intends to gradually reduce its securities holdings and sets initial monthly caps: USD6 billion for Treasury securities and USD4 billion for mortgage-backed securities. The cap for will Treasury securities increase in steps of USD6 billion at three-month intervals over 12 months until it reaches USD30 billion per month, while that for mortgage-backed securities will increase in steps of USD4 billion at three-month intervals over 12 months until it reaches USD20 billion per month. The caps will remain until the Federal Open Market Committee judges that the Fed is holding no more securities than necessary to implement monetary policy efficiently and effectively. Based on this plan, the cut

is expected to be USD300 billion in the first year and USD600 for each year ahead. If the total cut is USD2.7 trillion, it will take around five years.

### III.3 Spillover Effects of Policy Normalization

Policy normalization by the Fed will exert considerable impact on the world's economic situation.

**First, it is a double-edged sword to the U.S. In terms of the negative side, the policy normalization will lead to higher medium-to-long term interest rates, influencing fixed investment and economic growth.** According to estimation of the Fed's economists, due to the implementation of QE policy, the interest rate of ten-year U.S. Treasury bonds reduced by 100 BPs. With policy normalization and shortened duration, term premium and long-term interest rate will gradually pick up. It is expected that, at around 2023 when the process of policy normalization is basically completed, the premium will be only -24 BPs, which will limit investment spending of enterprises and restrict economic growth. Besides, increase of long-term interest rate will lay more debt burdens on enterprises and threaten financial stability. **As for the positive side, policy normalization is helpful to improve and diversify operation approaches of the monetary policy.** After the crisis, the Fed addressed economic recession by integrating the QE and interest rate policies, adjusted short-term interest rate with interest rate policy and meanwhile influenced medium-to-long term interest rates and yield curve by adjusting asset size and structure. Whereas the natural rate of interest has been low for a long term, while continuing to use the interest rate tool, the Fed will probably employ the balance sheet more often as a policy tool and periodically expand or shrink the balance sheet. The policy normalization this time can establish a complete and repeatable mode for the Fed's balance sheet operation and its interaction with interest rate.

**Second, policy normalization will tighten global liquidity and put pressure on asset price.** As the return on assets of the U.S. remains low, excess U.S. dollar liquidity has been flowing to emerging economies through cross-border lending, direct investment and purchase of international bonds. The launch of interest rate hike and policy normalization, coupled with Trump administration's tax cut, will lead to a sharp decrease in U.S. dollar liquidity worldwide and the selling of U.S. dollar by emerging economies to improve the liquidity of their domestic currencies. The world as a whole will face financial constraint, and the exchange rates of emerging economies and global commodity prices will be under shocks.

**Third, there will be negative impact on China. First of all, cross-border capital outflows will continue, putting depreciation pressure on RMB.** On the one hand, the Fed will further increase interest rate, the expectation on policy normalization will be rising, and US Dollar Index will continue to go up. On the other hand, as China's economy is expected to start with a higher growth and then slow down, GDP growth will be slightly slower in the second half of this year, with weaker support for the value of RMB. **Second, the domestic bond market will face corrections.** After policy normalization of the Fed, long-term interest rate will noticeably go up in the U.S. For the consideration of stabilizing market liquidity and preventing financial risk, the target range for the federal funds rate will not increase sharply, rise in short-term interest rate will be limited, and the yield curve will steepen. Due to frequent cross-border capital flow and high interconnection of global bond markets, the rise in yield of U.S. bonds will surely enhance the yield of China's bond market, cause the drastic fall of long-term bonds especially, and lead to corrections in the bond market of China. **Lastly, the realizability of foreign exchange reserves is weakening.** The size of U.S. Treasury bonds held by the Fed is two times that of China. Whether the Fed chooses to cut investments to Treasury bonds or directly sell them, price of Treasury bonds will fall sharply, bringing evaluation losses to investment in foreign exchange reserves of China. Moreover, as the Fed is the largest holder of U.S. Treasury bonds, its holding cut will influence the international demand and liquidity of Treasury bonds, leading to reduced realizability of China's foreign

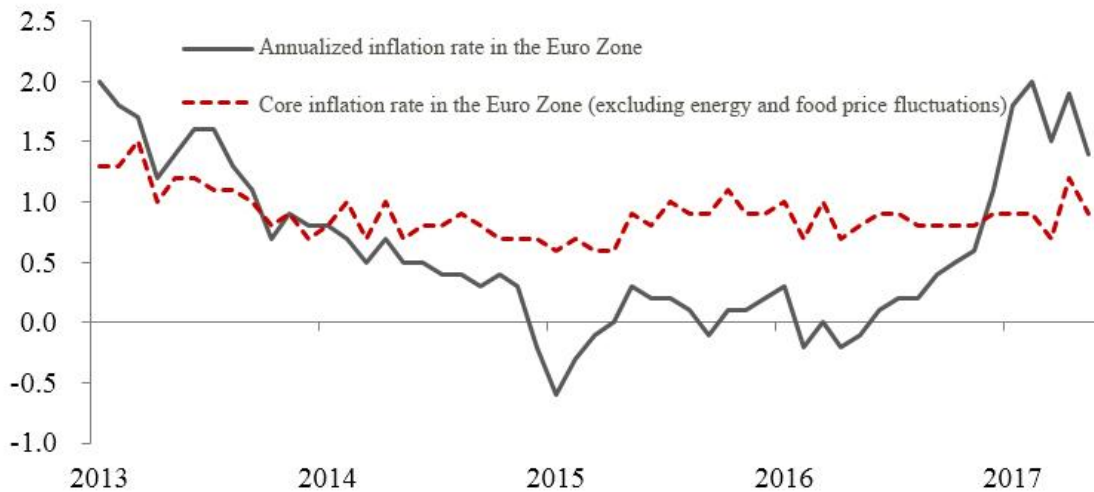
exchange reserves.

#### IV. When the European Economic Train can get back on Track?

In 2017, economy in the Euro Zone ushered in the fifth consecutive year of growth. Although the recovery momentum among member countries was still uneven, the growth has been widely seen in many countries, for example, the EU member states, including Greece, have all witnessed positive GDP growth. The Dutch and French general elections have come to conclusions, which, to a certain extent, mitigated the market concerns over populism, and uncertainty in political and economic areas have been weakened. However, the Brexit negotiations, the U.S. trade protectionism and geopolitical tensions will still cast shadow on the economic outlook in the Euro Zone, and internal and external downside risks still exist.

**Inflation indicators rebounded in the short-term, but are still far from the target.** Inflation trend has always been a guide for the European Central Bank to make monetary policies. The ECB made it clear when introducing the quantitative easing initiatives that it would stop the purchase of debt when the inflation in the Euro Zone rose to close to 2%; if the inflation situation failed to improve as expected, it would extend the debt purchase period. On one hand, CPI in the Euro Zone was affected by energy prices to a great degree. Between 2015 and 2016, international oil prices plunged 75%, and inflation indicators repeatedly presented “negative” figures. Affected by the recent rebound in oil prices, CPI in the Euro Zone saw sharp growth. Excluding price fluctuations in energy and food, core inflation rate in the Euro Zone remained at about 1% (Figure 7). As the distortion effect caused by oil price fluctuations, and other seasonal factors, including European holidays, were gradually subsided, there was still a distance for the inflation level in the Euro Zone to reach the target of ECB’s monetary policies to completely reverse.

Figure 7: Change of Inflation Indicators in the Euro Zone



Sources: Eurostat, BOC Institute of International Finance

The structural problems of the labor market inhibited core inflation. Since the debt crisis in Europe, unemployment rate in the Euro Zone has dropped from 12% to 9.3%, the lowest since March 2009. However, most of those new job offers were temporary contracts and part-time contracts, while the proportion of permanent full-time contracts was 67%, the lowest level since 2003. The current labor market structure led to weak wage growth, which to a certain degree affected the core inflation rebound. Therefore, economic growth in the Euro Zone did not drive sustained consumer price increase. Affected by price fluctuations, the level of inflation was unstable, and the temporary and short-term rise was not fully in line with the ECB’s expected monetary policy target. **Overall,**

**the expectation of ECB's monetary policy return to normal has increased, but it is still in need of a great amount of caution.**

According to the ECB's judgment, inflation rate of Euro Zone will be 1.3% and 1.6% respectively in 2018 and 2019, which may reach 2% in the next few years. The ECB needs to see the continuous growth of the overall inflation rate, the core inflation rate, and the wage income, so as to fundamentally change the existing monetary policy. Meanwhile, the ECB recently increased the GDP growth rate outlook in the Euro Zone by 0.1% over the next three years, the Euro Zone economic outlook may continue to improve and in terms of the monetary policy, the QE scale may be cut or there may be a small rate hike. Compared with other markets, the European economy as a whole is still weak and faced with many uncertainties, and the future European monetary policy is still up to the changes of economic data in the next period.

**Italian general election will be the focal point of the next stage.** Although the Dutch and French elections have ended, and the political situation in Germany has become increasingly clear, political risks within the Euro Zone are still prominent. After the UK general election announced hung parliaments on June 9, the Italian Five Star Movement Party, whose support rate is basically the same as the other major Democratic Party, asked to put the election ahead of the agenda and called for Italy to withdraw from the Euro Zone. The Italian election and polls will affect the bond market and the euro performance, and once the risk increases, the ECB may need to slow down the pace of exiting the QE and negative interest rate practices.

If the ECB gets rid of negative interest rates and allows the normalization of monetary policy, it will have a significant impact on banking operations. The rise of benchmark interest rates will increase the financing costs of banks, and the increase in lending rates may reduce the demand for loans. Therefore, the ECB needs to be careful and think more about the money market impact that may be brought about by raising interest rates or withdrawing from QE. Meanwhile, government bonds of some Euro Zone countries, such as Portugal, Italy and Spain, have depended heavily on the ECB's purchase for a long time. Once the ECB decides to stop the QE program, capital markets in those countries will face a sharp decline in demand immediately, leading to substantial increase in bond yields, rise of fiscal financing costs, and deterioration of economic situation.

It is expected that by 2017Q3, the ECB will have a more comprehensive idea of the recovery situation in the Euro Zone. It is very likely that the ECB will have a discussion on tightening the QE program in the September meeting. The interest rate will be maintained at the current level for a long period of time and will probably go up after the tightening or exiting of the QE program. The ECB's monetary policy return to normal, and the preliminary end of the differentiation trend of monetary policies of major global central banks, will drive the global liquidity to go tight. In the next two years, the European economy and policy train is expected to return on track.

## **V. Sustainability of Japan's Economic Recovery and Monetary Policy Prospects**

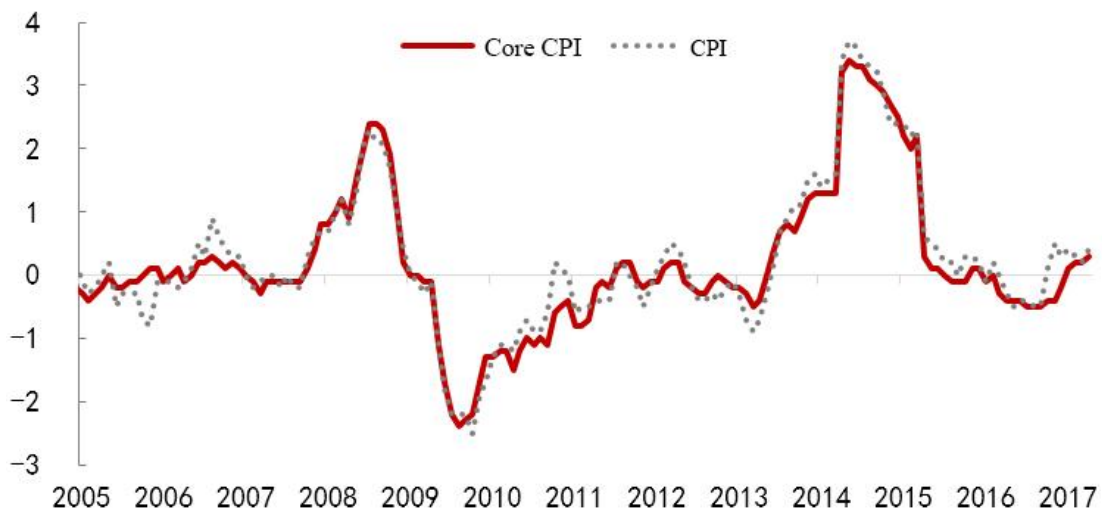
### **V.1 Assessment of Japan's Economic Recovery**

Recently, the Japanese economy has shown stronger signs of recovery, which were mainly reflected as follows: First, **GDP realized positive growth for five consecutive quarters**, the longest term in the past decade. GDP growth was relatively stable; though not strong, it maintained a growth rate of more than 1%. Second, **exports grew at a faster pace**. Japan's exports have grown faster since 2017, with the figure reaching 14.9% in February, the highest level in two years. **Third, prosperity indexes moved upward**. Since 2016Q4, Japan saw steady growth in fixed asset investment, and continuous increase of corporate profits, driving all prosperity indexes to move upward, which included PMI in manufacturing and service industries, Japan Cabinet Office's Index

of Business Conditions and the BOJ Tankan, and the market confidence in the manufacturing industry hit the highest point since the global financial crisis.

However, not all data were so promising. For example, **consumption, which contributed 60% of Japan's GDP, was relatively weak**, mainly due to the insufficient wage growth. During the 2013-2015 fiscal years, Japan's real wage showed negative growth for three consecutive years, and the figure was only 0.4% in the FY2016. The lack of household wage growth led to a decline in purchasing power, which caused Japan to fall into a sluggish liquidity trap: shortage of the national purchasing power - decline in demand - shrinking production - inability to raise wage - weak investment and consumption demand. In addition, **the deflation situation was still not significantly alleviated**. Although the core CPI in Japan, after a lapse of more than a year, edged up by 0.1% since January, (Figure 8), it was far from the 2% inflation target, and the inflation rate increase was mainly due to the higher prices of imported goods brought about by oil price recovery and the depreciation of yen, instead of the recovery of domestic demand. At present, the global commodity still maintained the overall pattern of oversupply, and commodity prices were difficult to continue to rebound, which made it hard to drive inflation higher. Therefore, in general, Japanese investors still have doubts about the future trend of rising prices, which weakened the willingness of consumer spending and corporate investment.

Figure 8: YoY Growth of Japan's CPI (%)



Source: Wind

As for Japan's economic growth prospects, the BOJ made following statements in June's meeting: the Japanese economy will maintain a slow recovery momentum, the stronger global economic recovery will lead Japan's exports to expand further, domestic demand is expected to improve, but the expectation for price rise are weakened, the core CPI will move around 0, and the inflation outlook is not promising.

## V.2 Assessment of BOJ's Monetary Policies

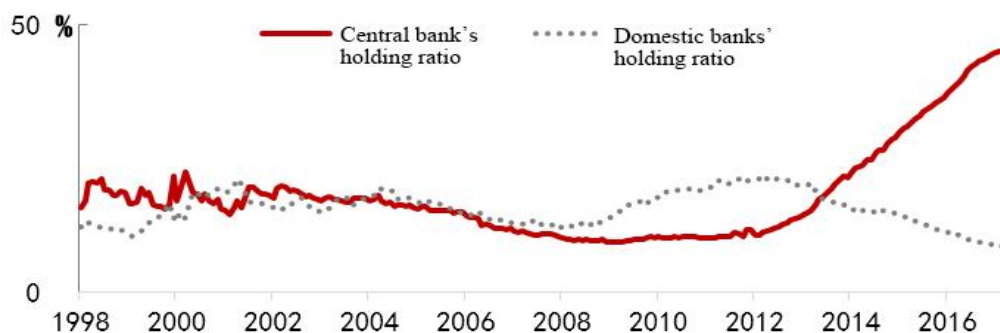
In its fourth meeting in the first half of 2017, BOJ kept its monetary policy unchanged, maintaining policy interest rate at -0.1%, and 10-year T-bond yield at 0%. In January's meeting, BOJ maintained an annual growth rate of holding JPY80 trillion government bonds, and extended the debt purchase plan for one year, to further the QQE project and the Yield Curve Control Program, for the purpose of achieving inflation targets. At the press conference in March, Governor Haruhiko Kuroda said that there was still a long distance from reaching the inflation target, so we would continue to implement strong easy monetary measures to reach the price target.

However, the announced economic data for Q1 indicated that the economic recovery situation had been consolidated, and coupled with the global economic recovery, and the fact that the Fed rate hike process continued to advance, the market began to consider the timing and strategy for BOJ to get out of the QE program. Many Japanese officials have repeatedly spoken about this matter, claiming that BOJ was thinking about it. In the meeting of June 15-16, BOJ's member Takahide Kiuchi, proposed to abandon the negative interest rate policy, re-launch the QE-centric monetary policy framework, and reduce the debt purchase to an annual rate of JPY45 trillion. However, Governor Haruhiko Kuroda said at a press conference that there was still a long way to go for reaching the 2% inflation target, and that it was not the right time now to discuss the monetary policy normalization or stimulus plan exit.

Therefore, we believe that if Japan's inflation has not been significantly and continuously improved, it is by no means easy to quit QE in the short term. It is mostly likely to continue with the easy monetary position for BOJ during the year and as there has been less room left for policy maneuver, it is certain that the monetary policy will turn its focus from intensity to efficiency.

**Japan's monetary policy was left with little space to maneuver.** Since the implementation of the "Abe Economics" in 2013, BOJ launched the QQE monetary policy, with its asset purchase scale increasing from JYP40 trillion per year in 2012 to JYP80 trillion per year, and its asset holdings following a sharp increase, which seriously distorted the capital market. As of March 2017, BOJ held 45% of the government bonds (Figure 9). The central bank's large amount of debt purchase caused the crowding-out effect on other investors, and led to a decline of long-term interest rates and excessive flat yield curve. Meanwhile, BOJ's holding of ETF has exceeded 55% of the total market amount, undermining the pricing function of the stock market. It can be seen that the BOJ's QE stunt has reached the limit. In January 2016, BOJ adopted negative interest rates as an alternative policy, but its side effects on the banking sector were very obvious, leading to a decline in bank profitability and increased potential risks to the financial system. BOJ, in its financial system report released in October 2016, noted that the impact of negative interest rates on the Japanese banking system was greater than that of Europe due to Japan's special interest rate structure. Given the fact of limited policy maneuver space of QQE and negative interest rate, BOJ turned its monetary policy target from "supply" to "interest rate" in September 2016, and kept the long-term interest rate of 10-year bond yields around 0%. Although the market once speculated that BOJ's new policy framework of Yield Curve Control has diluted the meaning of QE, BOJ stressed that the adjustment was mainly because they were concerned that the negative interest rates and large-scale QE practices would crack down on consumer confidence and weaken bank profits. Therefore, this adjustment did not represent a QE withdrawal, but the BOJ's monetary policy change of focus from "intensity" to "efficiency" instead. Data showed that in recent months, BOJ has significantly slowed the pace of debt purchase.

**Figure 9: Ratio of Treasury Bonds Held by BOJ and Domestic Banks (%)**



Source: Wind

**Residents' lack of confidence led to sluggish demands, which affected Japan's monetary policy effect.** In the second half of 2016, the intensive monetary and fiscal stimulus plans launched by BOJ and the Ministry of Finance did not reach expected results, leaving inflation situation unimproved, and people's confidence weakened. Residents' expectation and confidence were particularly important for Japan in the context of low inflation or even deflation during the past decade. As the Japanese government's stimulus plan has not been effective, and policy maneuver space was running short, residents began to question the sustainability of easy monetary policy. Residents' expectation of deflation delayed their consumption, which affected the rise of price. Inadequate confidence of residents made it hard for Japan's monetary policy to be productive, while on the other hand, the ineffective monetary policy further weakened the confidence of residents, creating such a vicious circle. Therefore, BOJ currently faces a daunting task of not only improving the economic and inflation environment, but also considering how to guide and direct residents' expectations.

**Japan will continue to maintain an easy monetary environment, and put more emphasis on policy efficiency.** It is hard for BOJ to withdraw from the easy monetary environment in the short term. In its March meeting, BOJ's Policy Board also expressed the same attitude, which showed that they were cautious towards Japan's current economy. Members of the Policy Board believed that as the CPI growth rate was too slow, it was impossible to raise the long-term interest rate. Obviously, the recovery of the Japanese economy has not yet reached the level where the easy monetary policy can be quit. Therefore, we believe that it is very likely that Japan's monetary policy will remain largely relaxed, and QQE policy will continue to weigh heavily, which may be used in conjunction with fiscal stimulus plans. However, with the growing tight space for policy to do its work, BOJ may be more focused on its policy efficiency, rather than policy intensity.

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