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BANK OF CHINA

Institute of International Finance

## China's Economic and Financial Outlook

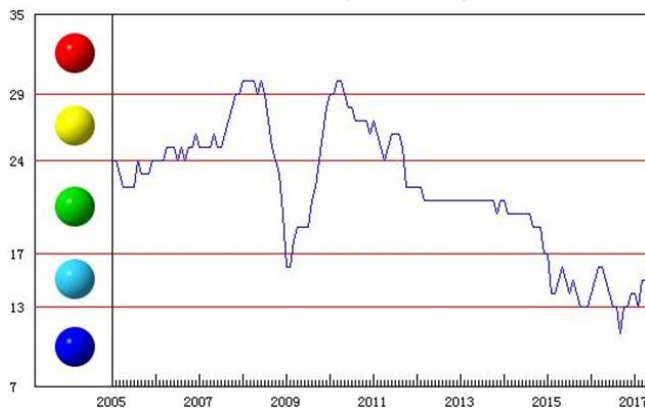
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### Highlights

- As a result of an improving external environment, rising commodity prices and a recovery in the real estate market, China's economic climate has improved in the first half of the year. Both new and traditional drivers of growth have strengthened and there is good synergy between supply and demand, investment and consumption, and industrial production and business efficiency. Our initial estimates suggest that in the first six months, China's GDP grew by around 6.8%, 0.1 percentage points higher than this time last year; CPI by approximately 1.4%, 0.7 percentage points lower than this time last year.
- Although the external environment will continue to improve and become more stable in the second half of the year, the domestic economy will face greater uncertainty, and close attention must be paid. We project that GDP will grow by about 6.7% and CPI by around 1.4% in Q3, with GDP growth in 2017 at 6.8% or so.
- From a policy perspective, special attention must be paid to the interaction between different policies to avoid excessive overlap. Should measures of financial deleveraging be further stepped up, and monetary and regulatory policies become tighter, then fiscal policy should be implemented at a faster and more proactive pace. As the current economic recovery lacks a solid foundation and endogenous drivers of the economy are still weak, it is essential to strike a subtle balance between financial deleveraging and steady economic growth, and to avoid stifling a recovering economy due to simultaneous tightening of fiscal and monetary policies.

### China's Macroeconomic Early Warning Index



#### 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)

Qu Kang (London)

Chen Zhihua (BOCIM)

Contact: Zhou Jingtong

Telephone: 010-66592779

Email: zjtlucky@163.com



## Striking a Balance Between Financial Deleveraging and Steady Economic Growth

### -- China's Economic and Financial Outlook (2017Q3)

As a result of an improving external environment, rising commodity prices and a recovery in the real estate market, China's economic climate has improved in the first half of the year. Both new and traditional drivers of growth have strengthened and there is good synergy between supply and demand, investment and consumption, and industrial production and business efficiency. Our initial estimates suggest that in the first six months, China's GDP grew by around 6.8%, 0.1 percentage points higher than this time last year; CPI by approximately 1.4%, 0.7 percentage points lower than this time last year. Although the external environment will continue to improve and become more stable in the second half of the year, the domestic economy will face greater uncertainty, and close attention must be paid.

Firstly, since monetary and regulatory policies are both at play, financial leverage will lead to continued tightening of liquidity and fast increases in market interest rates. Secondly, the rapid cooling off of the real estate market due to government policies may cause credit defaults, depressing of real demand and shrinkage of investment. Thirdly, rising interest rates and tightening of credit conditions will bring more difficulties to enterprises (especially small enterprises) in financing. Therefore, we project that GDP will grow by about 6.7% and CPI by around 1.4% in Q3, with GDP growth in 2017 at 6.8% or so.

From a policy perspective, special attention must be paid to the interaction between different policies to avoid excessive overlap. Should measures of financial deleveraging be further stepped up, and monetary and regulatory policies become tighter, then fiscal policy should be implemented at a faster and more proactive pace. As the current economic recovery lacks a solid foundation and endogenous drivers of the economy are still weak, it is essential to strike a subtle balance between financial deleveraging and steady economic growth, and to avoid stifling a recovering economy due to simultaneous tightening of fiscal and monetary policies.

#### I. 2017H1 Economic Review and H2 Outlook

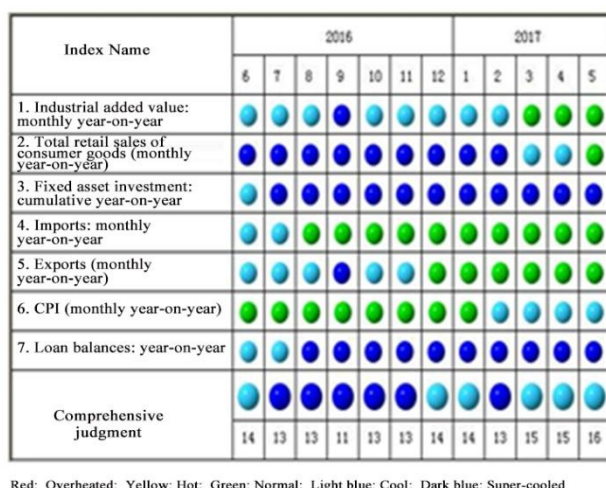
##### I.1 2017H1 Economic Review

###### I.1.1 China's economy is in fairly good shape

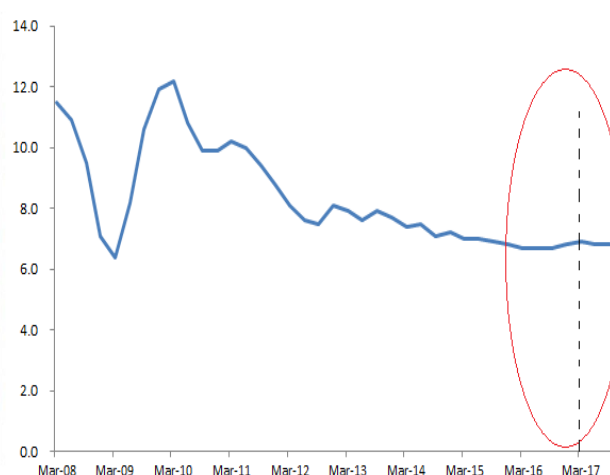
The first half of the year saw an improvement in China's economy, witnessing a steady recovery in the economy, stabilizing employment and price levels (Figure 1). This was reflected in three aspects. **Firstly, recovering economic growth.** GDP growth in the first six months is estimated to be around 6.8%, 0.1 percentage points higher than this time last year (Figure 2). On the supply side, industrial production picked up and the Services Production Index remained above 8%. On the demand side, consumption growth was more stable, a change from the trend of decline in the past few years, and contributed more to economic growth. Investment in the three key areas sped up simultaneously: Investment in the manufacturing sector increased at obviously markedly higher rate; investment in the real estate sector grew by more than expected; and the growth rate of infrastructure construction investment was higher than at any point last year. **Secondly, stable employment.** The first five months saw an increase of 5.99 million new jobs in urban areas, up by 0.22 million compared with

the same period last year. Surveys show that the urban unemployment rates nationwide and in 31 major cities were below 5% in May. The ratio of job vacancies against number of applicants<sup>1</sup> was about 1.13 in Q1, up 0.06 over the previous quarter, which shows that demand is slightly greater than supply. **Thirdly, a moderation in price levels.** CPI rose 1.4% year on year in the first five months, staying at this level for three consecutive months; core CPI (food and energy excluded) increased by 2.1% year on year, remaining at a relatively reasonable level.

Robust growth momentum in the first half of the year can be attributed both to an improvement in the external environment, as well as China's deepening of supply-side structural reforms and prudent implementation of macroeconomic policies. **Firstly, there was a marked improvement in the external environment.** For the first time since the global financial crisis of 2008, there has been a pronounced recovery in the world economy and global trade, in both developed and emerging economies. **Secondly, supply-side reforms are starting to take effect.** This year saw continued efforts in initiatives to eliminate overcapacity, reduce stock inventories, deleverage, lower costs of production, and bolster areas of weakness. The steel and coal industries were successful in eliminating overcapacity by over 60% and 40% respectively, and the costs of production for industrial enterprises continue to fall. Investment to address areas of weaknesses, such as in eco-environmental protection and public facility management, grew at a reasonably rapid pace. **Thirdly, strategies to encourage innovation have fostered new growth momentums.** New products suitable for industrial innovation maintained high-speed growth. In the first five months, year on year growth rates of industrial robots, lithium-ion batteries and integrated circuits were 50.4%, 28.2% and 25.1% respectively. Faster development of innovation industries is a source of new dynamism for economic recovery and growth. **Finally, macroeconomic policies adhered to the principle of seeking progress while maintaining stability.** The government continued to implement proactive fiscal policy and prudent monetary policy, accelerated fiscal expenditures to achieve desired effects, and further cut taxes and other excessive fees. With monetary policy remaining appropriate, efforts were stepped up to press ahead with financial deleverage, strengthen financial regulation, clean up financial irregularities, and gradually mitigate financial risks.

**Figure 1: China's Macroeconomic Climate Early Warning System**


Sources: Wind, BOC Institute of International Finance

**Figure 2: China's Quarterly GDP Growth Trend**


<sup>1</sup> The ratio of job vacancies against the number of applicants is defined as the number of workers needed divided by the number of job applicants, indicating the number of job vacancies per applicant in the market. For example, 0.8 means 10 applicants are competing for 8 vacancies.

### I.1.2 Consumption increases while investment slows down

**Consumption has seen a stable increase with strong spending on key retail commodities.** From January to May, consumption rose by 10.3% year on year, up 0.1 percentage points compared with the first four months and also this time last year. Consumption in May grew by 10.7% year on year, maintaining at above the 10.7% mark for the third month in a row. By expenditure categories, consumption displayed the following features. **Firstly, automobile-related consumption has grown faster by the month.** During the first five months, retail sales of “Enterprises above Designated Size” of the automobile industry increased by 4.2% year on year, up 0.8 percentage points over the first four months, and an increase for the third month in a row. **Secondly, housing-related consumption still grew rapidly.** During the first five months, retail sales of building and decoration materials, furniture and home appliances by “Enterprises above Designated Size” grew by 13.6%, 13% and 9.6% respectively, and 5.1, 4.5 and 1.1 percentage points above the average sales of “Enterprises above Designated Size”. **Thirdly, online spending accelerated remarkably.** During the first five months, retail sales of online goods and services rose by 32.5% year on year, up 4.8% over the same period last year and 6.3% over the entirety of 2016.

**Investment growth slowed down, but investment in manufacturing saw a rebound.** During the first five months, national fixed-asset investment (excluding agriculture) increased by 8.6% year on year, down 0.3 percentage points from the first four months and 1 percentage point from the same period last year, slowing down for the second month in a row. **Firstly, investment in manufacturing rebounded.** The first five months saw a growth rate of 5.1% year on year, up 0.2 percentage points over the first four months of 2017, 0.5 percentage points over the same period last year and 0.9 percentage points over the entirety of 2016. The recovery of investment in manufacturing was mainly due to improved profits and a stronger inclination to invest. Notably, investment in electronic equipment, automobiles and electromechanical devices grew relatively quickly. **Secondly, investment in infrastructure construction grew at a slower pace.** During the first five months, such investment (excluding power, heat, gas and water production and supply) rose 20.9% year on year, down 2.4 percentage points from the first four months, slowing down for the third month in a row. Slower growth of investment in infrastructure construction was mainly attributable to the commencement of a large number of construction projects last year, which resulted in high-speed growth of such investment at the beginning of the year. **Thirdly, real estate investment growth momentum has slowed down.** During the first five months, such investment grew by 8.8% year on year, down 0.5 percentage points from the first four months, and changing the previous trend of accelerated growth. This was mainly due to increasingly strict regulation of real estate markets across the country and slower growth of real estate sales. **Fourthly, projects and capital conditions that support investment growth were generally weak.** During the first five months, planned investment in new projects and the availability of funds decreased by 5.6% and 0.1% year on year respectively, indicating weak foundations for investment growth. **Finally, private investment picked up but with weak foundations.** During the first five months, private investment grew by 6.8% year on year, down 0.9 percentage points from Q1, falling for the second month in a row.

### I.1.3 Foreign trade continues to improve, as new business formats supported by policies become new growth drivers

Exports and imports reached USD 853.3 billion and USD 709.6 billion in the first five months, up 8.2% and 19.5% year on year respectively. Overall, the growth rates of exports and imports were 15.3 and 25 percentage points higher than those of 2016, showing a continued trend of recovery from the second half of last year. The turnaround of China's foreign trade was attributable to three factors. **The first was continued improvement of external demands.** PMIs of manufacturing industry in major economies such as the U.S. and the EU reached highs rarely seen since the global financial

crisis. Strength in these economies as also lifted growth rates in export-oriented economies such as South Korea and Taiwan, a vindication of booming external demands driving export growth. **The second was policies designed to support new business formats.** Recently, authorities have issued directives numerous times to support new business formats and foreign trade, including VAT exemption for market procurement forms of trade. In the first five months, exports in other forms of trade increased by 53%, pushing up total exports by 4.8 percentage points, more than the contribution made by general trade and trade in processing industries (4.3 percentage points). **The third was healthy growth of the domestic economy.** In the first five months, strong momentum in areas of investment and industrial production, and a considerable year-on-year increase in commodity prices, created favourable conditions in sustaining high growth rates of both export volumes and prices.

#### **I.1.4 Fall in food prices drags down CPI growth, as PPI growth rate falls back after reaching peak**

The Consumer Price Index (CPI) grew at a rate of lower than 1% again in February, remaining at a low level overall. The first five months saw CPI increase by 1.4%, down 0.7 percentage points from the same period last year. **Firstly, falling food prices was a key contributor to a lower CPI growth.** In the first five months, food prices decreased by 2.3%, compared with a 6.5% rise in the same period last year. Owing to a warm winter, prices of fresh vegetables dropped by 17.4% in the first five months, and 40 percentage points lower than the same period last year. In addition, as a result of a faster slaughter rate of pigs as well as a relatively high base number last year, pork price also fell after the Spring Festival, down 3.8% in the first five months. **Secondly, non-food prices rose at a relatively quick pace.** In the first five months, non-food prices increased by 2.3%, up 1.2 percentage points over the same period last year. Prices of services-based and upmarket consumption grew at a faster pace, such as apparel, housing, daily necessities, services, education, culture, entertainment, and healthcare.

**Prices of means of production increased at a slower pace, dragging down PPI growth.** After hitting a peak of 7.4% in Q1, growth rate of Producer Price Index (PPI) declined by the month, averaging 6.8% in the first five months. The prices of means of production rose by 9.1%, down 0.8 percentage points from Q1. The slowdown in PPI growth was attributable to: (1) the lower carry-over effect, which decreased from 6% in the previous two months to 4.6% in May; and (2) a substantial drop in the prices of energy and raw materials. The month-on-month change in the prices of means of production and means of livelihood both turned from positive to negative, falling by 0.4% and 0.1% respectively in May.

## **I.2 2017H2 Economic Forecast**

### **I.2.1 Economic growth will decelerate moderately**

The domestic economy will stay relatively stable in the second half of the year. **Although the global economy still exhibits a certain degree of uncertainty, external conditions are still broadly favourable.** Balance sheet reduction and increases in interest rates by the Federal Reserve is to an extent an indication of economic growth and recovery in the world economy. Major economies such as the Eurozone, the UK and Japan are performing better than expected. **Domestically, the effects of policy dividends continue to play a role.** Continued efforts to eliminate overcapacity, reduce inventories, deleverage, lower production costs, and bolster areas of weaknesses have led the real economy to improve and business profits to grow rapidly. Implementation of innovation-driven development strategies has enabled new growth momentums to gain traction, unleashing new dynamics in the economy.

**With both international and domestic environment at play, there are three positive factors for economic growth in the second half of the year.** Firstly, continued efforts to reduce inventories

and eliminate overcapacity, and apparent improvement of business profits are likely to make industrial production and investment expand moderately. Secondly, investment in infrastructure construction will maintain medium-to-high-speed growth, which will play a crucial role in stabilizing the economy. Thirdly, the basic conditions supporting consumption growth are improving, which will become a key factor for steady growth. Nevertheless, **there are also two factors that could impose short-term downward pressures on the economy.** With house purchase restrictions becoming gradually tighter, sales of and investment in real estate are expected to fall in the second half of the year, holding back housing-related consumption. In addition, relatively high base numbers in the first half of the year may bring downward pressure on growth in the second half of the year.

Overall, unstable and uncertain factors still exist around the world, while structural imbalances of the domestic economy remain prominent. However, China is steadily pressing ahead with transformation with a view towards keeping the economy steady. GDP growth rate has been fluctuating between the range of 6.7% and 6.9% for seven consecutive quarters. New growth momentums are gaining traction at a faster pace and play an increasingly crucial role in driving economic growth. All in all, it is projected that GDP will grow by around 6.7% in Q3, and 6.8% throughout the year.

### I.2.2 Consumption growth will remain stable

In the second half of the year, consumption growth faces favorable conditions. **Firstly, faster growth of residents' income.** In Q1, the per capita disposable income of Chinese residents was RMB 7,184, representing a nominal increase of 8.5% year on year, growing by 7.0% in real terms, 0.1 percentage points higher than the GDP growth rate. **Secondly, stronger consumer confidence and willingness to spend.** In April, the Consumer Confidence Index stood at 113.4, 2.4 points higher than in March and the highest since September 2007. According to a depositor questionnaire conducted by the PBOC in Q2, the ratio of depositors willing to spend in the next six months reached 25.4%, the highest since Q2 of 2009. **Thirdly, better consumption environment and quality.** In April the Consumer Satisfaction Index was 108.8, up 2.6 points over March and the highest since early 2008, showing improvement in the environment and quality of consumption. **Fourthly, faster consumption evolution among residents.** With the acceleration of urbanization, the launch of consumption policies in areas of travel, culture, sports, health and old-age care will propel faster growth of retail sales of goods and services related to consumption evolution. It is expected that consumption will grow by around 11% in Q3 and 10.5% throughout the year.

### I.2.3 Investment will continue to grow fast

In the second half of the year, there are both positive factors and uncertainties for investment growth. **Firstly, investment in infrastructure construction is likely to stay at a relatively high level.** With the loosening of project and capital constraints, the growth rate of investment in infrastructure construction will not keep falling; instead, such investment will continue to be a key force for stabilizing investment and even growth. Growth of the investment is estimated to remain at around 20%. **Secondly, investment in manufacturing is likely to increase.** Currently, the growth rate of manufacturing-related investment is lower than the potential economic growth rate; hence there is room for sustainable growth in the future. Driven by stronger external demand and improving business profits, investment in manufacturing is likely to rise. Investment in the high-tech industry, in particular, will maintain high-speed growth. **Thirdly, the effects of policies holding back the growth of investment in real estate will appear gradually.** On the one hand, housing inventories remain high. The floor space of houses to be sold in 2017 is 660 million square meters. On the other hand, with the effects of policies aimed at regulating the real estate market playing out, the area of land purchased and the sales of houses have both grown at a slower pace. Therefore, the growth rate

of real estate-related investment is likely to fall in the future. All in all, it is projected that investment will increase by 8.5% or so both in Q3 and throughout the year.

#### **I.2.4 Foreign trade will continue to recover, but growth momentum may falter**

In the second half of the year, external environment is tending towards improvement, with imports and exports keeping recovery, but there are also some adverse factors. **Firstly, faster recovery of the world economy will facilitate the growth of trade.** The IMF revised its forecast for global economic growth upwards from 3.4% to 3.5% in April, the first time it had done so in the last six years. In May, the WTO released the World Trade Outlook Indicator and the Export Orders Index, which rose to 102.2 and 104.2 respectively, both hitting new highs since May 2011. **Secondly, policies that contribute to the continuous recovery of trade will still be at play.** Pilot programs to develop new trade formats, including market procurement, have demonstrated success, and the effects of policies for exemption from value added tax will further take shape. **Thirdly, the higher base number for commodity prices, along with other factors, will bring certain pressures.** After 2016Q2, commodity prices began to rebound substantially after bottoming out, ending the previous falling trend. Owing to low base numbers this time last year, nominal growth rate in the first five months of this year appeared abnormally high. Now PPI is gradually falling after peaking, hence trade growth may be under pressure from lower prices. **Fourthly, the cycle of recovery is past the halfway mark.** Growth rate of trade picked up after hitting bottom during mid-2016, and the rally has continued for nearly one year. Historically, the recovery cycle of trade is normally 1-1.5 years, rarely more than 2 years, which means the current cycle of recovery is at least half-completed.

#### **I.2.5 Consumer prices will increase moderately, “scissors spread” between CPI and PPI to narrow further**

In the second half of the year, **consumer prices will increase moderately.** **Firstly, the carry-over effect will gradually taper off.** The carry-over effect of CPI is around 0.8% in Q3, down 0.2 percentage points from Q2. **Secondly, liquidity conditions will be tighter.** Market liquidity is expected to remain tight overall, which will be a key factor in inhibiting prices from rising. **Thirdly, food prices may bottom out.** Due to environmental protection efforts and other factors, pork supply is unlikely to see a substantial increase. At present, the pig stock and the number of reproductive sows are at historical low levels; given lower base numbers during the same period last year, pork prices are expected to rebound in the second half of the year, resulting in an increase in food prices. **Fourthly,** with a shifting demographic structure and steady growth of consumer income, the evolution of consumption and rising labor costs will further push up non-food prices.

**PPI growth rate will fall back.** **Firstly,** policies aimed at controlling the real estate market are starting to take effect; growth of investment in infrastructure construction may slow down; support from the demand side will weaken, as will the upward momentum of energy raw material prices. **Secondly,** oversupply in certain industries will be difficult to rectify in the short term, so it would be unlikely that prices of relevant produce will rise substantially. **Thirdly,** the yuan-vs.-dollar exchange rate will remain steady, with little room for devaluation. Hence there is limited pressure on the price increase of imported goods. **Fourthly,** the carry-over effect will be weaker. PPI grew at a faster pace after August 2016, leaving a stronger carry-over effect (averaging 5.5% or so) on PPI in the first half of the year. But such effects will shrink notably in the second half of the year (averaging around 2.9%).

## **II. 2017H1 Financial Review and H2 Outlook**

In the first half of 2017, People's Bank of China forced the financial sector to deleverage by raising the interest rate of medium-term lending facilities (MLF) and soaking up liquidity. With monetary policy tightening as a whole, regulation targeted at deleveraging has been gradually stepped up.

Especially since Q2, CBRC, CIRC and CSRC have simultaneously launched regulatory policies in an intensive manner to rein in regulatory arbitrage, restrict the development of interbank business, and guide funds to flow out of the virtual economy and into the real one. So far, policies aimed to deleverage have shown effects: money supply is in steady decline, credit structure is more balanced and interbank business starting to shrink. In the meantime however, new problems have emerged, such as a surge in money market rates and dearth of new financing in the bond markets. In the second half of the year, it is essential to watch out for excess overlapping of regulation and deleveraging policies, which may lead to rising liquidity risks in the financial system, greater difficulty in obtaining financing at low costs in the real economy, and monetary tightening turning into a credit squeeze.

## II.1 2017H1 Financial Review

### II.1.1 Money supply saw steady decline, financial deleveraging intensified

As of the end of May, M2 grew by 9.6%, down substantially by 0.9 percentage points from the end of April, and lower than the target of 12% set at the beginning of the year. Such a drop in growth rate was attributed to a slowdown in investment in fixed income, equity and other assets by commercial banks, as well as a slowdown in the interbank business, in addition to a tightening monetary policy and increasingly strict regulation. In the first five months, the PBOC withdrew RMB 795 billion (net) through open market operations, whereas it injected RMB 1,667.2 billion (net) in 2016. Since the start of 2017, PBOC, CBRC, CSRC and CIRC have continuously issued directives to carry out financial deleveraging, with interbank business, wealth management and investment business being the priority of regulatory work throughout the year.

**The scale of total social financing increased moderately, with the proportion of direct financing falling.** In the first five months, total social financing grew by RMB 9.38 trillion, up RMB 1.28 trillion over the same period last year. Such growth was mainly related to increases in undiscounted bank acceptance bills, trust loans and RMB loans, which rose by RMB 1,594.8 billion, RMB 865.1 billion and RMB 597.5 billion respectively compared with the same period last year. Meanwhile, the scale and percentage of direct financing both decreased. In the first five months, bond financing and equity financing by non-financial enterprises declined by RMB 1,797 billion and RMB 64 billion from the same period last year. Direct financing accounted for 2.47% of the increase in total social financing, down 21.3 percentage points from the end of last year.

**Loan structure was more balanced, with loans going to non-financial enterprises and households on a fifty-fifty basis.** In the first five months, RMB loans increased by RMB 6.76 trillion, up RMB 597.5 billion over the same period last year. The steady and rapid growth of RMB loans was attributed to (1) rising credit demand as the economy stabilized, and (2) the transfer of certain off-balance-sheet financing to on-balance-sheet loans due to tightening regulation. Data from a bankers questionnaire showed that the Loan Demand Index was 66.9% at the end of Q2, up 9.4 percentage points from the end of 2016. In terms of loan structure, non-financial enterprises and households each accounted for about half of the loans granted. In May, loans to households grew by RMB 610.6 billion, up RMB 39.6 billion from April, representing 55% of the new loans in the current month. This is a change from the situation of additional loans going disproportionately to households in 2016.

### II.1.2 Money market rates rose across the board, with liquidity tending towards tightening

Since the beginning of the year, market liquidity has tended to be tighter on a steady footing. **Firstly, money market rates rose across the board.** On June 19, the overnight SHIBOR stood at 2.8635%, up 36.65 BPs and 65.5 BPs respectively from early April and the beginning of the year. Moreover, SHIBOR rates of other maturities rose by varying degrees (Figure 4). The rising rates were due to

pressure brought by the US Fed's rate increases and plans to shrink its balance sheet, as well as beefed-up financial regulation and tighter monetary policy. **Secondly, market interest rate volatility was lowered further.** From early April to June 14, the standard deviations of the overnight and 1-week SHIBORs were lower than those in Q1, standing at 0.1462 and 0.0807 respectively, indicating lower volatility. This mainly resulted from the improvement of operational flexibility and transparency of the central bank's monetary policy, and a seasonal decrease in volatility early this year. **Thirdly, the interbank borrowing rates on liabilities were higher than the rate of return on banks' assets.** Recently, SHIBORs and LPRs of the same maturities exhibited an inversion in yields (Figure 3), due to the contraction of banks' interbank business and higher pressure on liabilities given tighter regulation and a tightening monetary policy.

Figure 3: Trends of Shibors and LPRs (%)

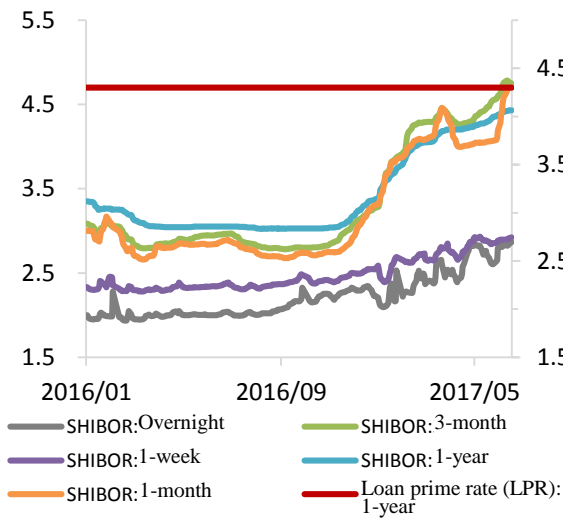
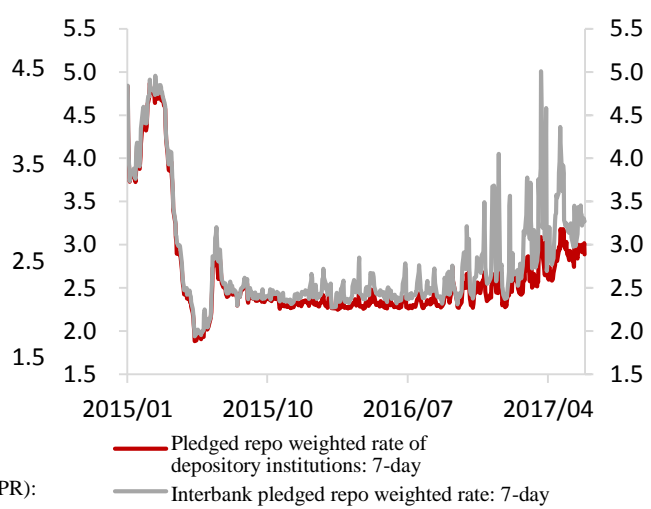


Figure 4: Weighted Rates on Pledged Repos (%)



Sources: Wind, BOC Institute of International Finance

### II.1.3 The bond market continued to slump, with the scale of issuance and financing both reduced

Following great volatility in the last quarter of 2016, the bond market continued to slump in the first half of the year as a result of tighter money supply and regulatory policies aimed at deleveraging. The China All-Bond Index tumbled amid turbulence, closing at 168.01 points on June 16, down 1.69 points from the beginning of the year. **Firstly, the scale of issuance decreased.** In the first five months, bond **issuance** totaled RMB5.6 trillion, down 28.9% from the same period last year. Amongst which, the volume of treasury bonds, local government bonds and corporate bonds issues fell by 33%, 47% and 77% year-on-year respectively. **Secondly, bond issue rates increased.** By the end of June, the coupon rates of treasury bonds, local government bonds, listed company bonds and corporate bonds issued were 3.6376%, 4.1213%, 5.6639% and 5.95%, up 0.82%, 1.07%, 0.83% and 0.42% respectively from the end of 2016, rising at a much faster than Q1. **Thirdly, yield curves were flattened.** Bond yields of various credit ratings continued to rise, but the yields of short-term bonds increased by further. By the end of June, the YTM of 3-year and 10-year treasury bonds was 3.5549% and 3.568% respectively, up 0.77% and 0.56% from the end of 2016. **Fourthly, credit spreads widened.** By the end of June, the YTM of 3-year corporate bonds (rated AAA) closed at 4.70%. The credit spread between such bonds and 3-year treasury bonds was 1.14%, up 28 BPs from the end of 2016.

#### II.1.4 Stock markets fell after rising, as a result of policy changes

In the first half of the year, China's stock markets rose before tumbling. At the end of Q1, the Shanghai Composite Index and the Shenzhen Component Index closed at 3223 points and 10429 points respectively, representing an increase of 3.8% and 2.5% over the end of 2016. As of June 15, the two indices closed at 3133 points and 10222 points, down 3.6% and 4.0% from the end of Q1. The growth in Q1 was mainly attributed to the stable and improving domestic economy and better annual results disclosed by listed companies. The fall of the stock markets in Q2 was related to tighter regulation and financial deleveraging, which led the median market valuation of enterprises to drop universally with risk preference lowered. This not only led to a fall in trade volumes, but a divergence in the trends of large and small caps. On June 15, the median P/E ratio of all the A stocks was 50x, down 10% from March. Strengthened regulation weakened the risk appetite for trading. Also on June 15, the CSI 300 Index, which tracks large caps, rose 2.1% over the end of March; whereas CSI 500, which covers small caps, dipped by 6.3%. The divergence in trends is a stark contrast with the synchronous rise and fall in Q1.

#### II.1.5 RMB exchange rate fluctuated, and a counter-cyclical adjustment factor was introduced into median price formation mechanism

Affected by both internal and external factors, the RMB exchange rate fluctuated in the first half of the year. On June 16, CFETS's RMB exchange rate index was 93.24, slightly lower than the beginning of the year. As of June 15, the quoted median price of the dollar against RMB was 6.7852, up 1.68% over the end of Q1, or 2.43% over the beginning of the year. This was mainly due to: **firstly, widening interest rate spreads between China and the U.S.** China's economic prosperity improved in the first half of the year, and market rates rose under a relatively tight monetary policy, which widened interest spreads between China and America, and boosted RMB's appreciation against the dollar. **Secondly, the weak dollar as a whole.** Due to the US economy being influenced by the alleged collusion of Trump with Russia and other incidents, and the strong recovery in major economies such as the Eurozone and Japan, the dollar was weak overall in Q2. As of June 15, the dollar index stood at 97.5066, down 5.25% from 102.9075 at the beginning of the year. **Thirdly, a counter-cyclic adjustment factor introduced into the RMB midpoint price formation mechanism to moderately hedge against the cyclical tendency of market sentiments.** On May 26, CFETS launched an RMB central parity counter-cyclical factor on the basis of the original "closing exchange rate + exchange rate changes against a basket of currencies" approach, an indication of the Chinese central bank's stance of maintaining exchange rate stability, but also helping to guide the exchange rate market to better reflect economic fundamentals.

### II.2 Financial Forecast for 2017H2

#### II.2.1 Monetary credit will grow steadily with off-balance sheet activities returning back onto the balance sheet

In the second half of the year, monetary credit will continue to grow steadily and fast. **Firstly, the real economy has slowed down but will maintain steady growth.** Credit demand in the areas of external demand, consumption, infrastructure construction and real estate will not drop significantly. **Secondly, it is unlikely that monetary policy will see further tightening.** The original intention of deleveraging policies was to force financial institutions to deleverage through monetary policy without becoming a potential trigger for financial risks. Therefore, monetary policy operations are expected to be more flexible in the future. Meanwhile, the stabilization of the RMB exchange rate has enabled afforded the central bank greater flexibility. **Thirdly, with reinforced regulation, off-balance sheet activities will return onto the balance sheet.** Before financial risks are fully exposed, strict regulation aimed at deleveraging will not change course. The financing function of bonds and stock markets may be affected in the short term, which will return social financing needs onto the

balance sheet. However, credit growth also faces some downsides: on the one hand, rising market rates have increased the difficulty of raising funds with growth of loans of certain banks likely to be restricted by their financing capacity. On the other hand, it is more difficult to manipulate the asset structure of banks under intensified supervision. Off-balance sheet wealth management and other interbank businesses may shrink for a period of time. It is expected that the growth of money supply and social financing will diverge. By the end of Q3, M2 will grow by around 10.0%, and existing social financing by 13% or so, reflecting a “tight balance” in money markets; by the end of 2017, M2 and existing social financing will grow by around 10.2% and 13.2% respectively.

### **II.2.2 With market rates prone to rise instead of dropping, money supply will remain in “tight balance”**

In the second half of the year, money supply is expected to remain in “tight balance” with the price of capital prone to rise. Firstly, the Chinese economy is improving in stability, which provides room for stronger financial regulation. Secondly, the deleveraging process has not ended. With non-financial enterprises deep in debt and real estate markets still overheated, financial regulation will be further reinforced, and monetary policy may remain steady and tight. Thirdly, as the US Fed completes the latest rate rise, consensus has been reached on its future “balance sheet shrinking” plan, which will bring certain pressures on capital outflows. Fourthly, monetary demand is still strong, but capital sources are limited. Changes in the basic capital demand-and-supply will push up capital prices. But liquidity will not become overly tight, as keeping liquidity stable is a key objective of monetary policy. Going forward, the central bank will employ instruments such as stepping up reverse-repos and MLFs to smooth out the disturbance of temporary and seasonal factors to liquidity.

### **II.2.3 With the marginal improvement of liquidity, the bond market is not likely to continue falling substantially**

In the second half of the year, it is not very likely for the bond market to slump further. Firstly, the macro economy will be weaker than the first half year on the whole, propping up the bond market. Since Q2, the growth of fixed asset investment, industrial production, PPP and corporate profits has all slowed down, which will lead the bond market to pick up. Secondly, monetary policy is less likely to tighten further, and the marginal improvement of liquidity is favorable to the bond market. Thirdly, the shock effect of the “bond market crash” has faded, and the launch of the “Bond Connect” platform has brought good news. On May 16, PBOC and the Hong Kong Monetary Authority jointly released an announcement on “Bond Connect”, of which the “northbound trading” phase has been implemented. In March 2017, domestic bonds held by foreign financial institutions and individuals increased by RMB 14.8 billion over the previous month, showing the negative impact of the “bond market crash” at the end of 2016 is continuing to weaken. However, as money supply remains in “tight balance”, and tight regulation continues, it will be hard for the bond market to rebound substantially.

### **II.2.4 Stock markets will remain in moderate fluctuation, as interest rate trends become a trigger for market reversal**

Judging from the fundamentals and money supply, stock markets will remain in mild fluctuation in the second half of the year. There may be structural dynamics, but not trending ones. In terms of the fundamentals of listed companies, the pressure of slowdown in profit growth may emerge gradually. As PPI continues to fall after hitting a new high this year, profit growth of industrial “enterprises above designated size” has shown signs of slowing down, and a cyclical drop in activity in certain sectors will become a drag on market performance. In terms of capital flows, with the real economy further improving and growing, money will flow out of the virtual economy and into the real one, not the other way round. Against such backdrop, there will be no incremental capital flowing into stock market, which would still in the game state of the existing capital. But there are still positive

factors. The 19<sup>th</sup> National People's Congress will free imagination for reform and opening up. If the trend of interest rates shifts and the suppression of high market rates on the median valuation of stock markets are removed, the market may have more vitality to shake off the ongoing state of tepid fluctuations.

### II.2.5 With spillover effects lessening, the RMB exchange rate will remain stable on the whole

In the second half of the year, the exchange rate of RMB against the dollar will remain mostly stable mainly due to the following factors: firstly, China's economy is steady overall, which helps maintain the stability of the foreign exchange market. Secondly, the impact of the US Fed's rate rise is weakened. After the rate increase in June, the Chinese central bank has kept open market rates unchanged without following the Fed's footsteps of raising interest rates. Thirdly, the introduction of a counter-cyclical adjustment factor will reduce irrational volatility of the foreign exchange market and strengthen the central bank's effective guidance of the foreign exchange market. Fourthly, capital flight pressure is partially alleviated, as higher interest rates in China have reduced residents' need to purchase foreign exchange. Fifth, China's foreign exchange reserve has risen for five consecutive months and stands above the USD3-trillion mark, suggesting capital is flowing back into the country. Finally, with capital markets further opened up, the launch of "Bond Connect" will facilitate the inflow of international capital. However, given the US Fed's detailed plan of balance sheet reduction, its monetary policy may be normalized at a faster pace, bringing back a strong dollar. Moreover, with the continued recovery of the world economy, other major economies such as the Eurozone and Japan are likely to gradually resume normalized monetary policies. Therefore, global capital flowing into emerging capital markets will decrease, and RMB will still face certain devaluation pressures in the second half of the year.

**Table 1: Forecasts on China's Major Economic and Financial Indicators in Q3 and 2017 (%)**

Indicator	2013 (R)	2014 (R)	2015 (R)	2016(R)	2017			
					Q1 (R)	Q2 (E)	Q3 (F)	Full Year (F)
GDP	7.8	7.3	6.9	6.7	6.9	6.8	6.7	6.8
Industrial value added of enterprises above designated size	9.7	8.3	6.1	6.0	6.8	6.5	6.5	6.5
Value added of the services sector	8.3	7.8	8.2	7.8	7.7	7.6	7.6	7.6
Fixed asset investments	19.6	15.7	10.0	8.1	9.2	8.0	8.5	8.5
Total retail sales of consumer goods	13.1	12.0	10.7	10.4	10.0	10.7	11.0	10.5
Exports	7.8	6.0	-2.9	-7.7	8.2	7.0	6.5	6.3
Imports	7.3	0.5	-14.3	-5.5	24.0	13.0	10.0	12.4
Consumer Price Index (CPI)	2.6	2.0	1.4	2.0	1.4	1.4	1.4	1.4
Producer Price Index (PPI)	-1.9	-1.9	-5.2	-1.4	7.4	5.7	4.5	5.0
Broad money supply (M2, ending balance)	13.6	12.2	13.3	11.3	11.5	9.8	10.0	10.2
Private financing size (existing)	17.5	14.3	12.4	12.8	12.5	13.0	13.0	13.2

Source: BOC Institute of International Finance

### III. Macroeconomic Policy Orientation

#### III.1 Proactive fiscal policy will be implemented at a faster pace

**Firstly, continue with tax and fee reductions to alleviate the burden on enterprises.** In the second half of the year, the government will launch structural tax reduction policies on all fronts, simplify the structure of value added tax rates, center on cutting tax burdens on small low-profit businesses, and expand the scope of preferential business income tax. It is estimated that tax and fee reduction policies will cut the burden on enterprises by around RMB 1,001 billion in total, fulfilling the government's promise of alleviating burdens by one trillion yuan.

**Secondly, deepen tax system reform, and allow it to adjust.** Efforts will be made to further implement the policy of replacing business tax with value added tax, which is the keynote of tax reduction policies. Total tax reductions this year will exceed the RMB 500 billion achieved in 2016, and possibly go up to RMB 700 billion. In addition, personal income tax reform will be advanced by combining general and categorized approaches, focusing more on “increasing the income of low-income earners, expanding the ratio of middle-income earners, and step up taxation on high-income earners”. The reform will start with increasing the number of special deductions items, and introduce a reporting mechanism on tax-related information provided by third parties. Moreover, it is important to deepen the reform of resource tax and environmental protection tax, and guide and promote industrial energy conservation to push through economic transformation via energy conservation and emissions reduction.

**Thirdly, increase fiscal expenditures to help overcome weaknesses and improve people's livelihood.** In the second half of the year, fiscal policy will still focus on supply-side structural reforms, especially in supporting rural areas, agriculture, housing security, science and technology, social security, employment, energy conservation, environmental protection and poverty relief. It is essential to speed up the implementation of general transfer payments from the central government to local governments, allocate fiscal subsidies to poor areas as soon as possible, highlight the key areas of coverage, and enhance the effectiveness and accuracy of expenditures. Local governments are encouraged to optimize their expenditure structure, make good use of their debt limits, give preferential support to the key tasks above, strengthen the management of government debt projects, and give play to the guiding role of government funds.

**Fourthly, carry out PPP projects to plug the gap for infrastructure construction.** In the second half of the year, the government will continue to optimize the orientation of its PPP policy, fully exert its guiding role to attract more private capital investments, step up investment in municipal works, comprehensive urban development, communication and transportation, and eco-environmental protection (among others), promoting the efficient operation of PPP projects, protect the rights and interests of related parties, and promote the healthy growth and development of the PPP market.

#### III.2 Monetary policy will promote financial deleveraging in an orderly and steady manner

Given that downward pressure on the economy still exists in the second half of the year, and there is higher pressure on liquidity in the financial system, monetary policy will properly handle the balance between “stabilizing growth” and “preventing risks”, appropriately applying the right level of force and setting the rhythm for financial deleveraging, avoiding excess overlapping of monetary tightening and regulatory policies aimed at deleveraging, give full consideration to the tolerance of markets and the real economy, and prevent fast-rising short-term interest rates from negatively impacting the economic and financial system.

**Firstly, step up open market operations, and alleviating panic about market liquidity.** It is important to closely track the liquidity conditions of the financial market at key times, and fine-tune

policies to step up the provision of MLFs and other mid- and long-term funding when financial regulation is overly-tight or key assessments are due.

**Secondly, stabilize interest rates to avoid further increases in the costs of real economy enterprises.** Currently, the faltering growth of the American economy and weak dollar relieve the exchange rate constraints on China's monetary policy, and boost the proactivity and flexibility of interest rate control. In such a situation, the interest rates of MLFs and other policy tools will remain unchanged or decrease slightly, which can guide financial institutions to support the real economy, create a good financing environment, and foster new drivers of growth without imposing too much pressure on the RMB exchange rate.

**Thirdly, strengthen coordination between policies and promote financial deleveraging in an orderly and steady manner.** It is important that regulatory policies set window periods so that financial institutions will not tighten up credit too fast or move assets around to meet due standards in the short term and cause a rise in the number of credit risk events.

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**BOC Institute of International Finance**

**1 Fuxingmen Nei Street, Beijing, 100818 China**

**Tel: +86-10-66592779**

**Fax: +86-10-66030183**